THE GOVERNMENT'S CORPORATE INSOLVENCY REFORMS – AN OVERVIEW OF THE PROPOSALS AND R3 COMMENT *(September 2018)*

In August 2018, the Government unveiled a set of proposals which, if introduced, would represent the most significant changes to the UK's corporate insolvency and restructuring framework since the Enterprise Act 2002. This update outlines the changes the Government is intending to introduce.

The proposals are based on two earlier consultations: the Government's May 2016 '[Review of the Corporate Insolvency Framework]' and the Government's March 2018 '[Insolvency and Corporate Governance]' consultation. The proposals based on the 2016 review are much more detailed than those proposals based on the 2018 consultation, and the Government intends to introduce these at the earliest legislative opportunity. The proposals based on the 2018 consultation will be, for the most part, subject to further consultation.

As well the proposals for introducing new tools and procedures, the Government has also announced a number of planned smaller changes, such as the increase in the Prescribed Part cap from £600,000 to £800,000, or plans to consult on wider corporate governance issues, including consultations on director training and shareholder responsibilities. Details on these changes are not included below.

R3 has played a key role in ensuring the Government has addressed members' concerns with its proposals – many of the planned reforms have been significantly revised from what was originally proposed by the Government. Among other changes, a planned 'moratorium' is now much shorter and features a protected role for insolvency practitioners; 'essential supplies' reforms are less potentially less onerous for suppliers, and are less open to abuse; many of the recent corporate governance reforms have been significantly scaled back.

The Government is still open to feedback from the profession on what it is proposing. Over the coming weeks, R3 will be seeking members' views on the revised proposals and we will be communicating any concerns and feedback to the Government. We want to hear from you: you can email your thoughts on the reforms to association@r3.org.uk.

Reforms Based on the 2016 Consultation

The Moratorium

What's Being Introduced?

A procedure which will prevent enforcement action by creditors against a financially distressed company (for an extendable 28-days) while the company considers its options. The company's directors will remain in charge during the course of the moratorium, although the process will be overseen by a licensed insolvency practitioner acting as a 'monitor'. The procedure will be similar to the existing pre-CVA moratorium for small companies, although it will be supposedly less onerous for insolvency practitioners and open to all companies (the existing moratorium pre-CVA moratorium is being repealed – the new moratorium may be used instead).

Triggering the Moratorium

A moratorium will be triggered by filing papers at court (as with administration). The moratorium monitor will need to file their consent to act and to confirm they have assessed that the eligibility tests and qualifying conditions have been met. The monitor will be required to send notice of the moratorium to all known creditors and will have to register the company's entry into a moratorium at Companies House. Creditors do not need to be provided with prior notification of a moratorium, nor is their consent required (except in the case of extensions).

Eligibility

The moratorium is only for solvent companies. The test will be that the company is 'facing prospective insolvency' and that a company will become insolvent if action is not taken. Companies entering a moratorium will also have to meet a 'prospect of rescue' test: companies should have to show that rescue is 'more likely than not' before they can enter a moratorium. Companies will have to show that they have sufficient funds to continue to trade and pay suppliers during the moratorium. The monitor must assess whether this criteria is met or not.

Exemptions

Companies which had entered a moratorium, administration, or a CVA in the previous 12 months cannot qualify for a moratorium. Companies subject to a winding-up petition can enter a moratorium, subject to asking for permission from the court (i.e. the moratorium cannot be triggered by a simple filing).

Creditor Objections and Protections

Creditors can make an application to court to challenge a moratorium at any point. 'The same principles will apply' when objecting to a moratorium as those which apply when objecting to an administration.

The Government had originally proposed that liability for wrongful trading would be suspended in the moratorium; following feedback, the Government has now changed its mind. The Government believes the way the moratorium is structured should prevent wrongful trading from occurring.

To prevent directors from abusing the moratorium, the Government will consider whether or not to apply the sanctions used in the existing Schedule A1 moratorium to the proposed new moratorium.

Length

The moratorium will last an initial period of 28 days, extendable by a further 28 days. Ahead of any extension, the monitor must confirm that the qualifying conditions continue to be met and must notify creditors. Creditor approval is not required at this point. Extension beyond 56 days will be possible but must be approved by secured and unsecured creditors (support of more than 50% of secured and unsecured creditors is needed). The company can also apply to court to seek an extension without creditor approval.

In the event of a CVA proposal, the moratorium extends automatically to cover the notice period for a consideration of the CVA. The time spent in a moratorium will not be deducted from the statutory length of an administration.

Oversight and the Role of the Monitor

Only an IP can act as a 'monitor' – the Government notes that there is 'little support' for anyone other than an IP taking the role. However, the Government intends for the monitor's qualification and requirements to be set out by regulations, which would allow the Government "to amend the list of qualified persons if and when it becomes appropriate to do so."

The company's directors will remain in control of the company's operations during the moratorium. The monitor's duties will be restricted to the "functions necessary to support the integrity of the moratorium process and [to] ensure creditor interests are protected."

The monitor will be responsible for: assessing the eligibility conditions of the commencement of the moratorium; assessing and monitoring the qualifying conditions at the commencement of and throughout the duration of the moratorium; where the qualifying conditions cease to be met during the moratorium, terminating it; and sanctioning asset disposals outside the normal course of business and the granting of any new security over company assets.

The Monitor will have the power to request any information from the company they "may reasonably require in order to satisfy themselves that the eligibility tests and qualifying conditions are met at the commencement of the moratorium, and that the qualifying conditions continue to be met." Directors will have a legal duty to provide this information. When the Monitor concludes a company no longer meets the qualifying conditions, they will be required to immediately commence the termination of the moratorium. The Monitor will be required to notify the court, company and the creditors. The government intends to give monitors immunity from claims stemming from erroneous termination, providing they acted in good faith.

Prohibitions on Second Appointments

IPs will be prohibited from taking an appointment as the administrator or liquidator of a company for which they acted as monitor for up to 12 months after the end of a moratorium. This ban appears will only apply to individual monitors and not to firms, but the Government will "consider this point further."

The ban will not apply to CVAs or the planned restructuring tool (so that the moratorium can be used as a prelude to either. The planned restructuring tool does not require an office holder appointment anyway). The Government has justified the ban on subsequent appointments as being necessary to "[create] a positive perception of the new pre-insolvency moratorium."

Ending the Moratorium

The Monitor will be required to terminate the moratorium, by notifying creditors, the company and the court, when the qualifying conditions are no longer met. The moratorium can be ended on a date agreed by creditors before the end of the 28 days (in the event of a consensual workout or subsequent procedure).

Fees

The Government proposes no special fees framework for the monitor and says that fees are a contractual matter between the monitor and the company appointing them.

Moratorium Costs

Costs will be treated in the same way as an expense in an administration. Where a company exits a moratorium and enters administration or liquidation, any unpaid moratorium costs will have super-priority over any costs or claims in the administration or liquidation – including the expenses of these procedures. Highest priority would be given to suppliers prevented from relying on contractual termination clauses. Any other costs would rank next, followed lastly by the unpaid monitor's fees. However, the Official Receiver's statutory fees will not be subject to the super-priority rules.

Communicating with Creditors

The Government's original proposal was that "creditors will have the right to reasonably request information from the supervisor at any point in the process, as long as the information can provided in accordance with any legal requirements on sharing such information." The Government has backed away from this, recognising that this blanket right could create unhelpful burdens and costs on the monitor and company. Instead, the Government has now said that it will "seek to develop a solution that provides creditors with information in a timely manner, [while] minimising the burden on the monitor and the debtor company."

Essential Supplies

What's Being Introduced?

The Government recognises that an ability to continue to access or receive key supplies can be a significant barrier to business rescue. The need to protect essential supplies is particularly acute in the planned moratorium Therefore, the Government intends to introduce new legislation which will prevent the enforcement of 'termination clauses' by a supplier in contracts for the supply of goods and services where the clause allows a contract to be terminated on the ground that one of the parties to the contract has entered formal insolvency.

The implication in the proposal is that this protection would apply in any rescue procedure, although this is not explicit.

Protections for Suppliers

Suppliers will be able to terminate contracts on any other ground permitted by the contract, including: non-payment of liabilities incurred following entry into a moratorium, restructuring plan, or insolvency procedure; giving notice in accordance with other terms of the contract; or any other ground that gave rise to termination, save for those connected with the debtor company's financial position, or the fact it had entered a moratorium, restructuring plan, or insolvency procedure.

Contracts can also come to an end if their term expires during the rescue procedure – suppliers will not be compelled to continue or renew the contract.

Suppliers will be given the option to seek the permission of the court to terminate a contract if they can demonstrate that their position is significantly adversely affected by not being able to terminate a contract – the court will consider whether continuing to supply would make the supplier more likely than not to enter an insolvency procedure; the court will also consider the impact any termination would have on the debtor company.

Exemptions

The Government says that certain types of financial products and services could be exempt from the reforms.

While the Government intends that contractual licences (e.g. software licences) should be covered by the essential supplies rules, it does intend to include licences issued by public authorities or which form part of regulatory licensing regimes.

Personal Guarantees

The Government says that many of the consultation responses advocated requiring the directors/IPs providing personal guarantees against essential supplies. In its latest paper, the Government is clear that IPs/directors are not expected to give a personal guarantee in return for the cancellation of a termination clause. It is not clear from the document how this would affect the personal guarantees currently required of office holders in these situations – it may be that the Government is scrapping personal guarantees for existing essential supplies, too.

Restructuring Tool

What's Being Introduced?

A new cross-class cramdown procedure available to any company seeking to bind creditors to a restructuring proposal. The procedure will be very similar to the existing Schemes of Arrangement, and there will be a significant role for the creditors and the courts in reviewing and approving proposals. The new procedure will be 'standalone' and will not involve changes to Schemes or CVAs (as originally floated by a 2016 government consultation).

There will be limited prescription for what the restructuring tool can cover. The changes proposed by the plan can be economic and financial. The Government suggests that, among other things, the plan could be used for debt write downs, debt postponement, a change in the management team, or selling off loss-making parts of the company.

Eligibility

The Government proposes that the new tool be available to companies of all sizes, including small companies. The Government notes warnings that the tool may not be appropriate for SMEs but claims that there may be situations where an SME might be more effectively rescued through a restructuring tool than through a CVA. Companies excluded from the tool include those currently excluded from the Schedule A1 moratorium (i.e. those companies involved in specific financial market transactions, rather than medium or large companies). Solvent and insolvent companies can use the new tool. Companies already in an insolvency procedure will also be allowed to use the new tool (acting through the office holder).

Process

The new tool will be modelled on Schemes of Arrangement: the Government feels this will help build familiarity with the new tool and will provide a well-established body of jurisprudence for the courts to work with.

The key parts of the process are that: a restructuring plan will be sent to creditors and shareholders and will be filed at court; a first court hearing will examine classes of creditors and shareholders, as defined by the company; creditors and shareholders may then challenge class formation if they think these are inaccurate; if satisfied, the court will confirm that a vote on the proposal can be conducted on a specified date ahead of a second hearing (provided there are no challenges or counter-proposals from creditors or shareholders); once voting thresholds are met, the court will schedule a second hearing at which it will consider whether requirements for the proposal have been met; if the court determines requirements have been met, the court will confirm the plan and make it binding on affected creditors and shareholders.

The Government intends to prescribe mandatory information which must be provided to creditors so that they may make an informed vote on the proposal (the Government says this may take the form of the explanatory statement used in schemes). While only a company can instigate a restructuring proposal, creditors and shareholders may submit a counter-proposal; the court may permit that this counter-proposal be put to creditors and shareholders. Voting may be conducted electronically.

Role of the Court

The Government proposes that the court is there to safeguard creditor and shareholder rights by: examining class formation after a restructuring plan has been filed at court; confirming the restructuring plan once it has been approved by creditors and shareholders; and applying a cross-class cramdown of dissenting creditors. The court will have absolute discretion when deciding whether or not to confirm a restructuring plan (so may presumably over-rule a vote); there will also be a right of appeal to court once a plan has been confirmed. As above, the Government intends to model all aspects of the new tool on Schemes of Arrangement – this includes modelling class formation on the approach used in schemes.

Voting

The Government intends to retain the voting thresholds proposed in the original consultation:

- 75% in value (gross debt) of creditors in each class (who vote) must approve the plan;
- More than 50% of the total value of unconnected creditors must also approve the plan;
- One class of impaired creditors (who will not receive payment in full) must vote in favour of the restructuring plan in order for a cross-class cramdown to be confirmed by the court.

Oversight

The Government says that 'several stakeholders' queried whether a 'supervisor' would be required to oversee the introduction of the plan once confirmed by the court. The Government says it does not intend to create such a role, but feels that the tool is flexible enough that creditors could successfully demand to have such a role included as part of any restructuring proposal. The Government says that any 'supervisor' appointed as part of a plan would not be subject to any specific qualifications apart from those agreed to by creditors.

Cramdown

Where a cross-class cramdown is applied, a dissenting class must be satisfied in full before a more junior class may receive any distribution or keep any interest under the restructuring plan. The Government says that this is a safeguard for creditors and ensures the order of priority used in liquidation and administration will apply in the restructuring tool.

The Government is aware of comparisons between this proposal and the 'Absolute Priority Rule' used in Chapter 11; the Government also says it is aware of criticisms of the APR and wants to make the UK version more flexible. To do this, the court may permit a restructuring plan which does not follow this rule where non-compliance is: Necessary to achieve the aims of the restructuring; and just and equitable in the circumstances. The Government expects the rule to be followed in most cases, and believes the two-stage test for permitting non-compliance is a high bar. This test is in addition to the court's absolute discretion whether or not to confirm a plan. As above, one class of impaired creditors must vote in favour of the restructuring plan before cross-class cramdown can be confirmed by the court. Fines and confiscation orders will not be able to be crammed down (as is the case in liquidations and administrations – other types of debt may be included in this exemption on public policy grounds).

The original consultation proposed that there be a minimum liquidation value test as the basis for determining whether a cramdown plan is fair. The Government now agrees with stakeholders that, while this would allow a valuation based on administration (as this is a minimum requirement for a valuation, not a ceiling), which is the most likely alternative to a restructuring plan, the rule could be misinterpreted and the minimum liquidation value would be provided as standard when a more appropriate alternative could have been used instead. The restructuring tool will now have a 'Next Best Alternative for Creditors' valuation requirement.

Length and Impact

The Government is not setting a limit on how long a restructuring plan approved by the court may last – it is leaving this decision to the company and its creditors. The original proposal was for a plan to last 12 months. Following the confirmation of a restructuring plan, any creditors' previous rights will be extinguished: if a company were to enter an insolvency procedure after the agreement of a restructuring plan, only the debts owed after the plan's agreement could be claimed.

Reforms Based on the 2018 Consultation

Sales of Distressed Subsidiaries

Original proposal

In March 2018, the Government proposed that directors of a company to be held liable for losses following a sale of a group subsidiary if the following criteria are met: at the time of the sale, the subsidiary was insolvent or insolvent but for guarantees provided by other companies or directors in its group; the subsidiary entered administration or liquidation within two years of the completion of the sale; the interests of the ex-subsidiary's sale must have been adversely affected between the date of the sale and the later insolvency procedure; and, at the time that they made the decision to sell the company, the director(s) could not have reasonably believed that the sale would have led to a better outcome for creditors than placing the subsidiary into administration and liquidation. If the above requirements are met, an administrator or liquidator of the ex-subsidiary could apply for a court order that the director(s) contribute a sum that the court thinks fit towards the subsidiary's creditors. The directors would be liable for disqualification, too.

New proposal

Directors of a holding company who do not give due consideration to the interest of the stakeholders of a financially distressed subsidiary when it is sold may be subject to disqualification if that subsidy enters liquidation or administration within 12 months of the sale. This 'reasonable belief' test will be considered by the courts. The Government will introduce (through legislation and/or guidance) a non-exhaustive list of matters which the court will take into account, including whether professional advice was sought, the extent of consultation with stakeholders prior to a sale, and any other steps taken by the director(s) to ensure that the sale was no worse an option than a formal insolvency procedure. The proposal will apply where an insolvency occurs within 12 months of a sale.

Value Extraction

Original Proposal

Office holders would be given new powers to reverse a transaction considered to have unfairly removed value from a company ahead of insolvency in cases where the company had previously been rescued or received fresh investment.

New proposal

There was significant criticism of this proposal from respondents (concerned about the deterrent it would pose to business rescue and investment) and the Government now "agrees that making improvements to enhance existing recovery powers can achieve its objective of ensuring all creditors are treated fairly in insolvency. The Government says it "will work with stakeholders to look at how the [extortionate credit transaction] provision might be better framed to capture situations where other creditors are unfairly disadvantaged by credit transactions, while also having regard to the risk being taken by the person providing the credit".

The Government will align preferential payments and transactions at an undervalue provisions so that the ‘insolvency test’ is removed from the preferential payments powers. This, the Government says, will make it easier for office holders to challenge preferential payments to connected creditors.

The Government notes that some respondents (including R3) had concerns that evolving case law and legal uncertainty made it hard to use existing office holder powers. Particular issues include: uncertainty about whether the granting of security can be challenged as a transaction at an undervalue; uncertainty about whether shadow directors can be targeted under the provisions providing a remedy against delinquent directors (section 212 Insolvency Act 1986); and difficulties pursuing wrongful trading claims against directors (section 214 Insolvency Act 1986). The Government will “work with stakeholders to consider whether clarification of these provisions is required.

Extension of the Disqualification Regime to Dissolved Companies

What’s Being Introduced?

The Government intends to empower the Secretary of State to extend the Company Director Disqualification Act (CDDA) 1986 to include directors of a dissolved company. This will allow disqualification of dissolved companies’ directors without the expense and delay of restoring the company to the register. An investigation will be triggered via a complaint or through connection with an existing live or insolvent company investigation.