Government
Commercial
Function

CENTRAL GOVERNMENT GUIDANCE ON CORPORATE FINANCIAL DISTRESS

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Contents

1. Introduction

Central Government and the wider public sector outsource the delivery of a significant volume of public services. Many of these are critical services where interruptions to delivery could put Government in breach of its statutory obligations or have a significant adverse impact on public health and safety or national security. One cause of interruption to delivery could be the financial failure of the supplier.

We assess the financial health of our suppliers (and hence their risk of financial failure) when we procure the services. However, the financial health of our suppliers can deteriorate after procurement, either suddenly (for example because of the loss of a major contract or major litigation) or over time (for example, as a result of gradual changes to the profitability of a sector).

We should therefore monitor the financial health of our key suppliers (i.e. those providing critical services to Government) on an ongoing basis. Early recognition of the risk of supplier failure should allow us to be better prepared to deal with such failure and limit its impact on the continuity of critical public services.

1.1. Purpose of the guidance

The purpose of this guidance is to provide a basic understanding of corporate
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financial distress for individuals engaged in the management of Government supply contracts (whether within Finance, Operations or Commercial functions). Specifically, the guidance is intended to:

- assist in identifying indicators of financial distress at an early stage;
- provide an overview of different restructuring outcomes (solvent and insolvent);
- suggest practical steps, in the short and medium term, for contract managers where they have concerns over a supplier’s financial health (including escalation outside the Department);
- support contingency planning to ensure Departments have plans to manage continuity of supply;
- provide an understanding of the key stakeholders and their various positions; and
- provide a list of key contacts for additional support and advice.

This guidance is not intended to be a detailed technical manual and should be read in conjunction with any existing Departmental guidance. Where Departments and/or individuals are unsure of the approach to take, they should seek specialist support from within HM Government (see Section 7 Additional support’)

2. Outsourcing and HM Government

2.1. Why outsource?

It is not always efficient, or practicable, for Government to provide public services itself, together with all the activities and business processes that underpin them. Adopting a balanced approach with a mix of public, voluntary and private sector involvement has several benefits.

The private and voluntary sectors bring a range of specialist skills, world-class expertise and deeper knowledge to bear on what can be complex issues.

Open and fair competition within free markets encourages creativity and innovation. This means fresh perspectives can be applied to existing policy challenges leading to the delivery of higher quality public services.

Outsourcing delivers economies of scale that mean services can be provided more efficiently, at lower cost and at better value for the taxpayer. Risk can also be shared between those best positioned to manage it.

2.2. Benefits and drawbacks of outsourcing

The principal potential benefits and drawbacks of outsourcing include:

2.2.1. Benefits

- **Improved effectiveness**: the supplier may bring greater expertise and technology, enabling it to provide a superior service, faster and at lower cost;
- **Greater focus**: outsourcing services removes distractions and allows Government to focus on setting and implementing policy;
- **Risk transfer**: responsibility for delivery and other risks can be placed on the supplier, where they are better placed to bear them, with potentially less recourse to Government (although this needs to be managed to ensure contracts do not become unduly onerous for the supplier);

2.2.2. Drawbacks

- **Loss of control**: by delegating responsibility through a contract, the Government loses direct control of a service. As a result, without good contract management it can lose its access to information and the power to react to poor delivery or changing circumstances;
- **Interruptions in service provision**: the risk of interruptions in service provision due to supplier insolvency; and
- **Confidentiality risk**: the risk of material data breaches (potentially with a security impact) can increase when data is transferred between more parties.

2.3. The risk of supplier insolvency

Private sector providers are in business to generate a profit for their owners. They are therefore incentivised to take intelligent risks to develop new products and processes and reduce inefficiency in order to compete with rival providers to grow their businesses.

Whilst this approach can generate significant benefits (advances in technology, new goods and services), it can occasionally fail and where it does, this can have an adverse impact on an organisation's profitability and cash generation.

Where the impact is so severe that the organisation cannot generate sufficient profits or cash to continue to trade, it can fail (i.e. become insolvent (see Section 3 Understanding corporate financial health').

A supplier's insolvency risks leading to an interruption in service delivery which could have a significant impact on public services. It is therefore vital that we monitor the performance and financial health of our suppliers.

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3. Understanding corporate financial health

3.1. What is corporate financial health and why is it important?

Good financial health generally means that an organisation is sufficiently profitable, and has sufficient cash, to continue operating (in the short to medium term) without significant concern over its ability to meet its liabilities. It allows an organisation to maintain the confidence of its stakeholders and invest in its business with a view to generating future growth.

Financial health is therefore important, not just to an organisation's owners and employees, but also to its other stakeholders such as Government as a customer.

As financial health declines and an organisation experiences greater financial challenge, the risk of it failing and not being able to maintain service provision increases.

3.2. What is financial distress and what are the causes?

Broadly, an organisation experiences financial distress when it has, or expects to have, difficulty paying its debts as they fall due. This may be for one or more reasons (lower profitability, mismanagement, etc).

There is no single indicator of distress, but it will usually manifest itself through poor profitability and cash flow. If not addressed, the organisation ultimately risks running out of cash and having to enter a formal insolvency procedure.

Many organisations experience financial challenge at some point in their lives. In some cases, this may not be evident externally; in other cases, the organisation may be visibly distressed. Each situation will be different and will require a different response.

Organisations are very sensitive to signs of financial distress becoming public as this in itself can have significant adverse consequences for them:

- **Loss of banking facilities**: An organisation's lenders may seek to reduce their exposure by reducing the size of the organisation's credit facility (i.e. the organisation may not be able to borrow as much);
- **Loss of trade credit**: Its suppliers may start to offer less generous credit terms or demand cash up front before supplying the organisation;
- **Loss of custom**: Customers may begin to lose confidence in the organisation's ability to continue to

trade as a going concern and seek alternative suppliers; and

- **Loss of key staff**: Employee morale may suffer and the organisation may start to lose key staff and other employees as they seek safer employment elsewhere.

The impact of these issues often exacerbates the financial distress an organisation is experiencing.

3.3. Identifying the signs of financial distress

When monitoring an organisation's financial health, it is important to consider a broad range of potential indicators beyond its profitability and cash position. Both financial and non-financial indicators can be helpful. Some of the more common potential indicators are set out below:

3.3.1. Potential financial indicators

- **Revenue declining or not growing as budgeted**: This can put pressure on profits and cash flow if the organisation is unable to reduce its costs in response. It is particularly relevant for organisations with a significant proportion of fixed costs (i.e. where costs do not fall in line with revenue);
- **Margin declines and/or losses**: These can be a sign that an organisation is unable to pass on cost inflation to its customers or that it is lowering its prices or taking on less profitable work to fill its capacity;
- **High debt to equity ratios**: If an organisation has a high proportion of debt relative to equity on its balance sheet, it will probably have higher finance costs and its profits and cash flow will be more exposed to any deterioration in performance;
- **Covenant breaches**: A lender will generally attach conditions (known as covenants) to the credit facility it provides, such as the organisation maintaining a certain level of free cash flow to service its debt obligations. If these covenants are breached, this can cause the organisation to default on its credit agreement, allowing the lender to demand immediate repayment of all its outstanding debt;
- **Falling credit ratings**: Independent credit ratings and other agencies monitor the financial health of organisations. If the credit rating of a supplier is downgraded, or its credit score falls, this is a good indicator that it may be experiencing financial distress;
- **High borrowing cost**: When an organisation borrows money its cost of borrowing (typically the interest rate it pays) will reflect lenders' perception of its financial health. If its borrowing cost is high relative to its competitors, or is increasing, this can be a sign that it is experiencing financial distress. (Note that a lender is also likely to have access to a greater level of financial information on the organisation than is publicly available);
- **Not paying creditors on time**: If an organisation is experiencing cash pressures it will often resort to paying its creditors later than they are contractually due to be paid. Where trade creditors are rising as a proportion of cost of sales, this may indicate financial distress; and
- **Share price performance / shorting**: Where an organisation is quoted, underperformance of its share price relative to its competitors can indicate

investor concern over its future profitability or financial position. Other measures of investor activity can also be analysed, such as the amount of "shorting" (selling of borrowed shares with the intention of acquiring them back at a lower price (and hence making a profit due to the loss in value)).

3.3.2. Potential non-financial indicators

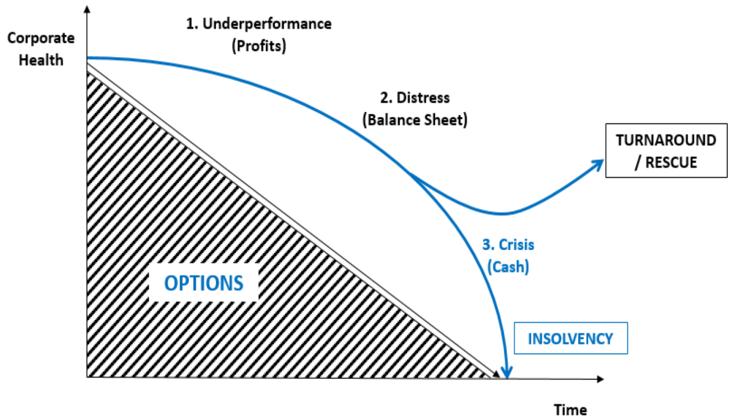
- **Poor relationship with lenders**: If the relationship between an organisation and its lenders has deteriorated, this can often be a sign of financial distress;
- **Poor operational performance**: The key performance indicators used to measure a supplier's operational performance will be specific to a particular contract. However, poor operational performance can often result in poor financial performance; for example, it may suggest the existence of management issues or that an organisation is trying to cut the cost of providing the service as a result of short-term financial pressure. Declining service quality can also lead to falling new business or to regulatory action when a supplier is not meeting required standards;
- **Unexpected resignations of key management or high staff turnover**: Staff morale is often low in poorly performing companies, resulting in a high turnover of staff. If a key member of management unexpectedly resigns, this can also be an indicator of distress;
- **Weak management**: It is helpful to understand the structure of the management team and to assess the key members of management. Organisations with poor corporate governance or where the directors lack key skills are often less effective;
- **Delayed filing of statutory accounts or late provision of management information**: Management teams will often delay providing information showing poor performance. Where statutory accounts are filed late at Companies House or management information you expect to receive is delayed this can be an indicator of financial distress; and
- **Failed corporate transactions**: an unsuccessful or withdrawn corporate transaction may indicate financial distress, for example if a potential acquiror had the opportunity to scrutinise an organisation and subsequently withdrew.

These non-financial indicators can often provide an early warning of financial distress, as financial information is often backward-looking.

3.4. Distressed organisation decline curve

Financial decline often first manifests itself through worsening profitability, then, over time, as a weakening balance sheet. Finally, a crisis arises as the organisation runs out of cash (as illustrated in the following decline curve).

The number of options available to an organisation will decrease as it becomes more distressed; therefore, the earlier issues are identified and addressed, the greater the prospect of recovery.



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4. What are the options for an organisation in financial distress?

4.1. Solvent restructuring options

Where organisations are experiencing financial distress, early intervention is key. The earlier that the directors of an organisation recognise the challenges, the more time and options they have to try to turn it around and avoid insolvency.

There are a number of possible restructuring options open to an organisation before it needs to contemplate insolvency. These are set out below.

4.1.1. Turnaround plan

The starting point is generally a credible turn-around plan:

- An organisation undertakes a detailed review of itself and its business to understand its current financial position and the factors (operational or financial) that are driving its underperformance;
- The management team then formulates a series of plans to address whatever issues it has identified and return the business to profitability / cash generation over a period (usually 1 - 2 years);
- This might include the wind-down or sale of unprofitable business units and/or contracts. Customers may be asked to renegotiate contracts with higher prices and/or more favourable terms for the supplier in order to ensure continuity. Where Departments receive such approaches from suppliers, they should engage their Commercial teams as early as possible and consider any procurement law, state aid implications and other issues.

4.1.2. Options to improve liquidity

In parallel with a turnaround plan, an organisation might explore a number of other options to provide access to cash or reduce debt such as:

- **Amend and extend**: the terms of the organisation’s borrowings are renegotiated, and the repayment profile extended to provide a greater level of headroom or breathing space while the turnaround plan is executed;
- **New money**: Additional cash is injected into the organisation sufficient to meet an expected shortfall. Ideally, this would be provided by the shareholders, but it may be provided in conjunction with (or sometimes solely by) the lenders. If this is in the form of debt, the overall level of borrowings will increase further, so the way this is structured is important.

In this option, departments may sometimes be asked, as key customers, to provide financial support to the organisation alongside other stakeholders/lenders. Extreme care must be taken in this situation to avoid i) breaching state aid rules and procurement law and ii) a commercial agreement that does not represent value for money. *If this is an option, departments should contact UK Government Investments (UKGI) for advice immediately*.

- **Debt for equity swap**: The lenders agree to write-off a proportion of a company's borrowings in return for an ownership (i.e. equity) stake in the company meaning the existing shareholders' percentage ownership is significantly diluted or wiped out.

  This will reduce the company's debt and could provide the lenders with "upside" in the long term should the turn-around plan be successful. This is likely to be a last resort however as i) most lenders are not in the business of owning distressed businesses, and ii) existing shareholders are typically very unwilling to surrender ownership.

- **Asset sale**: The organisation may sell strategically valuable or non-core assets / business units to raise cash. This can then be used either to repay existing borrowings or to meet future cash requirements.

If successful, the organisation will emerge from the turn-around process in a stronger and more sustainable position, and be able to continue servicing its contracts without ever having entered insolvency.

4.2. Insolvent options

In this and subsequent sections we refer to limited companies (the most common form of business organisation amongst our suppliers) and describe the position in England and Wales; slightly different insolvency rules apply to other forms of organisation. There are separate, equivalent rules for companies incorporated in Northern Ireland. The insolvency rules for companies incorporated in Scotland are distinct in some respects.

4.2.1. What is insolvency?

Insolvency occurs when a company is unable to pay its debts as they fall due.

To determine whether a company is insolvent, either or both of the following two tests apply:

- **Cash-flow test**: is the company unable to pay its debts as they fall due? and/ or
- **Balance sheet test**: are the company's assets worth less than its liabilities, taking into account its contingent and prospective liabilities?

These tests are not mutually exclusive, so a company can be insolvent if the answer to either of these questions is yes. This is a complex area of law; however, in practice, it is more common for the courts to find that a company is insolvent on the basis of the cash flow test as this is demonstrably easier for creditors to evidence.

4.2.2. Directors' responsibilities

If the directors continue to trade when there is no reasonable prospect of avoiding an insolvent liquidation they risk being liable for wrongful trading. As soon as the directors become aware that the company may not pass either of the tests therefore, they are likely to seek professional advice from the company's lawyers and financial advisers.

While a company is trading solvently, the duties of the directors are owed to the company for the benefit of its shareholders. However, once a company becomes insolvent or there is a doubt as to the solvency of the company, the directors must also consider or act in the interests of the creditors in order to minimise the potential loss to them.

If the directors breach these duties, they can be personally liable for losses and face disqualification from acting as a director or being involved in the promotion, formation or management of a company for a specified period.

There are three main forms of insolvency for companies. These are:

- Administration;
- Company Voluntary Arrangements; and
- Liquidation.

4.2.3. Administration

Administration is designed to keep an insolvent company running while the insolvency practitioner (the Administrator) determines the most appropriate course of action (e.g. sale of the business as a going concern or a wind-down).

An administration is only viable if sufficient funds are available to cover the costs of the process and the ongoing working capital needs of those parts of the business the Administrator chooses to continue.

The Administrator can raise funds from the sale of assets, from cash available in the business, or from stakeholders providing money to support the process in the expectation that they will get a better return from an administration than the alternative of winding up the company through a liquidation.

There are two ways in which a company can go into administration – by court order or by the lodging of certain documents at court (the "out of court" route). An application for a court order can be made by a number of people/organisations such as one or more creditors of the company, the company itself, its directors or a liquidator. The out of court route can be commenced by the company itself, its directors or by party with a qualifying floating charge (usually a lender).

The directors will usually appoint an Administrator (who must be a qualified insolvency practitioner), although certain secured creditors can also appoint the administrator. The Administrator (instead of the board of directors) will run the company while considering future options.

The first objective of administration is to rescue the company as a going concern. If this is not possible, it is to achieve a better result for the company's creditors as a whole than liquidation, or, failing that, to make a distribution to one or more secured or preferential creditors.

Once a company goes into administration there is a moratorium which prevents creditors and others from taking or pursuing legal proceedings against the company, so giving the company time to get its affairs in order.

4.2.4. Pre-pack sales in administration

A pre-packaged ('pre-pack') sale of some or all of the assets of a company is an option available to the administrator and happens when all or part of the business is sold immediately after the appointment of the Administrator.

The terms of sale are negotiated by the directors prior to the appointment of the Administrator but under his advice. The swift nature of the process preserves value for creditors by minimising damage to the business arising from public knowledge of its financial distress (see Section 3.2 'What is financial distress and what are the causes?'). It also enables the business to continue to trade preserving jobs for employees and maintaining services for customers.

The business is normally sold without the burden of the company's debts. This can lead to a negative perception that this is a method to shed debts at the expense of creditors, especially where the existing owners of the company buy the business back. Stakeholders may also question the robustness of the valuation if a deal is made "behind closed doors".

Such concerns can be minimised where the pre-pack sale is to a connected party and the purchaser chooses to apply to the "Pre-pack Pool" for the transaction to be independently assessed. The Pre-pack Pool is an independent body of experienced business people, which was established by the insolvency profession in response to the recommendations from Teresa Graham's report into pre-pack administrations to increase transparency and assurance to creditors.

4.2.5. Company Voluntary Arrangements

A company voluntary arrangement ("CVA") allows a company to continue trading by agreeing a payment plan with its creditors.

Under a CVA, creditors agree to accept reduced or rescheduled repayments while the company is restructured. In order to proceed, a CVA will need the approval of 75% of creditors (by value).

A CVA must be authorised and overseen by an insolvency practitioner, to whom the company directors will submit a report on the company's finances, together with a debt repayment plan. Importantly, the directors retain control of the company, unlike in an administration.

The insolvency practitioner is responsible for ensuring that the company makes payments to creditors. If payments are not made as agreed, the CVA will fail and the creditors will take steps either to agree a new CVA or to place the company into administration or liquidation.

If the CVA is completed with all payments made, the company will emerge from the process with its debts repaid.

4.2.6. Liquidation ("winding up")

An insolvent company can be put into liquidation if it is determined that the company needs to be closed down and its business operations stopped in order to avoid it accruing further debts. Once this happens, there is no chance for the company to rescue itself.

Liquidation can happen in two ways:

- Compulsory liquidation: This is a creditor led process where creditors petition the court to wind up the company and appoint a Liquidator; and
- Voluntary liquidation: The directors determine that the company is insolvent and pass a resolution to appoint a Liquidator, then approach creditors to secure their agreement to the process.

A creditors' voluntary liquidation should be distinguished from a members' voluntary liquidation. The latter is a solvent winding up of the company in which all creditors are paid in full and the company ceases to exist.

Once appointed, the directors' executive powers cease, and the Liquidator sells the assets of the company and, provided there are sufficient funds after his / her own costs have been covered, makes a distribution from the proceeds to creditors. The Liquidator will normally be an insolvency practitioner. However, where there are insufficient assets to fund the appointment of an insolvency practitioner as Liquidator, the Court will appoint the Official Receiver (an employee of the Insolvency Service).

In some instances, a Court may appoint a Liquidator on a provisional basis (a provisional liquidation), usually to safeguard the assets of the company and maintain the status quo until the Court can determine the petition for liquidation; this might be necessary where there is an allegation of fraud or misconduct.

There are other forms of insolvency such as a Fixed Charge Receiver, LPA (Law of Property Act) Receiver and Administrative Receivership, but these are less common.

The purpose of these receivers is to realise security for the benefit of the security holder only (as opposed to administration or liquidation which is for the benefit of all creditors (secured or unsecured – refer to Section 6.3 'Who are the principal stakeholders in an insolvency situation?').

5. Guidance: Monitoring and managing concerns over suppliers' financial health

5.1. Monitoring suppliers' financial health

It is vital that departments regularly monitor the operational and financial performance of each of their key suppliers, to satisfy themselves that i) the supplier is delivering the contract to the agreed service levels; and ii) the supplier has sufficient financial strength to continue to provide the services.

The focus should be on suppliers delivering critical contracts. Further information regarding criticality and categorisation of contracts can be found in the Guidance Note Assessing and Monitoring the Financial and Economic Standing of Suppliers.

Where a department has concerns over a supplier's financial health and has not received reassurance from the supplier, it should escalate these concerns within the department / Government and follow them up promptly. There may be limited time to prepare for the potential interruption to service delivery which can result from the financial distress and possible collapse of a supplier.

The scale of the risk will depend on:

1. the level of financial distress at the supplier and risk of collapse (see Section 4 'What are the options for an organisation in financial distress?');
2. the criticality of the service;
3. the risk of service interruption as a result of the distress and/or collapse; and
4. the extent of prior preparation within the department / Government.

Each situation will be different. However, there are a number of steps that departments can take in the short and medium term to better understand the situation and put themselves in a stronger position.

This guidance should be read in conjunction with departments' existing guidance, processes and protocols for dealing with such events.

If departments require further support in establishing appropriate processes, they should contact the Cabinet Office Markets & Suppliers team on: marketsandsuppliers@cabinetoffice.gov.uk

5.1.1. Short term

When concerns emerge over the financial health of a supplier, you should consider the following steps:

1. **Articulate the issue**: Depending on the circumstances, action may need to be taken quickly. Being able to articulate clearly and concisely the reasons for your concerns and, so far as you can ascertain them, the potential implications for the Department or Government, is important.

   Key information includes:

- the basis of your concern(s) (e.g. profit warning, external credit analysis, notice from the supplier);
- the dates (when did this first arise and/or when was the last piece of information?);
- the perceived extent of the financial distress (is the supplier lightly challenged and does it just require further monitoring, or is it deeply distressed and at risk of being unable to continue paying its debts as they fall due?);
- the potential implications for the department or Government (what services does the supplier provide and is there is a risk of interruption? Are there wider risks – for example, might the supplier provide other public sector services or hold confidential data? Are there reputational risks?)

2. **Discuss internally**: Discuss your concerns with colleagues from Commercial, Risk management and Business Continuity teams to identify any additional information to support your concerns (e.g. have Commercial colleagues identified a deterioration in contract performance, have financial concerns been raised before over this supplier, have colleagues experienced this issue with other suppliers and what action did they take?)

   Gathering a broad range of information (financial and non-financial) will provide a more rounded view of the issue.

3. **Discuss with Finance**: Discussing the position with the department's finance team may:

- provide additional insight into the supplier's behaviour. For instance, financially challenged suppliers may request that invoices are paid earlier than usual (or in advance) to improve their own cash flow; and
- provide an independent and experienced view of the concerns.

4. **Escalate within the Department**: Based on the information available, Commercial / Finance managers will need to decide whether the concerns are significant enough to require escalation.

   In the first instance, individuals should escalate to their line managers, who will, depending on the scale of the concern / risk decide whether to escalate to departmental Commercial / Finance Directors.

   The decision to escalate within a department will depend on a number of factors. The most critical will be the likelihood, and timing, of a break in supply – if the risk is high and imminent then the issue should be escalated immediately.

5. **Engage with the supplier**: Individual contract managers will normally have liaised with the supplier to seek reassurance prior to escalating the issue. Where significant concerns remain regarding a supplier's ability to maintain service provision, departments should consider engaging at higher level with the supplier to understand whether the concerns are valid.

   Depending on the sensitivity and complexity of the issue, engagement should be led by senior officials (SCSs) with sufficient knowledge of the contract and organisation (potentially with support from specialists at Cabinet Office and / or UKGI).

   Key issues to understand from the supplier include:

- Confirmation, or not, of the facts that have led to the department's concerns and our interpretation of them;
- The implications for the supplier organisation (e.g. is it business as usual; what action is the supplier taking; what are the timescales involved);
- The implications for the department (i.e. is there a risk to service continuity, what is the timing of any potential event);
- Who the department should contact if it has further concerns or requires further information.

6. **Review and, where appropriate, update contingency plans**: Where departments have not received the information or assurances they sought (and even where they have), they may continue to have concerns regarding the ability of the organisation to provide on-going services.

If this is the case, departments should review their current contingency plans and consider updating them or, where appropriate, asking the supplier to update their plans (see Section 5.3 'Developing and maintaining contingency plans').

For further information or support, Departments should contact Cabinet Office Market & Suppliers team or, where the criticality of the contract is severe, UKGI.

Where the contract was procured under a Crown framework agreement, the Crown Commercial Services team (within Cabinet Office) may also advise on contractual rights or processes.

Departments should ensure that they have access to:

- copies of the signed versions of all relevant contracts (including all of the schedules and any deeds of variation and change control notes) with the supplier are readily available; and
- any service continuity plans, exit plans and resolution planning information to which they are entitled under the contract (see guidance on Resolution Planning).

  For the avoidance of doubt, these situations are highly sensitive and therefore any concerns regarding a supplier's financial health must be held in strictest confidence.

5.1.2. Medium term

Where the risk of supplier failure is less imminent, departments should also consider the following actions:

1. **Meetings with Management**: Establish a schedule of regular meetings between the management team of the supplier and a core group of officials to monitor progress and act on available information (with specialist restructuring support from Cabinet Office and / or UKGI where required).

2. **Intelligence Gathering**: Find out what business the supplier might currently be bidding for, all of the existing contracts within the department (and potentially central and local government - including NHS and police), as well as any contracts in the private sector that may affect UK infrastructure / interests.

   It is important to establish all of the points of risk where contingency plans may be needed. This information could be obtained through the Cabinet Office (Markets & Suppliers team), Civil Contingencies Secretariat - Commercial Intelligence Team and the supplier themselves.

Contingency planning: Where contingency plans do not already exist, departments should create them as soon as possible (see Section 5.3 'Developing and maintaining contingency plans') focussing on the highest risk contracts in the first instance (i.e. those contracts that, should they fail, would have the greatest financial, operational, strategic or political impact).

   Departmental legal teams can provide further advice regarding the rights and obligations of both parties to support this process.

   The Civil Contingencies Secretariat (within the Cabinet Office) can provide quality assurance on individual contingency plans, once departments have developed them.

4. **Strategic Planning**: Across Government, other teams and departments have experience in managing large supplier failures and can advise on any additional strategic options that could be pursued.

   In the first instance, the Cabinet Office Suppliers & Markets team and UKGI can advise on alternative options and strategies.

5.2. Escalation within Government

Where the supplier delivers services to multiple departments or its insolvency may have wider implications for Government, Cabinet Office should be informed as a centre-led approach may be more appropriate to coordinate the Government's strategy and overall response. Any case involving a Strategic Supplier to HMG is likely to be coordinated from the centre.

Where a centre-led approach is adopted, features typically include:

- **Team**: A working group may need to be established depending on the severity of the situation. Potential participants include Cabinet Office (Markets & Suppliers team and Civil Contingencies Secretariat - Readiness and Response Team), HMT spend teams, UKGI, Crown Commercial Service (where relevant) and Government Legal Department (GLD) as well as any external expertise (financial advisers, insolvency practitioners, lawyers) that may be required.
- **Press lines and communication**: Establish contact with the Cabinet Office press team to coordinate media responses across central government. Clarify the level of communication required. All documentation should be marked with the appropriate security classification and weekly updates should be written for relevant officials and Ministers as necessary.
- **Other workstreams**: Every situation will be different depending on the breadth and depth of the supplier's contracts. Other workstreams may be needed.

  One potential workstream may be to identify and resolve any disputes or issues with contracts which may be contributing to or exacerbating the difficulties of the supplier (provided the risks and/ or impact to Government can be managed).

The workstreams above are indicative and will evolve over time. Certain situations may have more time to establish a programme management team while other situations may not, so prioritisation and judgment is required.

5.3. Developing and maintaining contingency plans

There are broadly two aspects to maintaining services in the event of supplier insolvency:

1. Short-term maintenance of the services provided, should a supplier become insolvent with little or no notice; and
2. Putting in place an alternative commercial solution for the longer term, through processes such as re-tendering or, if necessary, bringing the services in house, either into the Department or into a Government owned company.

Contingency plans to maintain continuity of critical outsourced services should include both short-term and medium-term components.

Many contracts contain obligations on suppliers to provide:

- business continuity and disaster recovery (BCDR) plans to deal with interruptions to key dependencies; and
- exit plans and provision of exit information including for an emergency exit.

Departments should check whether these are available, confirm that they cover BCDR events and exits arising out of the insolvency of a supplier or a key member of its group and ensure they are regularly updated.

Some suppliers (particularly suppliers of critical contracts) may also be subject to obligations to provide additional resolution planning information (see guidance on Resolution Planning). Where resolution planning information is available, it should provide a wider view on the potential implications of a supplier's insolvency and the key dependencies to which continued service provision is subject.

Departments should maintain their own internal contingency plans for critical services dealing with risks arising from supplier insolvency. These should build on any plans provided by the supplier and consider items such as the Department's options to re-procure the services or bring them in house at short notice. See Contingency Plan template.

As with all contingency planning, the extent of preparations should be risk-based to ensure the effort and level of readiness is proportionate to the risk.

Contingency plans should involve staff from departmental Commercial, Finance, Risk Management and Business Continuity teams from an early stage. The Cabinet Office Markets and Suppliers Team, Civil Contingencies Secretariat, Crown Commercial Service (where relevant) and UKGI can facilitate this and offer advice

6. Guidance: During a financial restructuring

6.1. Government's objectives

In the potentially short period of time between a supplier experiencing financial difficulty and entering a restructuring process, Government will need to develop a view as to its preferred outcome.
In most such situations, Government will have several, possibly competing objectives, principally:

- **Ensuring continuity of critical services**: While the uninterrupted provision of some operational services will be paramount, other services may be interruptible for a period without a material impact;
- **Protecting national security interests**: Some contracts may be vital for national security, others less critical. This includes data security;
- **Minimising financial, operational and employee impact**: Government will wish to minimise the financial, operational and employee impact;
- **Value for money**: Government will need to consider the value for money to it of each option taking account both of the direct cost and of any wider impact;
- **Fostering a vibrant and competitive market for public services**: A financially stable outsourcing market plays an important part in creating a healthy and competitive tendering environment for public sector contracts. Sale of one company's contracts or business to a competitor will likely concentrate the market. Inappropriate intervention from Government could result in mis-priced risk in future contracts; and
- **Maintaining public trust**: Where a supplier provides politically sensitive services, its insolvency can damage public trust. Careful planning and management can limit this.

6.2. What happens to outsourced contracts during a potential insolvency?

There are a number of possible outcomes. In the various scenarios discussed above, the department will normally have a right to terminate the contract. Whether it chooses to do so, will depend upon individual circumstances.

In a solvent restructuring and CVA (and in the absence of any termination by the department), contracts will generally continue as previously subject to any permitted changes negotiated to their terms and conditions to support the longer-term sustainability of the contract (and therefore the organisation).

Where a company has entered into an insolvency process (see Section 4.2 ‘Insolvent options’) however, there is greater uncertainty with contracts at risk of termination either by the insolvency practitioner or by the department.

An Administrator who decides to trade the business as a going concern may consider a contract worthwhile if it is cash generative and profitable and, if continued, would result in a higher return to creditors. However, an Administrator may decide not to honour certain contracts (typically unprofitable or onerous contracts) and may terminate them, normally at short notice, unless the terms can be improved.

In a liquidation, the company is wound up. All contracts and supplies will therefore be terminated, normally at very short notice, unless arrangements to assign or novate the contracts to another supplier can be agreed (and are permitted); alternative arrangements will be required.

For departments the issue is typically how swiftly they can switch suppliers at short notice, particularly where the services are critical and uninterruptible and where their continued delivery depends on central services or other dependencies.

6.3. Who are the principal stakeholders in an insolvency situation?

In a potential insolvency situation, there are a number of interested stakeholders. The most common stakeholders and their respective positions are summarised below.

6.3.1. Directors

In the ordinary course of business, the directors have a statutory duty to act in the best interests of the company to ensure that it meets all of its obligations. In an actual or potential insolvency situation, the directors have a duty to act in the best interests of the company’s creditors.

Directors are therefore critical to a solvent restructuring and have the ability to declare insolvency but lose relevance once Administrator or Liquidator has been appointed.

6.3.2. Shareholders

The shareholders own the company and have a significant stake in its performance but are not responsible for its day-to-day management. They have no enhanced rights and no ability, in their shareholding capacity, to place the company into a formal insolvency process.

On an insolvency shareholders rank behind all creditors in the ‘distribution waterfall’ (the order in which proceeds are distributed). It is therefore highly unlikely that they will receive any distribution once the assets of the insolvent company have been realised.

Shareholders are important in a solvent restructuring as a possible source of additional funds or where their approval is required (e.g. for a debt to equity swap). In an insolvency situation however, they have limited relevance save to the extent that they may represent a purchaser for the business if it is sold.

6.3.3. Insolvency Practitioners

Insolvency Practitioners (IPs) are the individuals who take on the Office Holder roles of Liquidator, Administrator or CVA

Supervisor. They are typically qualified accountants who have obtained an Insolvency Practitioners Licence.
On appointment, it is typical for at least two IPs to be appointed in an Office Holder role for each insolvent company with joint and several liability for their actions. IPs are appointed to realise the assets of the company for the benefit of its creditors and therefore owe certain duties to those creditors as well as being officers of the court.

Note that in some cases IPs may not be prepared to take on an Office Holder role for an insolvent company. In addition, in exceptional circumstances the role may be taken on by the Official Receiver through the Insolvency Service. This may arise if lenders do not wish to fund an administration or the returns from a liquidation are likely to be insufficient to cover their costs.

6.3.4. Advisers (Lawyers/Accountants)

Lawyers and accountants play a key role in assisting the directors of a company through the often-challenging period of uncertainty that precedes the formal insolvency of a company. The advice provided can take the form of reviewing cash flows, providing restructuring advice, assisting in the accelerated sale of the distressed business (sometimes termed “Accelerated M&A”) including pre-pack sales, contingency planning for the company’s insolvency through to providing advice to directors on their duties and the mechanism for placing the company into an insolvency process.

Creditors may also appoint their own accountants and lawyers to provide advice on how to protect and improve their positions prior to and following the insolvency of a company.

6.3.5. Auditors

A company’s audited accounts are a significant indicator of its financial health. When an auditor audits a company, he or she has an obligation to consider its ability to continue as a going concern and must give a statement to that effect. If, in the Auditor’s opinion, there is substantial doubt over its ability to continue to trade in the future (defined as the following 12 months), the Auditor must include a ‘going concern’ qualification in his or her opinion on the company's financial statements.

The appearance of such a statement will be of significant concern to the company’s customers and creditors and can often lead to the withdrawal of credit facilities by its lenders. A company will normally delay issuing its audited accounts therefore while it looks for a way to achieve a solvent restructuring in order to avoid the inclusion of such a statement.

6.3.6. Regulators

Regulatory bodies provide sector oversight and monitor individual companies to ensure they adhere to regulatory guidelines. Entities such as the Prudential Regulation Authority and the Care Quality Commission are able to prescribe sanctions on companies if they are not performing to the standards required, the ultimate sanction being the removal of the company’s licence to operate in a particular sector.

The financial distress of a company can result in enforcement action being taken against it. Conversely, enforcement action itself can lead to the financial distress of a company if the entity is no longer able to operate in its chosen sector.

6.3.7. Lenders

Many companies rely heavily on credit facilities, loans and overdrafts provided by lenders for the day-to-day running of their businesses. Such facilities are predicated on the company's ability to repay sums owed under those facilities when demanded. A company in financial distress will find it difficult to repay its debt yet is even more likely to rely on credit facilities to enable it to continue to trade.

Of all types of creditors, Lenders are perhaps the most important to the ongoing trading of a distressed business. If a business is in financial distress it will almost certainly rely on the ongoing support of its lenders to survive. If the lenders take the view that the facilities they are providing may not be recovered in full then they are likely to withdraw support. If there is no possibility of refinancing with alternative lenders or a significant cash injection the company will face almost certain insolvency.

Perhaps more significantly, lenders typically control the timing of a company's insolvency either by enforcing a security (see below) they may have and directly appointing an Administrator to protect their interests, or by withdrawing their support for the company and forcing the directors' hands.

Lenders will be driven principally by a need to avoid lending more money to avoid incurring additional exposure and a need to recover all, or as much as possible, of their existing debt.

6.3.8. Secured creditors

Secured creditors have greater protection in an insolvency than unsecured creditors as they will have a first claim on the assets of the business usually agreed through legal contracts (the most common are the company's lenders who will have a charge over property, similar to a mortgage for individuals).

6.3.9. Unsecured creditors

Unsecured creditors of insolvent companies comprise any creditor which is not a secured creditor and will generally include all suppliers and sub-contractors. It will also include any other groups owed money, for example creditors arising from the exercise of a guarantee or landlords under a rental agreement. In an insolvency situation, unsecured creditors rank almost at the bottom of the distribution waterfall (after secured creditors but before shareholders) so may receive little more than a few pence for every pound they are owed when the assets of the company are realised and distributed.

However, their unsecured status does not mean that this class of creditors are not able to influence the course of the insolvency process. Administrators and liquidators will require the approval of all creditors throughout the course of the process for a number of key decisions. Creditors can also group together and form creditors' committees to apply pressure on Office Holders such as Administrators and Liquidators, hold them to account and ensure that they are conducting themselves appropriately and for the benefit of creditors as a whole.
Where the unsecured creditors include other suppliers further down the supply chain, these may, in due course, experience financial challenges of their

own as a result of their invoices not being paid or payment being delayed.

6.3.10. Employees

The rights of employees of companies in insolvency depend on the type of insolvency procedure and what happens to the company.

Where an Administrator keeps the business going, employment may continue or employees may be asked to continue to work, either for a limited period or on an ongoing basis if the Administrator is able to turn the business around.

If the business or parts of the business of the company, is sold as a going concern, employees may under certain circumstances have rights under the Transfer of Undertakings (Protection of Employment) Regulations (TUPE). These may include a right to transfer to the new owner and rights of consultation.

If employees' roles are made redundant, they may be entitled to redundancy payments. Statutory redundancy payments and statutory notice payments may in certain circumstances be guaranteed by the National Insurance Fund. Claims for unfair dismissal may be made against the company; however, these would normally require a stay on legal proceedings to be lifted. Depending on the number of proposed redundancies, there may be a requirement for collective consultation with employee representatives for a set period of time and for the Secretary of State to be notified.

The law in this area is complex and specific advice should be sought from Departmental legal teams or externally where required.

In some situations, certain claims from employees may be paid before claims from other secured and unsecured creditors (for example, remuneration owed for the four-month period before the start of the relevant insolvency proceedings, subject to a capped amount); in these cases the employees will be preferential creditors.

6.3.11. Pension Schemes and the Pension Protection Fund (PPF)

Although funds already held in a pension scheme for the benefit of its beneficiaries do not form part of an insolvent company's estate, the insolvency of the company will crystallise its liability for the deficit in any defined benefit schemes in which it has employees. This can often represent a significant liability and may result in employees not receiving their full pension entitlements under the scheme unless there is a separate third party guarantee.

The position of the pension scheme and its trustees must therefore be taken into account where a company is in financial distress and a restructuring is proposed.

On insolvency any defined benefit scheme will enter a PPF assessment period to determine if it has sufficient assets to pay compensation to all members at minimum PPF levels. Employees are normally guaranteed compensation based upon a proportion of their entitlement under the applicable rules of the scheme. If the scheme has insufficient assets, the PPF will step into the shoes of the pension scheme trustees and take on liability for the scheme's beneficiaries. As a result, the PPF is a stakeholder in the company in distress and will seek to protect the position of the pension scheme beneficiaries by ensuring that any restructuring does not damage the position of the pension scheme and its beneficiaries.

Where a company has a defined contribution pension scheme, any impact is normally limited to any unpaid contributions as no actuarial deficit can arise for past service.

Most central Government outsourcings after 2013 will be subject to New Fair Deal. In such cases pension provision for many employees may be via the public sector pension schemes. For these employees the PPF may not be relevant and pension underfunding (other than any missed contributions) should not be a major concern.

6.3.12. HMRC

HMRC plays a key role in almost all insolvency situations. It is common for directors of companies in financial distress to use sums which should be payable to HMRC (for corporation tax, VAT and PAYE) to fund their business through difficulties.

Unlike other creditors of a distressed company, HMRC has little appetite to reach a commercial settlement for the sums owed to it, particularly where there appears limited chance of recovering any sums due. As such, HMRC does not hesitate to issue winding up petitions against companies with unpaid taxes where demands for repayment have not been met. Once a winding up petition has been issued by HMRC, it is unlikely to withdraw the petition unless the sums owed to it are repaid in full. The implications for the distressed company are significant – an advertised winding up petition can lead to a company's bank accounts being frozen making attempts to restructure the business more difficult.

From 6 April 2020, when a business enters insolvency, taxes collected and held by businesses on behalf of other taxpayers (VAT, PAYE Income Tax, employee NICs, and Construction Industry Scheme deductions) will be repaid to HMRC on a preferential basis (i.e. ahead of floating charge realisations and unsecured creditors). The rules will remain unchanged for taxes owed by businesses themselves, such as Corporation Tax and employer NICs with HMRC receiving distributions as an unsecured creditor.

6.3.13. Government

Government is actively involved in all insolvencies through the Insolvency Service (an executive agency of BEIS). As well as acting as the Official Receiver (the officeholder of last resort as outlined above) the Insolvency Service examines the affairs of insolvent companies reporting on any director misconduct, banning individuals from acting as directors where appropriate, and investigating and prosecuting breaches of company and insolvency legislation and other criminal offences on behalf of BEIS.

6.4. Other considerations

6.4.1. State Aid

As a general rule, Government is prevented from providing financial support to companies which are insolvent by virtue of state aid rules.

Although the Government is able to provide funding to rescue and restructure companies in difficulty, there are strict guidelines as to what can be provided, for how long and whether the funding in question needs to be repaid (contact the BEIS State Aid team if this is likely to be an issue).

It should therefore normally be assumed that this will not be an option unless there are compelling reasons to the contrary.

6.4.2. Pensions

Employees whose pension is an Occupational Pension Scheme will be reimbursed for some payments on a preferential basis. Subject to certain limits, these broadly comprise contributions deducted by the supplier from the employee's pay and not yet paid to an occupational pension scheme (limited to four months before the insolvency date) and contributions due from the employer to the scheme in the 12 months preceding the insolvency date but not yet paid in by the supplier.

Again, this may be relevant to Departments if affected employees require clarification; advice should be sought from Departmental legal teams or externally where required.

Use of Government owned companies (GovCos)

Where a supplier becomes insolvent, Departments sometimes establish a Government owned company to assume ownership and delivery of the service in the short-term (this is a form of in-house delivery). This may be because of uncertainty over whether there is sufficient time or market appetite to re-procure the service externally in the time available.

Although GovCos can be quickly set up legally, Departments should not under-estimate the time required to make them operational (for example, arranging management, bank accounts, insurance, systems, contracts with the Department, etc).

Where a Department wishes to establish a GovCo it should liaise with the Cabinet Office Public Bodies Review Team over the categorisation of the body for public accounts purposes.

7. Additional support

7.1. Resources and contacts

Cabinet Office, Markets and Suppliers team (within Government Commercial Function): responsible for overseeing contract performance by and managing the Government's relationship with its largest suppliers.

The team also has extensive experience in managing complex supplier situations and can provide practical recommendations for departments.

https://www.gov.uk/government/organisations/government-commercial-function

Email contact:
marketsandsuppliers@cabinetoffice.gov.uk

Cabinet Office, Civil Contingency Secretariat (Readiness and Response Team): provides assurance of Departmental contingency plans and would also play a key role co-ordinating the implementation of multiple contingency plans across HMG in parallel.

Email contact:
CCS.Control@cabinet-office.x.gsi.gov.uk

UK Government Investments (UKGI): UKGI is the Government's centre of excellence in corporate finance and corporate governance. Its Special Situations Group comprises experts drawn from the private sector with deep experience in financial restructuring. The team will support where the level of criticality is appropriate.

https://www.ukgi.org.uk/

Email contact:
SpecialSituations@ukgi.org.uk

Contact
For further information or to provide feedback on this document please contact SpecialSituations@ukgi.org.uk