Department for
Business, Energy
& Industrial Strategy

INSOLVENCY AND CORPORATE GOVERNANCE

Government response

26th August 2018

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Foreword from the Minister for Small Business, Consumers and Corporate Responsibility

The Industrial Strategy set out our ambitions for a new approach to how government and business can work together to shape a stronger economy. One of our strengths as a nation is our deserved reputation for being a dependable place to do business, with high standards, respected institutions and a reliable rule of law. Our system of corporate governance and our insolvency framework, regarded as best in their class, give us a competitive advantage in how we ensure the UK is the best place in the world in which to invest and do business.

If we are to retain our edge, we must always look for opportunities to improve. We are already implementing reforms to improve the transparency and accountability of executive pay, to give stakeholders, including employees, a voice in the boardroom, and to strengthen corporate governance in our largest private businesses.

We will also make changes to improve our insolvency regime to support companies in financial distress, whilst ensuring appropriate protections for creditors. Set out in this document are reforms to introduce a new moratorium period, and new ways to provide greater opportunities to effect corporate rescues and enable more of our companies not only to survive but to thrive.

It is right that we give every opportunity for companies to be restructured where they can continue to create value. But where a company cannot be saved, it is also right that those in charge of the company act properly and fully discharge their responsibilities. We have seen worrying evidence from recent company failures that a small minority of our companies are falling short of the high standards we expect.

The reforms the Government is announcing in this response will ensure that the responsibilities of directors of firms when they are in or approaching insolvency meet the standards that we require of them, and more generally improve the performance of directors and the effectiveness of the boards of public companies.

We also want to learn lessons from recent corporate failures which have had serious impacts on customers, suppliers and employees. We will take steps to enhance stewardship of our largest companies, through stronger mandates and greater transparency over group structures and dividend policies. And we will legislate to ensure that directors of dissolved companies can be held to account if they have failed to discharge their duties properly.

Taken together, these reforms will ensure more companies can be rescued or restructured; that stewardship and transparency are strengthened in our large companies; and that returns to creditors in insolvency, including small suppliers and pension funds, are likely to be higher.

These reforms will contribute to a business environment in the UK that remains open, fair and attractive and ensure that the actions of a few do not undermine the reputation of the UK as the best place to do business and the place where business is done best.

KELLY TOLHURST MP

Contents

General information

Purpose of this response

The Government's consultation on Insolvency and Corporate Governance is part of our focus on delivering a strong business environment in the UK – a key foundation of the Industrial Strategy. It sought views on ways to reduce the risk of company failures occurring through poor governance or stewardship and improving the insolvency framework in such circumstances.

This document summarises the views and comments received during the consultation and sets out the Government's next steps. It also responds to the *Review of the Corporate Insolvency Framework* consultation held in 2016.

Territorial extent

The territorial extent of the matters in this document is England, Wales and Scotland, with the exception of:

- parts of both the sale of distressed businesses and the value extraction schemes sections relating to companies in liquidation which are devolved in Scotland; and
- the group structures, professional advisers, dividends and shareholder stewardship sections which also apply to Northern Ireland.

The UK Government is responsible for the operation and regulation of business entities in England and Wales, and in Scotland. Previously, the Northern Ireland administration has agreed that, while the operation and regulation of business entities remains a transferred matter within the legislative competence of the Northern Ireland Assembly, amendments to the Companies Act 2006 and legislation regulating business entities should be made in the same terms for the whole of the United Kingdom.

Executive summary

The UK has a good reputation for being a dependable place in which to do business. To safeguard that reputation the Government continuously looks to strengthen the UK's business environment. Two key elements of that environment are our corporate governance framework and our insolvency laws.

The Government has consulted on a range of potential reforms to corporate governance and insolvency issues in recent years. Following a major consultation on corporate governance reform in 2017 the Government is now implementing measures to improve transparency and accountability on executive pay, strengthen the employee and stakeholder voice in the boardroom and ensure more consistent corporate governance standards in large private companies.

In March of this year we consulted on further issues, focusing more specifically on reducing the risk of major company failures occurring through poor governance or stewardship, and improving the insolvency framework in such situations.

This document summarises the responses received to this latest consultation and sets out the Government's proposed next steps. In some areas the Government will legislate for reform; in others further consultation will be needed – particularly where the consultation paper put forward open questions rather than specific proposals.

Also set out in this document is the Government's response to the consultation published in 2016 on broader aspects of insolvency law. The Government intends to legislate for a number of changes that will increase protections for creditors whilst maintaining a fair balance between the rights of the company seeking to be rescued and the rights of the creditors seeking payment of the company's debts.

Taken together, these various reforms will help ensure the UK's business environment continues to be open, fair and attractive, and that the actions of a few do not undermine the broader reputation of British business.

Responses to the March 2018 consultation on insolvency and corporate governance

A total of 93 responses were received. Of these, 36 of the responses were from professional advisers such as legal or consultancy firms and insolvency practitioners, and a further 12 from professional associations. 20 responses were received from business and trade representative groups and individual businesses from a number of sectors across the economy. Nine responses were received from the investment community such as institutional and retail investors (including those managing large pension funds) with the remaining responses coming from academic institutions, think tanks, trade unions, wider society bodies and individuals writing in a private capacity. Departmental officials also held discussions and attended briefings and events with many of those that responded, as well as with other government bodies such as regulators. The Government is grateful to all who responded.

Respondents, particularly those representing shareholders and wider society, argued the need for reform. Well-run companies are more likely to deliver long term success for their owners and for stakeholders such as employees and customers. Most companies do not become financially distressed overnight. Many respondents argued that the UK needs a framework that supports effective intervention by shareholders and (where necessary) regulators at first signs of trouble. A number of shareholder groups warned, however, that good stewardship alone cannot prevent company insolvencies where the underlying business is unviable. Stewardship cannot be a replacement for strong board-level governance and it relies on transparency through reporting, all underpinned by a strong foundation from the Government and regulators.

Respondents from professional organisations gave general support to targeted reforms where a regulatory gap was identified, but cautioned against wider action until investigations into recent high profile insolvencies have been completed and it can be seen whether existing rules and powers are sufficient. Significant reforms to the regime without due consideration and evidence could bring unintended consequences.

Many respondents argued that the regime is fit for purpose despite recent high profile failures. Those failures were, they argued, due to the actions or inactions of directors in contravention of their duties. These respondents suggested more should be done to ensure that current powers are used and enforced.

A number of trade representative bodies also argued that the UK's insolvency and company law frameworks have been ranked comparatively highly internationally because those frameworks have evolved to meet changing circumstances and provide a commercially sympathetic legal environment which balances clarity, predictability and flexibility.

The Government has considered all these views in reaching its conclusions. It now proposes to take the actions summarised in the paragraphs below. They are explained in more detail within the various chapters.

Action to further strengthen the UK's corporate governance framework

The March consultation document did not put forward specific proposals for corporate governance reform, asking open questions instead. In the light of views received, the Government will now take forward the following specific actions, subject to further consultation where necessary on the detail of its proposals:

- strengthen transparency requirements around **group structures**. The consultation document highlighted concerns about the oversight and control of complex groups and asked questions about how they are effectively managed and governed. The responses put forward a number of suggestions and the Government will pursue options to require groups to provide explanations of their corporate and subsidiary structures;
- strengthen **shareholder stewardship**. The consultation document highlighted concerns about shareholder stewardship (particularly from institutional shareholders) and whether, and how, it could be made stronger and more effective. The Government agrees with many respondents that stewardship should be strengthened. Working with the investment community, the FRC and other interested parties the Government will identify means to incorporate stewardship within the mandates given to asset managers by asset owners and establish safe channels through which institutional investors and others can escalate concerns about the management of a company by its directors, including the discharge of their duties under section 172 of the Companies Act 2006;
- strengthen the UK's framework relating to **dividend payments**. Significant concerns were raised that companies could pay dividends even when in financial distress. Many respondents argued for more transparency about capital allocation decisions, including more information about the affordability of dividends in relation to a company's liabilities and other demands on its capital. The Government shares these concerns. It expects that investor pressure and recently introduced new reporting requirements will lead to better reporting, but will bring forward further measures if necessary. The Government is also concerned about the practice of companies avoiding an annual shareholder vote on dividends by only declaring interim dividends and has asked the Investment Association to report on the prevalence of the practice. The Government will take further steps to ensure that shareholders have an annual say on dividends if the practice is widespread and investor pressure proves insufficient; and
- bring forward proposals to **improve boardroom effectiveness** and strengthen **directors' training and guidance.** Directors have many responsibilities, particularly in larger companies, and suggestions were made in responses for providing more training for directors and improving the quality of the independent boardroom evaluations required under the UK Corporate Governance Code. The Government will therefore invite ICSA: The Governance Institute to convene a group including representatives from the investment community 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 will also bring forward proposals to strengthen access to training and guidance for directors, including for raising their awareness of their legal duties when making key decisions.

The insolvency framework

An efficient and equitable insolvency system that contains efficient procedures to allow for the financial rehabilitation of a company in distress is key to a modern economy. This should include a range of transparent rescue procedures to allow companies to restructure or seek new investment to give companies every chance of not failing, as well as ensuring fair and efficient procedures to protect the interests of creditors where companies do become insolvent. In response to stakeholder engagement and consultation, the Government will implement a number of significant reforms to ensure that the UK's insolvency regime retains its world-leading position including re-invigorating its rescue culture.

Action to improve the insolvency framework in cases of major failure

The consultation sought views on three areas, all designed to minimise the likelihood and mitigate the impact of major corporate failure. Having considered the responses to the consultation the Government will:

- take forward measures to ensure greater accountability of directors in group companies when **selling subsidiaries in distress**, but having regard to the concerns that the new measures should not disincentivise rescues or unnecessarily hold directors liable for the conduct of others over which they have no control;
- legislate to enhance existing recovery powers of insolvency practitioners in relation to **value extraction schemes** which have been designed to remove value from a firm at the expense of its creditors when a firm is in financial distress; and
- legislate to give the Insolvency Service the necessary powers to **investigate directors of dissolved companies** where they are suspected of having acted in breach of their legal obligations. This also responds to the many calls for the Government to act against the practice of "phoenixing" where a company is dissolved and another is created (usually with a similar but slightly different name) soon after which is a practice often used to avoid liabilities.

Action to increase protections for creditors, and achieve a fairer balance in insolvencies

The *Review of the Corporate Insolvency Framework* in 2016 proposed a package of measures designed to help companies in distress. There was a good response to that consultation with broad support for the measures. Since the summary of responses was published in September 2016, the Government has liaised with a wide range of stakeholders in order to refine and address concerns. The Government proposes a number of changes to the package consulted on and these are outlined below.

The aims of the reforms are to increase protections for creditors and to provide a fair balance between the rights of the company seeking to be rescued and the rights of the creditors seeking payment of the company's debts. These reforms include:

- **the introduction of a new moratorium** to help business rescue. This will give those financially distressed companies which are ultimately viable, a period of time when creditors (including secured creditors) cannot take action against the company, allowing it to make preparations to restructure or seek new investment;
- **prohibition of enforcement by a supplier of termination clauses in contracts** for supply of goods and services on the grounds that a party has entered a formal insolvency procedure, the new moratorium or the new restructuring plan; and
- **creation of a new restructuring vehicle** that would include the ability to bind dissenting classes of creditors who vote against it.

1. Strengthening corporate governance in pre-insolvency situations

This section of the consultation explored a number of further areas of law and practice relating to corporate governance that had been highlighted following recent company failures. This section outlines the Government's response to the issues raised.

Group structures

1.1 The Government's consultation sought views on whether stronger corporate governance and transparency measures might be required in relation to the oversight and control of complex group structures.

1.2 The consultation highlighted concerns that as businesses grow, particularly where they do so through acquisitions, their corporate structures are likely to become more complex. Where this occurs, it is important that these structures remain effectively managed and governed and that corporate governance arrangements and internal controls are robust, such that:

- groups have clear records on the entirety of their structure, including the identity of all directors of subsidiary companies and their functions; and
- it is clear to third parties which company within the group structure they are entering into contracts with, and which company within the group owns particular assets.

1.3 Premium listed companies are already subject to strong "comply or explain" provisions for directors to assess and report on their internal control systems and, at least annually, carry out a review of their board effectiveness, and report on that review in the annual report as required by the UK Corporate Governance Code. In addition, the Government is implementing reforms that will require companies of a significant size, including subsidiaries of a significant size within groups of companies, to disclose their corporate governance arrangements. The consultation asked what more might be done to strengthen governance and transparency in complex structures.

Summary of responses

Question 11 - *Are stronger corporate governance and transparency measures required in relation to the oversight and control of complex group structures? If so what do you recommend?*

1.4 Just over half of all respondents answered this question. Some respondents did not support any action by the Government at this time. A number of those opposed to new measures argued that time was needed to see the effects of a new reporting requirement announced by Government which will require large private companies (including subsidiaries of listed companies) to report on their corporate governance arrangements. They also referred to the introduction of stronger reporting on how directors are meeting their duty in section 172 of the Companies Act 2006. Others argued that current requirements are sufficient and that more effective enforcement of existing regulations was needed.

1.5 Other respondents made the point that complexity of group structures was not inherently problematic if there are effective controls in place. Groups often structure themselves with a number of subsidiaries in order to protect a brand name or manage assets related to a specific commercial activity or contract, manage risk, or for tax reasons. Some respondents also argued that inadequate controls were more often associated with smaller and medium sized companies, though there was a general recognition that large companies with diverse stakeholders pose more of a risk.

1.6 Some respondents argued that complex structures can sometimes be an indication or a warning sign of distress in a company, for example, where they involve cross-holdings between quoted and unlisted companies controlled by the same end-investor. A few respondents made the point that they would be against the Government taking action which would reduce the flexibilities available to companies to adopt the form of organisation or structure most effective and efficient for them.

1.7 A number of respondents, even those who opposed stronger measures, recognised the advantages of increased transparency, for example where suppliers could be notified when assets are transferred from a subsidiary to other parts of the group given the potential impact on the trading position, credit rating and stability of the contractual arrangements in place. Investor and shareholder groups favoured companies showing clear central oversight and record keeping on the directors of all subsidiaries in the group. They were keen to ensure there are improvements in how and when information about governance arrangements and strategy is communicated to investors. The point was also made that increased transparency would help to make clear where a subsidiary was in fact closely controlled by a holding company. Responses from the private equity and venture capital sector stressed the value they place on strong corporate governance arrangements in the portfolio companies in which they invest, as this is key to effectively managing and monitoring their investments.

1.8 There were a number of suggestions for increasing transparency by introducing a requirement for an organogram of the group structures alongside descriptions of the functions, relationships and controls in place. It was suggested that the process of producing and describing the organogram would itself help to focus directors' minds on the structure and accountability within it. Such an organogram could be included within the annual report.

1.9 There were also some calls for the Government to explore options to allow companies to rationalise dormant companies, potentially through a scheme of arrangement. It was noted that it was currently a somewhat complex and costly process which might dissuade some groups from rationalising their structures, especially given how easy it is to start a new company.

Government response

1.10 The Government recognises that complex group structures can serve a number of legitimate purposes and are not necessarily a problem, but is keen to ensure that adequate and effective controls are in place to ensure that directors are fully aware of any risks posed by subsidiaries to the overall group. Recognising the opportunity provided by the recent review of the UK Corporate Governance Code, the introduction to the revised Code now emphasises that the board of a parent company should ensure that there is adequate co-operation within the group to enable it to discharge its governance responsibilities under the Code effectively, including the communication of the parent company's purpose, values and strategy. **The Government will continue to work with the Financial Reporting Council to underline the importance of boards having a thorough understanding of how governance applies throughout a group and set stronger expectations that directors will keep complex group structures under review**.

1.11 **The Government will also consider whether further measures to improve transparency around group structures would be proportionate, business-friendly and beneficial. These could include working with industry to improve guidance, or introducing a requirement for corporate groups of a significant size to provide an organogram of their corporate structures along with an explanation of how corporate governance is maintained through the group.** This would facilitate adequate internal knowledge, oversight and control of complex structures, as well as external scrutiny for investors and regulators. Having a clear picture of subsidiary companies and management functions would also increase accountability for decisions and ensure that in the event of an insolvency it is possible to hold the right people to account. **The Government will also consider whether the process for dissolving redundant companies and streamlining group corporate structures could be simplified.**

Shareholder responsibilities

1.12 The consultation asked for views on whether, and if so how, institutional investors could play a stronger and more effective stewardship role to help promote the long-term success of the companies in which they invest. In the specific context of companies at risk of insolvency, the consultation asked what more institutional investors could do, collectively or otherwise, to address the warning signs of corporate distress that they may identify in the course of their stewardship activities.

Summary of responses

Question 12 - *What more could be done through a revised Stewardship Code or other means to promote more engaged stewardship of UK companies by their investors, including the active monitoring of risk? Could existing investor initiatives to hold companies to account be strengthened (e.g. through developing the role of the Investor Forum)? Could better arrangements be made to ensure that lessons are learned from large company failings and controversies?*

1.13 Almost all responses to the consultation acknowledged the powerful contribution that good investor stewardship can make to promoting prudent and responsible corporate leadership. Business groups, the UK investment community and other stakeholders were all supportive of the concept of stewardship as something that must go beyond the buying and selling of shares, and voting at companies' annual general meetings.

1.14 At the same time, several responses cautioned against over-inflating or misrepresenting the role of institutional investors in promoting the success of investee companies. In particular, it was argued that institutional investors' primary obligation is to the clients whose money they invest, rather than to the companies they invest in, and that they have a fiduciary obligation to their clients to withdraw their investment if they believe a company is failing and is not addressing the reasons for that failure. It was also noted that shareholders are not directors and have no direct executive powers to intervene and shape a company's future.

1.15 A number of responses also advised against establishing new initiatives around the role of shareholders without first taking account of, and improving as need be, the existing framework for stewardship in the UK. Those responses pointed in particular to the Financial Reporting Council's Stewardship Code, the Investor Forum and other investor-led initiatives (such as the Investment Association's public register of shareholder dissent and its long-term reporting guidance for companies) as existing mechanisms and tools which can enable good stewardship.

1.16 On proposals for change, the majority of respondents argued for changes to or better enforcement of the Stewardship Code. Several respondents said that the Code should encourage signatories to take stronger and more demonstrable account of ESG (environmental, social and governance) factors when monitoring company investments. Other respondents said the existing Code focuses too much on asset managers, and should be broadened to cover more meaningfully the role of pension funds and other asset owners in the investment chain. A number of responses pointed out that less than half of UK asset owners are signatories to the existing Stewardship Code.

1.17 Representatives of retail shareholders called for the establishment of shareholder committees at quoted companies, made up of a company's largest shareholders plus a retail shareholder representative, which would scrutinise and advise companies on governance and other matters and make voting recommendations to other shareholders. The Government previously considered this option as part of its Corporate Governance Reform green paper consultation in 2017 and concluded that it raised significant difficulties, both practically and in principle, including the challenge of a selective group of shareholders representing every other investor in a company.

1.18 A number of responses from investors, think tanks and civil society said that asset managers are not sufficiently or consistently empowered by their investment mandates (in effect, the contract between the asset owner and the asset manager) to undertake significant levels of stewardship. It was noted by one respondent, quoting a report on stewardship by a leading think tank this year, that only around a third of investment mandates currently have an explicit reference to stewardship. Several respondents said that there was considerable scope for stewardship to be better and more consistently embedded into investment mandates, as well as for asset owners themselves to be clearer about their commitments to stewardship.

1.19 Some investors and other respondents said that the Risk and Viability Statements introduced into company reporting since 2014 by the revised Corporate Governance Code provided a potentially useful tool to help shareholders understand a company's medium to long-term prospects and how it was addressing key risks. There were, however, concerns over the quality of such statements to date. One major investor commended new guidance on risk and viability reporting produced by the FRC's Reporting Lab in November 2017, and said that the FRC should establish an enforcement mechanism if companies do not explain how they have used this guidance in their reporting.

1.20 Finally, a major trade body said that there should be better opportunities for institutional investors to privately and formally raise concerns about a company, either to regulators, or to the company board, or both.

Government response

1.21 The Government recognises that many UK institutional investors are already pro-active in implementing active stewardship engagement which scrutinises the strategy, corporate governance, risk management and other factors that influence the long-term value of the companies in which they invest. The Government also recognises that there are a number of existing and positive regulatory and industry-led mechanisms and provisions in place to drive or enable active stewardship and scrutiny of investee companies, in particular the FRC's Stewardship Code, the Investor Forum and the Investment Association's Public Register and Long-term Reporting Guidance.

1.22 The Public Register, introduced in December 2017 at the request of the Government, has highlighted that the UK's major shareholders are increasingly ready to challenge companies on issues ranging from executive pay, board diversity and broader company strategy. The Public Register for 2018 shows that, at the midway point in this AGM season, there has been a 62% increase in companies featuring on the register because of shareholder votes against director re-appointments[1]. Encouragingly, there has also been a 19% increase this year (from 55 per cent to 74 per cent) in the number of companies who have pledged publicly to address the reasons for shareholder dissent.

1.23 Nonetheless, the Government agrees with the view of the majority of respondents who commented on this area that more can be done to:

- ensure that good stewardship is embedded throughout the investment chain, and that asset managers are clearly incentivised by their asset owner clients to practice good stewardship;
- promote consideration of ESG factors as integral to the assessment by institutional investors of financially material risks at investee companies, rather than an optional extra; and

[1] Inclusion on the register requires at least 20% of shareholders voting against one company resolution.

- better encourage or enable major shareholders to raise concerns they have about the governance or wider decision-making at companies in which they invest.

1.24 A major opportunity to pursue these goals will be through the revised Stewardship Code, on which the FRC will be consulting later this year. The FRC has already indicated that the revised Stewardship Code may better encompass the role of asset owners and promote more integrated consideration of ESG factors within companies' stewardship approach, and the Government agrees that this should form a key part of the consultation. The Government has appointed Sir John Kingman to conduct an independent review of the FRC, including its powers and remit. On the question of whether and how the revised Stewardship Code might be better enforced, beyond the tiering approach already operated by the FRC, it would not be appropriate for the Government to comment on this while the FRC review is ongoing.

1.25 The role of pension funds and other asset owners in the stewardship process also has the potential to be enhanced significantly through proposed changes to Department for Work and Pensions (DWP) legislation and through the forthcoming implementation of the revised Shareholder Rights Directive, as follows.

1.26 DWP is currently consulting[2] on new regulations that would require pension trustees to set out in their Statement of Investment Principles from October 2019:

- how they take account of financially material considerations, including those arising from environmental, social and governance considerations; and
- what their policies are in relation to the stewardship of their investments, including their engagement with investee firms.

1.27 The revised Shareholder Rights Directive which the UK intends to implement from June 2019 will:

- require asset owners and asset managers to disclose publicly their policy of engagement with investee companies and state annually how they have implemented this policy; and,
- require asset owners to disclose how they are incentivising their asset manager to make investment decisions and engage with investee companies that support medium to long-term performance.

[2] 'Consultation on clarifying and strengthening trustees' investment duties' (https://www.gov.uk/government/consultations/pension-trustees-clarifying-and-strengthening-investment-duties)

1.28 These forthcoming statutory and Code-based changes are welcome and should result in both better and more integrated stewardship across the UK investment chain. Beyond this, **the Government will:**

- **work with the investment community and other interested parties to discuss how the investment mandates given to asset managers by pension funds and other asset owners can, as a matter of good practice, make explicit reference to stewardship; and**
- **work with investors, regulators and other interested parties to see whether and how a new mechanism can be established through which institutional investors can escalate their concerns about a company or its directors. In doing so, the Government will consider the effectiveness of existing provisions for shareholders to raise concerns with company boards through the Chair or Senior Independent Director, as stipulated in the UK Corporate Governance Code.**

Payment of dividends

1.29 The consultation sought views on whether the UK's current regime based on the concept of "distributable profits" remains fit for purpose. This was in the context of examples of companies in apparent financial difficulties and approaching insolvency, nonetheless continuing to pay significant dividends.

1.30 It also asked whether there is sufficient transparency and accountability to shareholders for dividend decisions and broader choices about how any surplus profit should be allocated as between investment in the company, payment of dividends, payments to reduce pension fund deficits and other demands.

Table: Current UK framework for payment of dividends

- ***Dividends can only be paid out of profits available for distribution as shown in the relevant accounts drawn up in accordance with applicable UK law and accounting standards***
- ***Dividends cannot be paid out of capital; they can only be paid from a company's accumulated realised profits less its accumulated realised losses***
- ***A public company must also apply a net asset test: it may make a distribution only if, after giving effect to the distribution, the amount of its net assets is not less than the aggregate of its called up share capital and un-distributable reserves***
- ***The principle that companies cannot make distributions out of capital and can only be paid out of profits was mandated – for public companies - by EU law through the Second Company Law Directive (now consolidated into Directive 2017/1132)***

Summary of responses

Question 13 - *Do you consider reforms are required to the legal, governance and technical framework within which companies determine dividend payments? If so, what reforms should be considered? How should they be targeted so as not to discourage investment?*

1.31 The section on dividends attracted a significant number of responses ranging from critiques of the current "distributable profits" dividend regime and suggestions for how it might be improved, through to ways of improving transparency and accountability to shareholders. Overall, a significant majority of respondents thought that reform was required. Amongst professional advisory firms a small majority favoured reform, but amongst institutional investors and professional associations a significant majority thought that improvements could be made to the regime.

"Distributable profits" framework

1.32 Several professional representative bodies and some legal and accountancy firms questioned whether the current framework for dividend payments, based on the principle that profits can only be paid out of distributable profits, remains fit for purpose. It is perceived as being complex with the guidance on distributable and realised profits published by the Institute of Chartered Accountants England and

Wales running to more than 170 pages. According to one respondent, interpretation "is a challenge for even the most competent accountants and lawyers".

1.33 One respondent suggested that the formulaic nature and complexity of the current framework can distract directors from considering dividend payments in the context of their wider duty under section 172 of the Companies Act 2006. Another referred to a widespread view amongst lawyers and financiers that a system based on capital maintenance is, in practice, largely ineffective in protecting creditors. Several respondents referred to the backward-looking nature of the current regime and the fact that distributable reserves may bear little relation to the future profitability of a company and hence had little value as a safeguard for creditors.

1.34 Suggestions were made for improving the operation of the current framework. One accountancy firm, for example, suggested that it could be strengthened by redefining lawful dividends as being the distributable reserves shown by the relevant accounts, but deducting any sums the directors consider appropriate by reason of subsequent transactions or trading. Others thought that the definition of distributable profit and "net assets" could be tightened up, noting that some companies have paid dividends immediately preceding profit warnings. One suggestion was that monies owed to suppliers or retained from others should not be counted as an asset. Another was that the circumstances in which "goodwill" could be treated as an asset should be looked at more critically.

1.35 A significant number of respondents said companies should be required to disclose the audited figure for available reserves and distributable profits in their annual report and accounts. This was regarded as an important transparency measure for shareholders giving them more confidence about the underlying basis for decisions on dividends and helping to clarify the extent to which subsidiaries were contributing dividends payable by the group. It was suggested that this would also help clarify the current law.

Solvency-based framework

1.36 A number of respondents suggested that the UK should consider more fundamental reform to the dividend framework by adopting a system based on solvency statements by directors. This is the approach taken in a number of leading non-EU countries such as the US, Canada, Australia and New Zealand. Under this system, dividends can be paid only where the board is satisfied (and makes a solvency statement to that effect) that the company will, after the payment of the dividend, still be able to pay its debts as they become due in the normal course of business. It is usually allied with a net asset test requiring that the value of the company's assets will remain greater than the value of its liabilities. Key advantages of this system were perceived as being its greater simplicity and stronger protection for creditors.

1.37 A number of respondents noted that the distributable profits system is currently a mandatory requirement for public companies under the EU Second Directive on Company Law meaning that the scope for change, at least for public companies, is constrained. They also thought that such a significant change should only be considered after a full review. One accountancy firm, for example, said that it would be important to consider whether solvency-based rules on dividends would have the effect of reducing dividends paid by listed UK companies, tilting it more towards being a capital appreciation market with some overall effect on market valuations.

Disclosure of dividend policy and practice

1.38 A significant number of responses from wider society bodies and institutional investors called for companies to be more transparent about how surplus revenue is allocated to meet demands for dividends, investment in R&D, and pension deficit reduction, and the reasoning behind these decisions. Many institutional investors regard capital allocation decisions as playing a vital role in determining a company's long-term success and they are regarded as being amongst the most important responsibilities of company management and a key area for shareholder engagement with boards. One wider society body suggested that companies should be required to publish a pie chart showing how surplus revenues have been allocated to dividends, R&D, developing employee skills, marketing and other areas.

1.39 There was support from investors in particular for better disclosure of dividend policy and practice including the links between the level of dividend and the principal risks of the company and its future viability. Several respondents suggested that there should be wider uptake of the best practice on the disclosure of dividend policy and practice identified in the Financial Reporting Lab's report published in 2015.

1.40 Some respondents suggested that companies should provide better information about the affordability of dividends and the future financial and reputational health of a company. Amongst the metrics proposed was the ratio of dividend payments to net debt and the ratio of dividend payments to capital expenditure.

Interim dividends

1.41 A number of institutional investors and investor bodies raised concerns that they were sometimes being denied the opportunity to vote or express a formal view on company dividends. They referred to a growing trend for companies to pay only interim dividends. This is significant because company articles often provide that interim dividends, unlike final dividends, are decided solely by directors without the need for shareholder approval. This was perceived as a negative development as it took, dividend approval away from shareholder scrutiny. It was suggested that the Government should address this by requiring at least one shareholder vote per year on dividends, regardless of whether this was on a final or interim dividend.

Dividend payments and pension fund deficits

1.42 Several respondents addressed the question of whether dividend payments should be restricted where a company's pension fund was in significant deficit. There was very little support for dividends to be suspended in these circumstances. One respondent warned that "stopping dividend payments until a pension deficit has been cleared would make the UK a very unattractive place to raise equity capital." Another said that this would risk the "employment covenant" by making it more difficult for a company to raise share capital with the result that it would rely on debt instead which would usually rank higher than the pension fund in an insolvency.

1.43 Several respondents thought that there should be more transparency and stronger regulatory oversight of dividend payments where there is a substantial pension fund deficit. One respondent suggested that the Pensions Regulator should have enhanced powers to satisfy itself that, where there is a material scheme deficit, the payment of dividends or the sale of the company will not jeopardise the solvency of the fund. Another respondent suggested restricting dividend payments in circumstances where it was unlikely that there would ever be sufficient income in the future to make good the deficit.

1.44 A further suggestion was that where there is a deficit, directors should have to make a statement before declaring a dividend that the company will continue to be able to comply with the terms of any contribution agreement negotiated with the pension fund trustees. It was also thought that fuller disclosure of the details of a deficit reduction plan could provide stakeholders with useful additional information with which to hold management to account for decisions on pay-out policy.

Other suggestions

1.45 One business representative body suggested that a new legal form – a public service corporation - could be developed for public interest entities delivering major outsourced services for the public sector. Such entities would not be able to make significant dividend or bonus payments if there was a substantial pension fund deficit or if defined levels of debt were exceeded. The legal duties of board members would be aimed at maintaining a balance between the interests of different stakeholders.

Government response

1.46 The Government notes widely held views that improvements could be made to the UK's dividend regime which is seen as complex and potentially too backwards looking with insufficient weight placed on current profitability and future prospects and hence providing only limited protection for creditors.

1.47 **The Government will explore further with legal and accountancy bodies and with business groups (including the ICAEW, GC100 and the Law Society) the strength of the case for a comprehensive, review of the UK's dividend regime.**

1.48 **As part of these discussions, the Government will look further at the options for a proportionate strengthening of the existing framework. Options that will be considered for a potential review include a requirement for companies to disclose the audited figure for available reserves and distributable profits in their annual report and accounts and ways in which the definition of "net assets" might be tightened such as a more critical look at the valuation of "goodwill". The Government will also consider whether any review should extend to an examination of the case for more significant change such as considering the merits of a solvency based system and whether adopting this system, or elements of this system, would be beneficial, proportionate and business friendly.**

1.49 The Government agrees with institutional investors and some wider society groups that more companies should be following best practice and disclosing how they are allocating surplus revenue between shareholders, investment and R&D, rewards for employees, defined benefit pension schemes and other demands. They should also do more to explain the rationale for these decisions and how they support the long-term success of the company.

1.50 The Government is confident that pressure from institutional investors, including guidance issued by the Investment Association about full and effective reporting on capital allocation will lead to wider adoption of best practice. Further pressure will come from the implementation of new company reporting regulations which have recently been approved by Parliament. Amongst other things, these will require large companies to explain how their directors have had regard to the matters in section 172(1) of the Companies Act including the likely consequences of decisions in the long term. This is expected to encourage fuller disclosure of the rationale for capital allocation decisions. Reporting expectations will be reinforced in revised guidance on the content of strategic reports recently published by the Financial Reporting Council.

1.51 **The Government will legislate to require companies to disclose and explain their capital allocation decisions if investor pressure and new section 172 reporting requirements do not deliver sufficient progress.**

1.52 The Government is concerned at what appears to be a growing trend for companies to pay only interim dividends which, under most articles of association, do not require shareholder approval, and avoid paying final dividends which usually do need shareholder approval. It supports the steps being taken by some institutional investors to make it clear to companies that they disapprove of this practice which undermines boardroom accountability to shareholders.

1.53 **The Government has asked the Investment Association to assess the prevalence of this practice looking at evidence from the current reporting season, and to report its findings. The Government expects that investor pressure including if necessary formal investor guidelines will be enough to ensure that shareholders have an opportunity to vote on dividends. If this is not the case, the Government will legislate or take other steps to ensure that, for listed companies, there is at least one shareholder vote on dividends each year.**

1.54 The Government has noted respondents' views about dividend payments where a company's pension scheme is in significant deficit. It agrees with strongly held views that there should be no automatic bar on companies paying dividends in these circumstances. **The Government will, however, give further consideration to ways in which directors could provide stronger reassurances for shareholders and stakeholders that proposed dividends will not undermine the affordability of any deficit reduction payments agreed with pension fund trustees. This will be looked at as part of the consideration of fuller disclosure of capital allocation decisions and the case for a review of the UK's dividend regime.**

1.55 The Government is separately taking steps to safeguard defined benefit pension schemes. Following publication earlier this year of the White Paper 'Protecting Defined Benefit Pension Schemes' it is working to ensure, amongst other things, that there are clearer funding standards for all pension schemes, that the Pensions Regulator has enhanced powers to obtain the right information when it is needed and new powers to strengthen existing safeguards. The Protecting Defined Benefit Pension Schemes – A Stronger Pensions Regulator consultation published in June is seeking views on proposals to strengthen regulatory oversight of relevant events and transactions, such as the sale of controlling interest in a sponsoring employer, that may adversely affect a defined benefit pension scheme.

Directors’ duties and professional advisers

1.56 The consultation sought views on whether, when commissioning and using professional advice, company directors did so with an adequate awareness of their legal duties under the Companies Act 2006, specifically the duties in sections 172-177 which include the requirement to exercise independent judgement.

Question 14 - ***There are perceptions that some directors may not be fully aware of their duties with regard to commissioning and using professional advice. Do you agree, and if so, how could this be addressed?***

Summary of responses

Directors’ use of professional advice

1.57 The vast majority of responses expressed confidence that directors had a good awareness of their legal duties, including the need to apply an independent mind when making decisions on behalf of the company, taking into account any professional advice they may have commissioned. Many respondents stressed the importance of directors seeking professional advice and for that not to be hindered, nor the ability of professional advisers to be able to give frank and honest advice. Some respondents noted that problems can occur when directors shop around for the advice or the opinion they want, or advisers fail to exercise robust independence and flex their advice in the direction the client wants.

Training and guidance for directors

1.58 Respondents did suggest, however, that directors might benefit from more training to support them in their role. Responses from the professions in particular argued that whilst most directors are aware of their duties, many may have limited experience of dealing with situations where companies are in financial distress or are entering into insolvency. Consequently, they may be unfamiliar with the ensuing duties and potential liabilities, and so depend heavily on professional advice.

1.59 Those suggesting more training or guidance argued that a more explicit framework for professional conduct was needed to move directors from “gifted amateurs to professionals”. Other respondents suggested that specific guidance should be sent to newly appointed directors, or that newly appointed directors be referred to courses already provided by various professional bodies.

1.60 A significant trade body noted that although there was already an existing and extensive body of law and guidance available, much of it is difficult to navigate, particularly for small businesses. They suggested more could be done through worked examples and case studies, perhaps provided via a government website.

Independent board evaluations

1.61 Several respondents, particularly institutional investors, suggested that the market for independent board evaluations should be reviewed with a view to introducing minimum standards. The UK Corporate Governance Code requires boards to undertake an annual evaluation of their effectiveness and that this evaluation should be undertaken by an independent evaluator at least once every three years. Respondents argued that whilst many companies are embracing best practice in dealing with issues identified in evaluations, some do not. Additionally, some respondents pointed out that the standards or thoroughness of these evaluations can vary significantly.

Enforcement of directors' duties

1.62 Some respondents argued that stronger enforcement of directors' duties is needed, and that this would complement the new requirement for directors to report on how they have complied with their section 172(1) duties. There were a range of proposals for doing so, including clearer references to duties in the UK Corporate Governance Code, or giving responsibility for enforcement to a specific regulator.

Government response

Training and guidance for directors

1.63 The Government accepts the arguments that directors will in most circumstances be aware of their legal duties when commissioning or using professional advice to make decisions relating to matters of importance to the company. The Government, however, recognises the strength of the arguments for more guidance and training for directors, particularly newly appointed directors in charge of large complex firms managing significant numbers of employees and contracts and having to comply with regulatory regimes. Guidance on the application of the director's duty in section 172 of the Companies Act 2016 published recently by the GC100[3] at the request of the Government represents an important new resource in this respect. **The Government will bring forward further proposals to strengthen access to training and guidance for directors, tailored to different sizes of company, and will consider whether some level of training should be mandatory for directors of large companies.**

[3] https://uk.practicallaw.thomsonreuters.com

Independent board evaluation

1.64 The Government will also take steps in partnership with stakeholders to strengthen standards for independent board evaluations and consider also whether shareholders should have a role in the appointment of an external evaluator. The effectiveness of boards is pivotal in, amongst other things, providing direction for a company's management and culture, as well as creating the right framework for helping individual directors meet their statutory duties. Independent reviews should add fresh perspective and new ways of thinking to boards and can be particularly useful where there is a new chairman or there is a known problem around the board, or there is an external perception that the board is ineffective.

1.65 The UK Corporate Governance Code already requires a company within its scope to undertake an annual assessment of its board's effectiveness and for an independent evaluation to be undertaken at least once every three years. The recently revised Code also contains new requirements[4] for transparency around the evaluator's contact with the board and its individual directors, the outcomes and actions taken, and how it has or will influence board composition.

1.66 **The Government believes that there is scope to build on these provisions. It is therefore inviting ICSA: The Governance Institute to convene a group including representatives from the investment community 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.**

Enforcement of directors' duties

1.67 The Government believes that existing enforcement works, noting that over 1,200 individuals were disqualified from being a director last year. The Government has recently laid regulations to require all large companies to explain in their annual report how directors have had regard to the matters set out in section 172(1) of the Companies Act 2006, which includes the interests of employees, the likely consequences of decisions in the long term, and the need to foster business relationships with customers and suppliers. This new requirement will take effect from January 2019. The Government will assess the impact of that reform before considering further action. It will also consider any relevant recommendations from Sir John Kingman's review of the Financial Reporting Council.

[4] UK Corporate Governance Code (July 2018) - provision 23.

Protection of companies in the supply chain

Question 15 - *Should the Government consider new options to protect payments to SMEs in a supply chain in the event of the insolvency of a large customer? Please detail suggestions you would like to see considered.*

Summary of responses

The need for protection

1.68 The majority of respondents agreed that there was an issue to be addressed. Several noted that parties to a contract should not be in a position to extend payment terms once an agreement was in place, but that in practice small and medium-sized enterprises (SME) suppliers were reluctant or felt unable to make use of the legal remedies available to them including statutory interest, recovery action through the courts or a winding-up order.

1.69 Most respondents did not distinguish between protection against insolvency and protection against late payment where the customer remains solvent.

1.70 The size of businesses that might require greater protection was an issue about which respondents had a range of views. Whilst the majority highlighted that SMEs had a greater need for protection because of their reduced bargaining power, others saw merit in extending payment protection to businesses of all sizes and stated that existing protections were sufficient.

Late payment

1.71 Several respondents argued that greater transparency around payment practices was required, which they felt could be achieved by strengthening existing reporting requirements to introduce stronger incentives for prompt payment. This was seen as enabling better-informed decision making by SMEs. Some proposed ‘naming and shaming’ firms with poor payment practices in order to deter SMEs from contracting with such businesses.

1.72 Some trade bodies recommended that greater scrutiny should be undertaken of the financial stability of potential lead contractors before large public-sector contracts were awarded. It was also suggested that speed of payments to suppliers should be added to the procurement criteria used by the Government.

1.73 Other responses included:

- There is a ‘moral hazard’ if SMEs offer discounts in order to encourage prompt payment by their customers, this should not be necessary.

- Credit insurance and invoice finance were expensive options that were out of reach for SMEs according to one respondent, although others felt that these products could be valuable.
- Large companies, rather than their suppliers, should be required to take out credit insurance so as to reduce risk to the supply chain.

Project bank accounts and retentions

1.74 A number of respondents advocated greater use of project bank accounts (PBAs), whereby funds are paid by the client to a separate account in the name of the lead contractor (or jointly between lead contractor and client), with payments made directly to the supply chain without passing through the lead contractor's own account. There were a range of views on how PBAs would operate, how much they would cost, who would regulate them, their impact on payment times and what the incentive would be for clients to use them. Some respondents felt that PBAs assist Tier 1 and (possibly) Tier 2 suppliers but do not help those further down the supply chain, as the PBA is usually put in place before these levels of the supply chain have been fully established.

1.75 A majority of respondents felt that retentions were one of the most problematic features of construction contracts, and played a significant part in exacerbating cashflow problems for suppliers. There was some support for a mandatory deposit scheme, whereby retentions would be held by a third party, or covered by insurance, so that the supplier would not be exposed to loss in the event of insolvency of their client.

1.76 A number of respondents noted the risk of unintended consequences if supplier payments were segregated, whether by using PBAs for contract payments or separate accounts for amounts held as retentions. The main risk identified was that, because firms rely on these funds as working capital, reforms intended to help supplier cashflow could paradoxically lead to an increase in insolvencies overall. One respondent proposed research to better understand payment flows in complex supply chains.

Government response

1.77 This part of the consultation was aimed at protecting suppliers in cases of insolvency and the Government agrees with respondents that this is linked to a wider problem with late payment practices.

1.78 The Government agrees with the value of greater transparency about payment practices, which is why new rules were introduced from April 2017 requiring the UK's largest firms to report on their payment practices, policies and performance. This transparency measure aims to change behaviour as well as enabling better-informed decision-making by SMEs. The Government expects the majority of reports to have been submitted by the end of October 2018 and the Government will be monitoring the impact of this new requirement. The Department will soon publish a call for evidence which will consider ways the Government can go further to create a responsible payment culture.

1.79 The Government agrees that suppliers should not be required to offer discounts or to take up invoice finance or credit insurance. However, these can be effective ways for SMEs to manage risk and meet their working capital needs. The Government believes that invoice finance in particular offers the flexibility and speed of response that SMEs value. New regulations have been introduced that will improve access to invoice finance for SMEs wishing to use it. These will take effect at the end of the year, subject to Parliamentary approval.

1.80 In 2009, the Government Construction Board committed to using project bank accounts (PBAs) on public construction projects unless there are compelling reasons not to do so. They have since become widely used by a number of departments and agencies, including Highways England and the Environment Agency. The Government will continue to use PBAs but does not currently propose to mandate them for the private sector. Following industry feedback the Government is looking to increase knowledge and uptake of PBAs where they offer value for money. The Government agrees with the assessment of PBAs made by respondents, that they can be valuable in certain circumstances but that they currently offer fewer benefits for SMEs further down the supply chain.

1.81 Unjustified late and non-payment cause particular problems for small businesses in the construction sector and the Government is committed to tackling them. The practice of cash retentions is an issue that is frequently raised during discussions on fair payment within the sector. The Government has recently consulted on construction payment through two consultations. The first consultation[5] looked at how effective the 2011 changes to the Construction Act[6] had been in improving the clarity around construction payments. The second consultation[7] was on the practice of cash retention. The Government is currently reviewing the responses received to the consultation and will work with industry on these issues, with a view to determining what, if any further action may be required. The Government will publish its findings shortly.

[5] See https://www.gov.uk/government/consultations/2011-changes-to-part-2-of-the-housing-grants-construction-and-regeneration-act-1996
[6] The Housing Grants, Construction and Regeneration Act 1996
[7] See https://www.gov.uk/government/consultations/retention-payments-in-the-construction-industry

The “Prescribed Part”

Summary of responses

Question 16 - *Should the Government consider removing or increasing the current £600,000 cap on the proportion of funds that can be ring-fenced and paid over to unsecured creditors (the “prescribed part”) or enabling a higher cap in larger insolvencies? What would be the impact of increasing the prescribed part?*

1.82 There was a mixed response from respondents who answered this question with similar levels of support for: retaining the current cap; increasing the cap; and removing the cap. A number of respondents thought the cap should be removed and unsecured creditors should receive 20 per cent of all floating charge asset realisations. Other respondents expressed concerns that removing the cap would be likely to have an adverse effect on lending, particularly to distressed businesses, as floating charge-holders may not be able to accurately assess their level of risk and anticipated recovery rate in the event of the debtor’s insolvency.

Government response

1.83 As a number of respondents pointed out, the rationale for introducing the prescribed part under the Enterprise Act 2002 was tied to the abolition of Crown preference and the policy intention of redistributing these funds to unsecured creditors, rather than allowing the floating-charge holder to receive a windfall from the Government’s decision to give up Crown preference.

1.84 **The Government has noted the potential adverse effect on lending if the cap were to be removed but, in order to help unsecured creditors including those in the supply chain, has decided the best way to proceed is to increase the cap in a way that remains linked to the original policy intent of transferring funds given up by the Crown to unsecured creditors. The increase will therefore be linked to the impact of inflation on the current cap since it first came into effect in 2003. This approach corresponds with suggestions made by a number of respondents. Applying an inflationary increase to 31 March 2018 would result in the cap increasing from £600,000 to approximately £800,000.** While prescribed part payments very rarely reach the current cap, in the small number of cases that do, it will mean that unsecured creditors will benefit from increased payments.

2. Sales of businesses in distress

The consultation sought views on situations where a holding company with a controlling interest in a financially distressed, large, private or unlisted public company, a "group subsidiary", sells that interest.

2.1 The consultation asked whether the directors of the holding company should consider whether the sale is in the best interests of the subsidiary's stakeholders. The consultation suggested that to create an incentive to make this consideration, the director(s) of the holding company could be held liable for losses following a sale of the group subsidiary if:

- at the time of the sale, the group subsidiary is either insolvent, or insolvent but for guarantees provided by other companies or directors in its group;
- the subsidiary enters into administration or liquidation within two years of the completion of the sale;
- the interests of its creditors have been adversely affected between the date of the sale and the liquidation or administration; 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 lead to a better outcome for those creditors than placing it into administration or liquidation.

The consultation suggested that, if all of the above requirements are met an administrator or liquidator of the former group subsidiary should be able to apply to court for an order that the director contribute a sum that the court thinks fit towards the subsidiary's creditors. The director should also be liable to be disqualified where appropriate.

Summary of responses

Question 1 - *Do you think there is a need to introduce new measures to deal with the situation outlined?*

Question 2 - *Should the new measures be limited to the sale of a subsidiary or should a new measure extend to any act procured by the parent (through its directors), which operates to the prejudice of the creditors of the subsidiary once that subsidiary is insolvent? Might such measures create material conflicts for directors? If so, how might they be resolved?*

Question 3 - ***Should the target be the parent company directors responsible for the sale? If not, who else should be targeted; or who in addition?***

Question 4 - ***How can we ensure that there is no impact on sales which genuinely seek to rescue distressed businesses, or bring new investment into distressed businesses?***

2.2 Many respondents who answered these questions, whilst acknowledging the reasons for the proposals, did not consider that there was a need to introduce new measures. This opinion was particularly prevalent amongst professional advisers such as accountants and lawyers, and business representative associations, where a number of the respondents did not see a need for new measures. Business representative bodies were split equally on whether they supported the proposal. Some of those in favour of new measures across all categories of respondents agreed that the issues set out in the consultation document were problems that needed to be addressed. Those against the proposed measures referred to existing legislation being adequate, a risk of deterring legitimate business sales, the conflict that the measures might create in directors' duties as set out by the Companies Act 2006, and the potential to undermine limited liability. Some respondents also commented that the Government should avoid legislating based on the circumstances of a few high profile business failures.

2.3 Around a quarter of the respondents addressed the question about whether the proposed measures would create conflicts of duties for directors. The large majority of those who answered the question thought that the proposed measures would lead to a conflict between the duties that the director of the parent company owes to that company's shareholders, and the proposed requirement that the director also considers the interests of the subsidiary's stakeholders. Many respondents said that if there was any perceived risk of personal liability for the directors of the holding company considering a sale, the directors would be more inclined to place the subsidiary into insolvency proceedings rather than sell it. If this happened there would be fewer opportunities for distressed companies to be saved by rescue finance and restructuring experts, less inward investment (because many rescue finance investors are from outside the UK) and a greater number of insolvencies. It is likely that this would also lead to fewer companies being saved.

2.4 Where respondents were in favour of new measures, they were also generally in agreement that the parent company directors responsible for the sale should be targeted. There were also suggestions that the actions of the directors of the sold subsidiary should be considered, and that the board of the parent company had collective responsibility.

Government response

2.5 The Government wishes to ensure that any reforms will not damage the prospects for rescuing distressed but viable businesses. However, currently when a holding company sells a subsidiary which is in financial difficulties, the parent company directors may fail to take into account whether the sale is in the best interests of the subsidiary's stakeholders as opposed to placing the subsidiary into formal insolvency proceedings.

2.6 Whilst determined to address this issue, the Government recognises the valid concerns of respondents and the need to minimise any deterrent effect that the measures may have on efforts to rescue a distressed business. **Therefore, the Government intends that the measures introduced will enable directors to remain confident that a sale would not expose them to liability or sanction if they had a reasonable belief at the time of the sale that the sale would likely deliver a no worse outcome for the stakeholders of the subsidiary than placing it into a formal insolvency.** Whether a belief is reasonable will take into account any steps the director has taken, which might include considering professional advice on the impact of the sale on the subsidiary's stakeholders and engaging with major stakeholders during the sale negotiations. In order to ensure that the directors are not discouraged from selling a distressed subsidiary by the threat of personal liability, **the Government does not intend to take forward the proposed measure of creating a liquidator or administrator action for personal liability of a director**.

2.7 The Government firmly believes, however, that directors of holding companies should be considering whether a distressed subsidiary's stakeholders would be better off in an insolvency proceeding rather than the sale of the business, and where no such consideration has been given to the outcome those directors should be held to account. The directors of the subsidiary will have their existing duties to that company, and will be accountable for those. However, the Government considers that directors of holding companies should also give due consideration to stakeholders of the subsidiary in a sale scenario, recognising that the board of the holding company will often be involved in key decisions of the subsidiary and will be responsible for agreeing the sale rather than the directors of the subsidiary itself.

2.8 **The Government considers the courts are well-placed to consider issues surrounding reasonableness of director conduct and therefore intends to introduce a measure that will mean that a director of a holding company who does not give due consideration to the interests of the stakeholders of a financially distressed subsidiary when it is sold may be subject to**

disqualification action if that subsidiary enters insolvent liquidation or insolvent administration within a certain period after the sale.

2.9 The Government does not think that this will cause a conflict of duties for directors because they should at all times be acting within the law. In the context of the Government proposal, if the legal framework requires the interests of stakeholders of a subsidiary to be taken into account when decisions are made about its disposal, the directors will be legally obliged to do so. This does not infringe on their general duty to their own shareholders, as this duty is subject to the ordinary requirements to act within the law at all times.

2.10 **The Government will ensure that legislation is properly targeted to bring into scope those directors who had no reasonable belief that the subsidiary's stakeholders would be no worse off as a result of the sale than if the subsidiary entered liquidation or administration.**

2.11 **In order to assist a court in considering whether a director acted reasonably in relation to the sale, the Government will provide a non-exhaustive list (through legislation and/or guidance) of matters which the court may take into account.** Such matters may include:

- whether professional advice on the sale was considered;
- the extent to which the board of the holding company engaged and consulted with the major stakeholders of the subsidiary prior to the sale; and
- other steps taken by the director to ensure, as far as within their means, that the sale was no worse an option than formal insolvency.

2.12 In the consultation the Government proposed that the measures would apply where the subsidiary enters into administration or liquidation within two years of the completion of the sale. **To minimise the risk that the measures might cause parent company directors to perceive sales of distressed businesses as being too risky, the Government has decided to reduce this to a period of 12 months.**

2.13 In considering where there is the greatest potential for harm to stakeholders of a subsidiary, the measures will be further limited to sales of large subsidiary companies, that is those which do not qualify as small or medium sized companies under the Companies Act 2006.

2.14 Under current legislation, a director whose conduct has caused loss to one or more creditors and against whom a disqualification order is made or disqualification undertaking is accepted, could potentially also be the subject of a compensation order. This means that the director would be required to pay an amount by way of compensation to the creditors. There will remain the possibility of personal liability under a compensation order should the court find that a disqualified parent company director has caused loss to one or more creditors of the subsidiary.

2.15 The Government's intention is that introducing these measures will influence the actions of holding companies' directors when they are selling distressed subsidiaries, so that they consider whether, from the perspective of the subsidiary's stakeholders, the sale would provide no worse an outcome than insolvency proceedings. It should also serve to reassure the directors that if they act reasonably, given the circumstances and the information available at the time, and take appropriate steps to give due consideration to the interests of the subsidiary's stakeholders, they would not be liable for disqualification in the future as a result of their decision.

2.16 In order to minimise costs that might arise as a result of the measures, for example additional costs of seeking professional advice, **the Government will work with industry to develop guidance on the steps that a director should take when considering the sale of an insolvent subsidiary.**

2.17 **The Government will bring forward legislation to implement the measures as soon as parliamentary time permits. The measures will be clearly targeted to minimise the risk of deterring legitimate business rescue and to ensure that directors are clear as to their duties when selling a subsidiary in financial difficulties.**

3. Value extraction schemes

This section asked whether new powers should be introduced in addition to those that currently exist to undo a transaction, or a series of transactions, which unfairly strips value from a company, in order that insolvency law keeps pace with modern business practices.

3.1 Recent insolvency cases highlighted that value could be extracted from ailing companies via complex extraction schemes. The Government sought views on whether a new power should be introduced to allow an insolvency office-holder to apply to a court to reverse a transaction (or series of transactions) considered to have unfairly removed value from a company as it approached insolvency, to the benefit of an investor but to the detriment of creditors.

Summary of responses

Question 5 - *Are new tools needed to enable insolvency office-holders to better tackle this behaviour? Or could existing antecedent recovery powers be expanded to ensure this behaviour is tackled?*

Question 6 - *Do you agree the Government should introduce a value extraction scheme reversal power as outlined above? Do you agree that the insolvency test in the current powers is not appropriate in the circumstances outlined above?*

Question 7 - *Could the proposal adversely affect the availability of finance for distressed companies? Could it have other adverse effects? If so, how might the proposal be modified to mitigate these effects? Are there any protections that should be given to investors?*

Question 8 - *How could the proposal be developed to ensure that only those schemes which unfairly extract value and harm the interests of other creditors can be challenged by the insolvency office holder? Should concepts such as "unfair" and "excessive" be defined or left to the courts to develop through case law?*

3.2 The majority of respondents who expressed a view supported action by the Government to tackle unfair transactions in the lead up to insolvency. Of those supporting action, most advocated making improvements to existing recovery powers rather than introducing a new stand-alone provision. Many respondents, including those opposing changes and those promoting improvements to the existing regime, said that the new powers proposed in the consultation would overlap with existing provisions and would cause additional complexity and confusion. Some of those against the new powers thought they were too broadly devised and very subjective.

3.3 Most respondents thought that the powers originally proposed in the consultation would have an adverse impact on the availability of finance for distressed companies. They highlighted that lenders are entitled to expect rewards that reflect the uncertainty and risks involved in investment in a distressed company. Some specifically identified that the powers proposed may deter overseas investment into the UK. Some respondents thought the proposals would only deter investors with improper intentions and for that reason welcomed the Government taking action.

Government response

3.4 The Government does not wish to deter lenders who fund business turnarounds and thereby save companies that may otherwise end up in formal insolvency procedures, leading to job losses. Any future changes will be carefully balanced so as not to discourage genuine investment while targeting those who seek to unfairly extract value from distressed companies.

3.5 The Government agrees that making improvements to enhance existing recovery powers can achieve its objective of ensuring all creditors are treated fairly in insolvency. Ensuring a targeted approach will avoid unintended consequences of introducing a new power, such as an adverse impact on investment appetite or reducing the availability or increasing the cost of rescue finance. Respondents have provided valuable insight and evidence about how existing antecedent recovery powers could be expanded or improved to ensure inappropriate transactions can be reversed.

3.6 One method used to extract value identified in the consultation was excessive interest on loans from an investor. A number of respondents highlighted the difficulty in bringing a successful claim under the existing provision intended to allow insolvency office-holders to overturn an extortionate credit transaction. They drew attention to the significant evidence required in order to meet the legislative threshold to show a transaction “grossly contravened ordinary principles of fair dealing” or required “grossly exorbitant” payments to be made. This is a high hurdle and may be acting as a deterrent to office-holders bringing such legal claims to recover money for other creditors. **The Government will work with stakeholders to look at how the 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.**

3.7 Other value extraction techniques may involve the repayment of a debt to an investor in preference to other creditors. While preferences can be challenged under existing legislation, there is a requirement to prove that the company making the preferential payment was insolvent at the time of the transaction (or became insolvent as a result of it). This must be proven even where the recipient of the preference is connected to the company, unlike the similar provision that allows an office-holder to apply to reverse a transaction at an undervalue. In the latter provision, insolvency is presumed where the other party to the transaction is connected to the company (for example, a director) unless it is proved otherwise. **The Government intends to align these provisions to make it easier for office-holders to challenge preferential payments to connected creditors.**

3.8 Some respondents have suggested that the Government look at existing provisions where evolving case law or legal uncertainty has made it more difficult to pursue cases in practice. These 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).

3.9 **The Government will work with stakeholders to consider whether any clarification of these provisions is required.**

3.10 Respondents have provided further insight across the range of antecedent recovery powers in the Insolvency Act 1986, in addition to the specific examples set out above. The Government will engage with stakeholders and consider these complex areas in more detail to consider whether any more of these provisions could be refined to improve an office-holder's powers to challenge unfair value extraction.

3.11 **The Government will bring forward legislation as soon as parliamentary time permits.** These changes will be balanced and proportionate so as not to deter investment in the UK's sophisticated market for turnaround finance.

4. Dissolved companies

The consultation asked for views on whether the scope of the current investigation and enforcement regime should be extended to include former directors of dissolved companies. This will complement the existing powers to investigate director conduct and strengthen our ability to take rogue directors out of the marketplace.

Summary of Responses

Question 9 - *Do you agree that there is a problem in this area and that action should be taken to prevent directors from avoiding liabilities and scrutiny by dissolving their companies?* Question 10 - *Do you agree that director conduct should be brought in scope of the Secretary of State's investigatory powers?*

4.1 A large majority of respondents agreed that there was a problem posed by the current gap in legislation which prevents the Secretary of State from investigating potential misconduct by directors of dissolved companies.

4.2 Respondents were also in favour of the Government taking action to prevent directors avoiding liabilities via company dissolution. Respondents thought the proposal for a new investigation power was in the main, logical and sensible in view of the fact that it is prohibitively costly and time-consuming to restore a company that is struck off the register.

4.3 Some suggested there is widespread support in the construction industry for action to deal with this conduct and that the problem is particular to SMEs.

Government response

4.4 The majority of respondents were supportive of the proposal to widen existing powers to investigate the conduct of directors of dissolved companies and take action against those directors who are considered to have breached their legal obligations. Whilst the Government recognises that the dissolution process is important in maintaining the integrity of the company register, where a company is insolvent, dissolution should not be used as an alternative to insolvency proceedings. While dissolved companies can be restored to the register, this can be a costly and lengthy process and unnecessary if the company has ceased trading.

4.5 **When legislative time allows, the Government will proceed with amendments to the Company Director Disqualification Act 1986 (the CDDA) to extend the current investigation regime to include former directors of dissolved companies.** This will open the door to enforcement actions such as disqualification, prosecution and compensation. The provisions will mirror, as far as possible, the existing relevant provisions concerning the disqualification of directors of insolvent companies.

4.6 It is the Government's intention that the new investigation power replicates section 7(4) of the CDDA, which requires any person to provide information or produce records which are relevant to the person's conduct as a director as may be reasonably required. Similarly, the new duty on the court to disqualify unfit directors of dissolved companies will mirror existing provisions under section 6 of the CCDA.

4.7 Investigation and enforcement activities support fair and open markets. The Government is confident that extending the reach of its powers will safeguard those markets from individuals whose conduct is counter to the public good. **The Secretary of State will be empowered to take action against a former director of a dissolved company without the expense and delay of restoring the company to the register in cases where conduct is found to have fallen below expected standards. This includes instances of directors repeatedly dissolving companies and leaving behind debts and other liabilities – often to the detriment of small businesses and employees.**

4.8 Some respondents raised concerns about how appropriate cases will be targeted. Under the existing insolvent companies' regime, the Secretary of State has discretion to investigate alleged cases of misconduct of which he is notified. **The Government will ensure that the best value for money is achieved in terms of targeting those cases where investigation is most strongly in the public interest. The Insolvency Service has a rigorous vetting process which prioritises cases for investigation to ensure quality outcomes for creditors and all stakeholders affected by directors seeking to abuse limited liability. It is expected that an investigation will be triggered via a complaint or through connection with an existing live or insolvent company investigation.**

5. Response to *A Review of the Corporate insolvency Framework* (2016)

The core framework of the corporate insolvency regime has remained largely unchanged since 2003. Factors, including changes in the corporate debt market since the global financial crisis of 2007, led to the Government seeking views on possible improvements to the existing corporate insolvency regime in its consultation 'A Review of the Corporate Insolvency Framework'.

5.1 The consultation asked for views on four proposed areas:

- creation of a new moratorium period for financially distressed (but ultimately viable) companies. Creditors, including secured creditors, would not be able to take action against the company in this period, during which it would be making preparations to restructure;
- provision to require essential suppliers to continue to supply to a financially distressed company on existing terms and not use termination clauses or demand 'ransom' payments;
- creation of a 'new restructuring plan' – a company rescue vehicle that would include the ability to bind dissenting classes of creditors who vote against it (known as cross-class cram down); and
- measures to encourage 'rescue finance' (money lent to a company in an insolvency procedure to assist in its survival).

5.2 The responses to the consultation (and subsequent engagement with stakeholders) provided helpful and constructive discussion, identifying issues and concerns with some of the proposals made in the consultation. Most insolvency professionals and their representative bodies who responded, supported the first three proposals, but questioned some of the detail. Creditor organisations were, broadly speaking, opposed to the proposals, raising concerns about potential abuse and warning of negative impacts, such as increased cost of credit and knock-on insolvencies for creditors affected by the proposals.

5.3 Recent changes in the insolvency regimes in a number of different countries show a general convergence in the principle features of restructuring and rescue frameworks of sophisticated market economies. Certain ideas and approaches, with some modification for local conditions, appear to work well across the globe. This is reflected in the World Bank's *Doing Business* methodology and in other texts such as the

UNCITRAL[8] *Legislative Guide on Insolvency Law*[9], which give recommendations on the core provisions for an effective and efficient insolvency law. By way of illustration, the *UNCITRAL Legislative Guide on Insolvency Law* sets out provisions relating to a stay of enforcement action, treatment of contracts, a reorganisation plan and finance in its examination of core features of effective frameworks, provisions which share much in common with the Government's proposals which were developed with these in mind and tailored to ensure the right fit for business in Great Britain.

5.4 **The Government will seek to introduce new legislation to implement measures in line with the Government responses set out below as soon as parliamentary time permits.**

The introduction of a new moratorium to help business rescue

5.5 The Government proposed introducing a moratorium that would prevent creditor enforcement action being taken against a company while it considered options for rescue. The moratorium would be available to all companies (with some exceptions) providing the company meets certain eligibility criteria and qualifying conditions. Once commenced, the moratorium would last for up to three months with the possibility of being extended beyond that period. During the moratorium the directors would remain in control of the company. Creditors' interests would be protected through the involvement in the process of an authorised supervisor, who would monitor the company's compliance with the qualifying conditions throughout the moratorium.

Question 1 – *Do you agree with the proposal to introduce a preliminary moratorium as a standalone gateway for all businesses?*

5.6 The first question sought stakeholders' overall position on the proposal to introduce a moratorium during which distressed but still viable businesses could consider their options for rescue. The majority of respondents who commented on this proposal expressed support for the introduction of a moratorium. Those who supported the proposal felt that a new moratorium could encourage directors to act earlier to tackle financial difficulties.

5.7 Many of those respondents who did not support the introduction of a moratorium were creditor groups or creditor representatives. A common theme in these responses was that opposition was based, in part, on concerns that use of a moratorium would be abused, including by businesses that had no realistic prospect of rescue.

5.8 There were also concerns raised in responses, from both those who supported the introduction of a moratorium and those who were opposed, about adequate protection and safeguards for creditors whose right to take enforcement action against a debtor

[8] United Nations Commission on International Trade Law.
[9] See: http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency.html

company would be suspended by the operation of a moratorium. These concerns included:

- the proposed length of the moratorium;
- supervision of the company during the moratorium; and
- the position of creditors, suppliers and employees as the moratorium ran its course.

Government response

5.9 **The Government has considered the responses to the consultation carefully and has concluded, on balance, it agrees with those respondents who supported the introduction of a moratorium.** The introduction of a moratorium, modelled on the same parameters as the administration moratorium[10], will give financially distressed but viable companies the time to consider options for addressing financial and economic problems. This will, in many cases, facilitate the rehabilitation and rescue of companies in the longer term, thereby preserving value and safeguarding jobs.

5.10 A key objective of the Government's proposals is to reduce the costs and risks of restructuring. Stakeholders have criticised the existing Schedule A1 company voluntary arrangement (CVA) moratorium[11] for being restricted to small companies and being burdensome in nature for the insolvency practitioner acting as nominee, being both bureaucratic and carrying a risk of personal liability. Lifting size restrictions to allow medium and large-sized companies to use the Schedule A1 moratorium may help in theory. However, views on the shortcomings of this moratorium suggest that, in practice, it would rarely be used, as is already the case for small companies for whom it is already available.

5.11 While the Court has been willing to stay enforcement proceedings while a debtor attempts to finalise a scheme of arrangement[12][13], this has been exercised where negotiations were at an advanced stage and clearly represented a workaround to overcome the current absence of a statutory moratorium. The Government is aware of examples of schemes of arrangement being used for the purpose of creating a moratorium, as an interim measure before a more substantive restructuring can be effected via a further scheme of arrangement.

5.12 Further efforts to find workarounds to the current absence of a statutory moratorium can be evidenced by the attempted use of repeated notices of intention to appoint an

[10] See paragraphs 42 and 43, Schedule B1 of the Insolvency Act 1986.
[11] See Schedule A1, Insolvency Act 1986
[12] Schemes of arrangement are provided for under Part 26 of the Companies Act 2006. Schemes are not collective insolvency proceedings and are not covered by the EU Insolvency Regulation (EU 2015/848).
[13] See the Court's decision in *Re Bluecrest Mercantile BV*.

administrator in order to provide breathing space by benefitting from the interim moratorium provisions[14] while a number of possible rescue options are explored. However, the filing of such notices without a settled intention to appoint an administrator has recently been held by the court to be invalid[15].

5.13 The introduction of a moratorium with a clearly defined and streamlined entry process should reduce the cost of restructuring and will be accessible to companies of any size. This will aid company rescue by giving companies time and space to consider available options when it is most needed.

5.14 **As the moratorium process would be open to small companies currently eligible for the Schedule A1 moratorium the Government intends to repeal these much-criticised provisions on the basis they are no longer required.** Evidence shows the Schedule A1 moratorium is used in only a small percentage of cases,[16] this is possibly a reflection of the criticisms that a number of respondents and stakeholders made about the process.

5.15 Opposition to the moratorium proposal frequently focused on the matters discussed above. By listening to these concerns and engaging in further discussions with stakeholders, the Government has refined the package to address those concerns. Details of these changes are set out below. This ensures that the proposal strikes the right balance between providing the best opportunity to rescue a financially distressed but viable company while also safeguarding creditors' interests during that process.

5.16 **The Government would also clarify, in light of some uncertainty raised by some respondents, that using a moratorium would not be a pre-requisite for seeking the agreement of creditors to the restructuring plan proposal.** The two proposals are independent of one another and use of a moratorium for the purposes of negotiating a restructuring plan would be at the discretion of the company's directors, subject to meeting the eligibility tests and qualifying conditions.

5.17 It is worth noting that the introduction of a new moratorium procedure will not replace other options currently available statutorily or otherwise (other than the Schedule A1 moratorium for small companies, as mentioned above) so companies will still be able to, for example, negotiate contractual standstill arrangements with creditors without the use of a statutory moratorium. Some respondents argued consensual arrangements will often be more attractive to companies in financial distress - entry into a moratorium involves notice to all creditors which may bring with it a higher degree of stigma than consensual discussions. **The Government accepts such arguments and encourages companies to enter into dialogue with creditors early on in cases of**

[14] See paragraph 44, Schedule B1 of the Insolvency Act 1986.
[15] See the Court's decision in *JCAM Commercial Real Estate Property XV Ltd v Davis Haulage Ltd* in which the Court of Appeal held that issuing a notice of intention to appoint an administrator required a settled intention to appoint rather than the appointment being one of several possible options.
[16] An internal analysis of records held at Companies House showed fewer than 10 per cent of small companies proposing a CVA used the moratorium.

financial distress, however the option of a moratorium will be available to a company where needed.

Question 2 – *Does the process of filing at court represent the most efficient means for gaining relief for a business and for creditors to seek to dissolve the moratorium if their interests aren't protected?*

5.18 A majority of responses to the question agreed that the process of filing at court to obtain a moratorium was the most efficient way in which a company could gain relief from creditor action. There was widespread concern that a full court hearing could involve significant costs and delay at a time in a company's life cycle when speed is crucial. While many respondents agreed that creditors should have the ability to apply to court to challenge the moratorium as a safeguard, some respondents raised concerns about the cost of applying to the courts.

Government response

5.19 **The Government therefore intends that entry into a moratorium will be triggered by filing the necessary papers at court. This will resemble the current procedure for an out of court appointment of an administrator[17]. The supervisor will need to file their consent to act and confirmation that they have assessed the eligibility tests and qualifying conditions and are satisfied these have been met. The supervisor will also be required to send notice to all known creditors of the company and register the company's entry into the moratorium at Companies House. In this way unnecessary costs and delay will be avoided that could otherwise have prevented prompt action to save a struggling company.**

5.20 Requiring creditors to make an application to court where there is an objection will bring additional cost for that creditor, however, stakeholders were clear that they thought recourse to a judicial authority was necessary to ensure that the rights of creditors and the debtor company were protected. The requirement for a court application should also deter frivolous challenges that have little or no merit. Alternative forms of dispute resolution were discussed with stakeholders but this led to the conclusion that they were not well-suited to dealing with challenges and bring with them their own cost issues. On balance, the Government believes the need for robust creditor safeguards justifies this approach.

Question 3 – *Do the proposed eligibility tests and qualifying criteria provide the right level of protection for suppliers and creditors?*

5.21 There were relatively few comments from respondents regarding ineligibility on the grounds of a company having entered a moratorium, administration or CVA in the previous 12 months or is subject to a winding-up order or petition. One respondent thought that a company purchased out of administration in the previous 12 months

[17] See paragraph 22 of Schedule B1, Insolvency Act 1986.

should be eligible. The Government is content that if a company has entered into a moratorium, administration or CVA in the previous 12 months it should not qualify for a moratorium. A small number of respondents disagreed that a winding-up petition should be a bar to using a moratorium, arguing that an automatic prohibition may encourage creditors to issue a petition simply to avoid being affected by a moratorium or to gain the upper hand in any subsequent negotiations with the debtor company.

Government response

5.22 The Government agrees that automatic ineligibility may drive unnecessarily defensive or aggressive behaviour on the part of some creditors in order to increase their leverage over a debtor company. **The Government therefore intends that a winding–up petition that has been concluded in the previous 12 months (that did not result in the making of a winding-up order) should not be a bar to obtaining a moratorium, nor should a pending winding-up petition, the outcome of which is yet to be determined by the court.**

5.23 **In order to avoid abuse, the Government proposes that a debtor company subject to a pending winding-up petition would have to seek permission from the court to commence a moratorium and would not be able to follow the usual process of filing papers at court.** The court would have discretion on whether or not to grant a moratorium and have broad powers to determine ancillary matters such as staying the petition and how to treat the petitioner’s costs on the ultimate dismissal of the petition. Where a petition has been presented on public interest grounds[18], the company will be ineligible for a moratorium.

5.24 In cases where the court grants a moratorium for a company subject to a pending winding-up petition some modification to section 127 of the Insolvency Act 1986 may be required to avoid the need to obtain validation orders for payments made in the course of the moratorium[19].

5.25 Some respondents thought that there was insufficient detail on the qualifying conditions in the consultation. This may have led to misunderstandings on some aspects of the proposal. A number of respondents were opposed to the idea that the directors of the company would make the assessment as to whether or not the company met the qualifying conditions. This was not the Government’s intention as this would not provide a sufficiently robust and impartial assessment of the company’s position. **The Government’s intention was that the moratorium supervisor (now to be called a ‘monitor’ to avoid confusion with the existing insolvency office-holder of that title) would make this assessment. This will provide the objectivity and impartiality necessary to protect creditors.**

[18] See section 124A Insolvency Act 1986.
[19] There is an existing model for such modification in s.127(2) of the Insolvency Act 1986 and the Government will consider if this, or something like it, is required for a moratorium.

Financial state

5.26 There was a mix of responses on what a company's financial state should be in order to be eligible for a moratorium. The consultation said that a company should be already, or imminently in financial difficulty or insolvent in order to qualify. A number of respondents thought this requirement did not adequately protect suppliers and creditors. Others expressed the view that the proposed test would not encourage directors to address financial difficulties early enough if a company was still eligible for a moratorium when already insolvent. Several respondents favoured the existing test used in administration of '*is or is likely to become unable to pay its debts'*[20]. Several respondents thought the proposed test, *'already or imminently will be in financial difficulty, or is insolvent'*, could be more clearly defined and some of those thought establishing a statutory definition would be extremely difficult.

5.27 The Government notes the range of opinions expressed and recognises the significant challenge of finding the correct balance and translating that into statute. An analysis of legislative frameworks in other countries reveals that there is no consensus position on financial state in order to qualify for restructuring processes, including those jurisdictions with provision for a moratorium.

5.28 **After careful consideration, the Government believes the test for entry into a moratorium should exclude companies that are already insolvent.** This approach addresses concerns raised by many respondents centred on the belief that a moratorium could be mis-used by directors to delay an inevitable insolvency, increasing creditor losses in the process. It also addresses concerns surrounding the likely failure of the proposed test to encourage earlier action on the part of the company's directors.

5.29 A company seeking the protection of a moratorium must have legitimate reasons for seeking protection. **The Government thinks the test on financial state should be one of prospective insolvency, that is, based upon the requirement that a company will become insolvent if action is not taken.** This approach ensures that the moratorium process cannot be abused by healthy companies with relatively minor and short term cash flow issues.

Prospect of rescue

5.30 Few respondents expressed a view on the criterion that there needs to be a reasonable prospect that a compromise or arrangement can be agreed with the company's creditors.

5.31 A small number of respondents questioned how 'reasonable prospect' should be interpreted and at least one thought this may be too low a standard. This was further discussed with stakeholders following the consultation in order to refine this criterion.

[20] See paragraph 11, Schedule B1 Insolvency Act 1986.

The Government agrees that a higher bar should be applied, and that the appropriate level is one of on the balance of probabilities, so the test should be that rescue be more likely than not. A number of respondents thought that prior notification and consent from creditors, or certain types of creditors such as secured creditors, should be a mandatory requirement. **The Government believes that such notification or consent should not be a legal requirement.** However, in order for a monitor to reach a satisfactory conclusion as to the prospects of rescue, it is likely in practice that the company or the proposed monitor will have to undertake some level of consultation with key stakeholders in the restructuring process, before this can be determined.

5.32 It will be for a proposed monitor (and the monitor once the moratorium is in place) to assess whether or not a company meets this qualifying criterion thereby providing an adequate safeguard for creditors' interests.

Meeting current obligations

5.33 Few respondents disagreed with the requirement that a company must have sufficient funds to carry on its business during a moratorium, meeting current obligations as and when they fall due as well as any new obligations that are incurred in the moratorium. In a small number of cases where respondents disagreed, or had concerns, this appeared to be mainly based on the belief that it was the company (rather than someone independent from it) which would make this assessment.

5.34 **The Government agrees with the suggestion made by a number of respondents that it will be for the proposed monitor (and the monitor once the moratorium is in place) to assess whether or not this criterion is met.**

Exclusions

5.35 There was relatively little comment from respondents on the issue of companies that are to be expressly excluded from the moratorium on the grounds this was necessary for the proper functioning and integrity of certain markets. Some respondents thought this was sensible but some suggested that those categories of companies excluded from the existing CVA small companies moratorium and transactions that benefit from the Financial Collateral Arrangement Regulations ought to be similarly excluded. This is in order to avoid potential rating downgrades and to ensure the efficient functioning of financial markets. **The Government's intention is to exclude companies falling within scope of the exceptions listed in paragraphs 4A to 4J of Schedule A1 of the Insolvency Act 1986 from the moratorium. The Government has also considered the issue of the Financial Collateral Arrangement Regulations and agrees companies within the scope of these regulations should not be eligible for the moratorium.**

Question 4 – *Do you consider the proposed rights and responsibilities for creditors and directors to strike the right balance between safeguarding creditors and deterring abuse while increasing the chance of business rescue?*

5.36 A majority of respondents did not think that the safeguards were sufficient as drafted, though some respondents thought that insufficient detail was provided in the consultation document to make a judgement

Government response

5.37 In light of concerns and difficulties raised by a number of respondents, **the Government has amended its proposals to alter the balance between the rights and responsibilities of different affected parties. Further details are set out below.** It is worth noting that in a number of cases, respondents who raised concerns commented that many of the problems of the proposals as they saw them would be significantly mitigated by a reduction in the length of the moratorium period. The length of the moratorium, including changes to the consultation proposal, is discussed further below.

Creditors' rights to challenge

5.38 Several respondents commented that creditors should have the right to challenge the moratorium in court, either on the grounds the qualifying criteria were not, or are no longer met (or the company was ineligible), or creditors have been unfairly prejudiced as a result of the moratorium. It was noted by some that the grounds for challenge may not arise until later in the moratorium process, after the expiry of the proposed 28 day period for challenges outlined in the consultation, leaving creditors without a satisfactory method for protecting their legitimate interests.

5.39 **The Government accepts time-limiting creditors' rights of challenge would not provide the desired level of creditor protection favoured by many respondents and therefore intends to allow creditors to challenge the moratorium, either on the grounds of the qualifying conditions not being met (or the company being ineligible) or unfair prejudice to creditors, at <u>any</u> time during the moratorium.**

5.40 As was pointed out, there is a well-established body of case law where creditors have applied to court to have an administration moratorium lifted[21]. **The Government will take a similar legislative approach as seen in administration as it considers, for the most part, that the same principles will apply in a case of a creditor applying to court to have a moratorium lifted.** However, unlike in administration, the monitor would not be able to consent to actions that contravened the effect of the moratorium

[21] Under paragraph 43, Schedule B1 Insolvency Act 1986, the Court may give permission to actions that would otherwise breach the moratorium.

such as initiating legal proceedings. If the company did not consent, the creditor could only seek permission from the court. This reflects that the moratorium is a debtor-in–possession process[22] and that the monitor is not running the company.

Director liability

5.41 The proposal to exempt directors from liability, for example in a claim for wrongful trading under section 214 of the Insolvency Act 1986, was strongly criticised by a number of respondents. Some respondents thought suspending liability for wrongful trading was unnecessary as a moratorium was evidence the directors of the company were attempting a rescue, and therefore any such claims would likely fail in practice.

5.42 **The Government has noted the comments made and agrees that suspending liability for wrongful trading would be unhelpful, both to creditors and to directors.** It is important that creditors have faith in the rescue framework, otherwise they are unlikely to support efforts to address a company's financial distress and achieve a sustainable future for that company. Directors need to be clear as to what the law is, so that they are not placed in a position where they are uncertain of what their duties are or to whom they owe those duties.

5.43 **The Government accepts the argument made by several respondents that the proposed protection is unnecessary, as the qualifying conditions ensure that a company must meet its current obligations as they fall due, and a monitor must terminate a moratorium if this is not the case. The Government has therefore decided not to proceed with the proposal, and the wrongful trading provisions will not be modified by the fact a company may have spent a period of time in a moratorium prior to entering a formal insolvency.**

Sanctions

5.44 **In order to deter abuse by dishonest or reckless directors during a moratorium, the Government will introduce necessary sanctions for the types of behaviour discussed in the consultation document, thereby providing a further safeguard for creditors. There are sanctions in the existing small company moratorium in CVAs[23] and the Government will consider whether similar provisions are required for the new moratorium.**

Question 5 – *Do you agree with the Government's proposals regarding the duration, extension and cessation of a moratorium?*

[22] The term 'debtor-in-possession' means that the debtor (in this case the company) continues to operate its business. This contrasts with existing insolvency proceedings such as administration or liquidation where an insolvency office-holder takes control of the debtor's assets and affairs.
[23] For example, paragraph 16 Schedule A1 of the Insolvency Act 1986.

5.45 The majority of respondents who commented on this issue disagreed with the proposals for the length, extension and cessation of the moratorium as outlined in the consultation document.

Length

5.46 Several alternatives were proposed by those who disagreed with the proposed length. Most thought that it should be shorter than three months, citing difficulties with funding a lengthy moratorium period, and suggested that a shorter period would reduce the risk of abuse.

5.47 The most common length suggested was 21 days, but a number of respondents argued in favour of a variable period based on the size of the company seeking a moratorium. A few respondents thought that the moratorium should be longer than three months, commenting that, for example, it would not be possible to negotiate and sanction a scheme of arrangement within that window.

5.48 The Government has noted the significant opposition to the proposed moratorium period. Much of the opposition to the moratorium proposal, from both creditors and other categories of respondents, was on the length and the risks and potential abuse that may accompany a three month period.

5.49 While there was some support for a period of 21 days, **the Government believes that the moratorium should last for an initial period of 28 days, which may be extended (see below). This period achieves a good balance between allowing a company reasonable time to explore rescue options and temporarily suspending creditors' rights to take enforcement action against the company where there are grounds for doing so.** Smaller companies with less complex affairs will, in many cases, be able to formulate a rescue plan within the 28 days, and larger companies with more complex issues to address will have time to make an initial assessment of their options which can form the foundation of a rescue proposal and if necessary a proposal for extension.

5.50 **As the Government set out in the consultation document, it expects typical outcomes from a moratorium to be that a company agrees an informal restructuring with creditors, or a company enters an insolvency procedure, either a rescue procedure, such as a CVA, or a liquidation procedure.** The commencement of the outcome, either the date on which creditors agree a consensual workout or the statutory commencement of an insolvency procedure, will cause the expiry of a moratorium. Where no definite outcome is reached, a moratorium will expire at the end of the 28 day period (or the extended period, as discussed below), at which time creditors will regain their ability to take enforcement action against a company.

Extensions

5.51 A majority of respondents, who expressed an opinion on the proposed process for extending a moratorium, thought that the agreement of all secured creditors should not be a requirement. Some respondents suggested that the court could approve an extension if secured creditor agreement could not be obtained.

5.52 **To take into account the Government's decision to reduce the initial period of the moratorium from three months to 28 days, a new approach to extensions is necessary. The initial 28-day moratorium can be extended up to a further 28 days by the company, but the monitor must confirm that the qualifying conditions continue to be met. The monitor would then be required to notify creditors of the extension.**

5.53 When this possibility was discussed informally with stakeholders there was considerable agreement that this was sensible and proportionate. **Some stakeholders thought secured creditors should have a say in the initial extension approval, but the Government has decided against this suggestion to avoid an overly-prescriptive process.**

5.54 As a number of respondents noted, larger companies with complex debt structures may require more time to put together a successful rescue proposal, such as a scheme of arrangement or a restructuring plan. **For this reason, the Government believes it should be possible to extend a moratorium beyond 56 days.**

5.55 **As the Government appreciates from the responses received to the consultation, suspending creditors' rights beyond 56 days should only be done where there remains a good prospect of achieving a better outcome for creditors than might otherwise be possible. Such extensions must therefore be approved by creditors, both secured and unsecured. The required threshold for approval will be more than 50 per cent of secured creditors by value and more than 50 per cent of unsecured creditors by value. The Government also intends to allow the company to apply to court to extend a moratorium (much in the same way as it may extend the period of an administration[24]) if there are situations where seeking consent for an extension from creditors is impracticable.**

5.56 Where a statutory procedure, such as a scheme of arrangement or CVA, has been proposed to creditors before the expiry of a moratorium, but the outcome has not yet been determined (for example, a creditors' vote has yet to be taken), a moratorium would automatically extend until creditors approve or reject the proposal. It would be overly bureaucratic and unnecessarily costly for a company to seek an extension to cover the period during which a concrete proposal was being considered by creditors.

[24] See paragraph 76, Schedule B1, Insolvency Act 1986

Effect of a moratorium on the length of an administration

5.57 There were strong views expressed on the consultation proposal to subtract time spent in a moratorium from the statutory length of a subsequent administration[25]. A large majority of respondents who commented on this issue disagreed with the proposal. Objections included: administrative difficulties, disincentivising using a moratorium; and discouraging insolvency practitioners from taking administration appointments.

5.58 **In light of the strong opposition the Government has decided not to proceed with this particular proposal.** There was overwhelming support for this revised position when it was raised informally with stakeholders during further discussions after the summary of responses was issued.

Question 6 – *Do you agree with the proposals for the powers of and qualification requirements for a supervisor?*

5.59 **As referred to previously, the Government adopted the term ‘monitor’ during further discussions with stakeholders as it was felt the term ‘supervisor’ may lead to unnecessary confusion with the statutory office-holder in a CVA.**

Qualification

5.60 The consultation proposal of allowing an insolvency practitioner, solicitor or accountant with relevant expertise to act as a monitor provoked some very strong opinions with a large majority of respondents expressing the view that the role of supervisor could only be undertaken by a licensed insolvency practitioner.

5.61 In proposing to allow people other than insolvency practitioners to act as monitors, the Government was recognising the number of professionals involved in supporting business rescue upstream of formal insolvency as well as ensuring there was both capacity and competition in the restructuring sector[26] to undertake this work. It was, however, clear from a large majority of respondents, particularly creditors, that a licensed insolvency practitioner is seen as the only suitable professional to undertake the monitor role at this time.

5.62 There were a number of comments, not only from turnaround professionals, that insolvency practitioners did not possess the right skillset for restructuring, with some suggesting that insolvency practitioners’ strengths were weighted towards addressing balance sheet issues rather than dealing with a company’s economic problems including those related to its underlying business model. Some respondents also argued that only permitting insolvency practitioners to act as monitors would affirm in

[25] Under paragraph 76, Schedule B1, Insolvency Act 1986 the appointment of an administrator ceases to have effect at the end of the period of one year beginning with the date on which it takes effect (unless extended by creditors or the court).
[26] As of 1 January 2018, there were 1,276 appointment-taking insolvency practitioners in Great Britain.

suppliers' minds that a moratorium was an insolvency event, rather than a pre-insolvency event as intended by the Government.

5.63 **In spite of the comments mentioned above, the Government recognises that there is currently little support among creditors for anyone other than an insolvency practitioner to be able to act as a monitor. The Government agrees therefore that, at present, only an insolvency practitioner should be able to perform this role. However, the Government intends for the monitor's qualification requirements to be set by regulations, allowing the Government to amend the list of qualified persons if and when it becomes appropriate to do so, without the need for primary legislation.** This leaves open the possibility for other professions to develop regulatory frameworks that meet market expectations, with the aim of increasing competition in this sector.

Role

5.64 A common theme in responses on the role of the monitor was that respondents felt the proposals lacked sufficient detail to allow firm conclusions to be reached.

5.65 **While the company's directors remain in control of the company's operations during the moratorium, the Government intends the role of the monitor to be limited in scope to functions necessary to support the integrity of the moratorium process and ensure creditor interests are protected. The monitor will be responsible for:**

- **assessing the eligibility conditions at the commencement of the moratorium;**
- **assessing and monitoring the qualifying conditions at the commencement of and throughout the duration of a 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.**

5.66 **In order to undertake their duties successfully, a monitor will have powers 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.**

5.67 **Where the monitor concludes a company no longer meets the qualifying conditions, they will be required to immediately commence the termination of the moratorium. This is an important safeguard for creditors and will serve to**

avoid or minimise any new liabilities being created during a moratorium. The monitor will be required to notify the court, the company and the creditors.

5.68 **Following termination of a moratorium, creditors will again have full rights to enforce their debts. To address the risk of legal action being brought against a former monitor by a company where that monitor made an error in their assessment of the qualifying conditions, the Government intends to give monitors immunity from claims stemming from erroneous termination providing they acted in good faith. The Government believes this approach is justified in light of the importance of immediate termination if the qualifying conditions are no longer met, and it is designed to avoid monitors acting in an overly cautious manner to the detriment of creditors and suppliers.** Insolvency practitioners are subject to a detailed regulatory framework which provides appropriate avenues for complaint and redress where an individual fails to comply with their legal duties as an insolvency practitioner.

5.69 A number of responses to the consultation feared that rogue directors may abuse a moratorium by using it to unlawfully transfer assets from the company. **The Government confirms that, as an additional safeguard for suppliers and creditors, a monitor will be required to sanction any sale or other disposal of assets outside the normal course of business during a moratorium.**

5.70 In discussions after the consultation, some stakeholders argued that insolvency practitioners would be uninterested in a monitor role if it was limited in scope, as fees for such work would be relatively modest. However, there will be no prohibition on insolvency practitioners providing additional services to a company in a moratorium, such as restructuring advice or consultancy services.

5.71 It is important that no conflicts of interest arise in the course of a monitor’s duties or, if they do, they are managed appropriately to ensure all stakeholders’ interests are safeguarded. **The Government believes that the existing regulatory regime and the Insolvency Code of Ethics will achieve these aims.**

5.72 **Additionally, the monitor will be an officer of the court. The advantages of this include any wrongful interference with the monitor constituting contempt of court and the monitor having immunity against actions in respect of statements they make in the course of and for the purpose of proceedings. This should also act as a further safeguard for suppliers and creditors in that an officer of the court must act honourably and fairly and is subject to the direction of the court.**

Fees

5.73 The monitor’s fees are to be a contractual matter between the monitor and the company appointing them. During further discussions with stakeholders, there was little or no appetite for putting in place a statutory regime governing the monitor’s remuneration. If a company subsequently enters formal insolvency, an administrator or liquidator would have an express power to challenge the monitor's fees if they were unreasonable.

Subsequent appointments

5.74 There was considerable debate regarding the proposal to prohibit a monitor from taking an appointment if the company they had acted in respect of entered formal insolvency, for example administration. Some respondents highlighted the potential cost advantages of the same insolvency practitioner taking a subsequent appointment on the grounds that that person would be familiar with the company's operations, eliminating duplicated costs for another insolvency practitioner to conduct the same work or review work already carried out by the monitor. A number of safeguards were suggested by respondents, such as requiring creditors to approve the monitor's subsequent insolvency appointment. Others agreed with the proposal, citing conflict of interests concerns, or arguing that allowing monitors to act in a subsequent insolvency would lead to the damaging perception that monitors would be incentivised to encourage companies to enter formal insolvency.

5.75 **The Government has listened carefully and considered the contrasting viewpoints. It thinks that the potential for a slight increase in costs is a necessary price for creating a positive perception of the new pre-insolvency moratorium which, while not being an insolvency procedure, will nevertheless interfere with creditors' rights.**

5.76 **However, some modification to the original proposal seems justified. The prohibition on taking a subsequent appointment will last 12 months, but will only apply in the case of administration and liquidation. The monitor will be permitted to take a subsequent appointment in a CVA. The Government's consultation proposals are aimed at helping business rescue. The moratorium proposal is meant to provide a financially distressed company time to consider the options open to it. Where the company is viable and has a sustainable future, a CVA may be a realistic way to secure that future and deliver the best outcome for its creditors. The Government would therefore not want to discourage the monitor from facilitating this outcome by prohibiting them from acting as the CVA supervisor. It should also be noted that as the proposals for a new restructuring plan do not feature the role of a statutory office-holder, a monitor would not be prohibited from advising in relation to a restructuring plan once one had been agreed by creditors.**

5.77 A number of stakeholders said that they thought a greater level of protection would be provided if the prohibition on taking subsequent appointments applied to all insolvency practitioners from the same firm rather than to an individual practitioner. **The Government notes that insolvency legislation is predicated on individual appointments but will consider this point further.**

Question 7 – *Do you agree with the proposals for how to treat the costs of the moratorium?*

5.78 A sizeable majority of respondents who answered this question agreed that the costs of a moratorium should be dealt with as proposed in the consultation. A small number of respondents disagreed while some respondents felt there was insufficient detail in the proposal to make a determination.

5.79 **The Government intends that costs incurred during a moratorium will be treated in the same way as an expense in an administration. Where a company exits a moratorium and subsequently enters administration or liquidation, any unpaid moratorium costs will enjoy super-priority over any costs or claims in the administration or liquidation, including the expenses of such procedures. Highest priority would be afforded to any suppliers prevented from relying on contractual termination clauses (see section on "Helping businesses keep trading through the restructuring process"). Any other costs would rank next, followed lastly by any unpaid fees due to the monitor.**

5.80 Some respondents questioned the impact of this super-priority on subsequent insolvencies and this was discussed further with stakeholders. Some stakeholders thought insolvency practitioners would be reluctant to take appointments as administrators if their fees ranked below any unpaid moratorium costs.

5.81 **The Government accepts that there are downsides to giving super-priority to unpaid moratorium costs but, in order to encourage rescue, thinks this approach is justified.** The objective of the moratorium process is to facilitate rescue and where this is achieved there should not be any unpaid moratorium costs. As the monitor has a duty to ensure that the company continues to adhere to the qualifying condition that it meets its current obligations as they fall due throughout the period of the moratorium, any unpaid moratorium costs should, in most cases, be limited.

5.82 Insolvency practitioners are free to choose whether or not they take appointments in insolvency procedures. This is not the case for an official receiver when appointed as a liquidator by the court in a compulsory winding-up in England and Wales. **As such, the Government intends to make an exception for an official receiver's statutory fees, which will not be affected by the super-priority of any unpaid moratorium costs. This reflects an official receiver's unique role as liquidator of last resort.**

5.83 **The priority arrangements discussed in the paragraphs above mean that the Government does not intend to modify existing rules relating to set-off during the moratorium process.**

Question 8 – *Is there a benefit in allowing creditors to request information and should the provision of that information be subject to any exemptions?*

5.84 A large majority of respondents who commented on this proposal agreed that there was benefit in allowing creditors to request information. Many of those who did not agree with the proposal were insolvency practitioner firms. Common themes raised by both those who agreed with the proposal and those who were opposed included:

- the costs of responding to requests for information;
- the problem of excessive or even vexatious requests;
- other legal restrictions on using data;
- commercial sensitivity; and
- the potential for dealing with requests to distract from the task of rescuing the company.

5.85 There was widespread agreement that transparency is a desirable feature in the insolvency framework. However, there were fears that giving creditors a broad legal power to request information at any time could be costly and potentially disrupt the company's rescue. Respondents were, in the Government's view, unable to suggest effective solutions that would overcome the problems they had identified.

5.86 As the role of the monitor is to be a limited one, the monitor would not have access to information creditors may request. The directors would remain in control of the company throughout the moratorium process, but it would be burdensome and inefficient for the monitor to relay requests for information to the directors. Imposing a legal duty on directors to provide information on demand would be undesirable as this could cause distraction at a time when the company needs to focus on its rescue or restructuring.

5.87 **The Government wants the moratorium to be transparent for creditors but does not wish to confer unnecessary burdens on the process or on an already financially-distressed company. The Government will seek to develop a solution that provides creditors with information in a timely manner, whilst minimising the burden on the monitor and the debtor company.**

Helping businesses keep trading through the restructuring process

5.88 The Government proposed that in a moratorium, a company would be given the right to designate some contracts as essential contracts (in addition to the continued provision of IT and utilities which is already required by statute). Such contracts could not be terminated or varied during a moratorium, or subsequent CVA, or administration. The supplier would have to continue to supply, subject to safeguards.

Question 9 – *Do you agree with the criteria under consideration for an essential contract? Is there a better way to define essential contracts? Would the continuation of essential supplies result in a higher number of business rescues?*

Question 10 – *Do you consider that the Court's role in the process and a supplier's ability to challenge the decision, provide suppliers with sufficient safeguards to ensure that they are paid when they are required to continue essential supplies?*

5.89 The questions posed in the consultation document provoked a wide range of responses. Among those responses there was considerable support for the rationale behind the proposals, and wide agreement that measures of this nature were needed. Some respondents thought that the proposals would result in a higher number of business rescues.

5.90 There were also a considerable number of respondents opposed to the proposals, but many of these also agreed something could be done to address the problems of termination of supplies in insolvency situations, including that of ransom payments[27] . As with the Government's moratorium proposals, some respondents found these measures too weighted in favour of the debtor company and open to abuse. Warnings of potential negative consequences often focused on the risk of knock-on insolvencies among suppliers. At least one respondent thought such provisions were not necessary in the restructuring of large businesses with complex capital structures, noting that in such restructurings trade creditors were often unaffected.

5.91 A number of respondents suggested different approaches to the Government's proposals.

Problems identified

5.92 Several respondents expressed concerns that the proposals would have significant detrimental consequences for those suppliers designated as essential. A number of respondents argued that a supplier may already be a significant creditor, and forcing that supplier to continue supplies could have severe consequences if further supplies were not paid for. Respondents noted that commercial payment terms can sometimes be 90 or 120 days which could create unfair risk to suppliers designated as essential.

5.93 Concerns were also raised by a number of respondents regarding who would designate essential suppliers in a moratorium. Some respondents did not think the directors of the company should have an unfettered right to designate essential suppliers, with some respondents suggesting that the monitor should designate or at least have a role in the process, possibly even a power to veto the directors' designation.

5.94 There were a very significant number of responses that raised concerns regarding the supplier's ability to challenge the decision at court. While few were opposed to the principle of the court being involved, many responses focused on matters of timing and

[27] A ransom payment occurs in a situation where a supplier whose goods/services are crucial for the continuation of the business uses its leverage post-insolvency to demand higher payment (or repayment of pre insolvency balances) for the continuing supply of the same goods or services.

cost – on whether the supplier could afford the challenge, and whether the court would be able to hear it in a realistic timetable. One respondent thought that suppliers would automatically challenge being designated as essential, thereby increasing the costs of and reducing the likelihood of rescue.

5.95 It was clear, even from those responses that welcomed the measure, that there were significant problems with the essential supplies proposal. Issues of cost, speed, fairness and the impact on SME suppliers all led the Government to reconsider the matter.

5.96 One of the key underlying issues affecting the Government's consultation proposal was the principle of designation. The Government thought it was absolutely necessary to allow suppliers to challenge a designation as essential if they did not agree with it. While the court was considered the most suitable venue for determining questions around designation, the practical difficulties raised by respondents of timing and cost meant that the proposed right of challenge did not give adequate protection.

5.97 **The Government no longer intends to require the designation of essential suppliers by a debtor company. Instead, the Government will legislate to prohibit 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. This is an approach that is common among a number of other states with highly-ranked insolvency regimes.**

5.98 Termination clauses (sometimes called '*ipso facto*' clauses) that permit one party to terminate a contract due to the insolvency or financial condition of another party will not take effect where the recipient of the goods or services enters a formal insolvency procedure,[28] the pre-insolvency moratorium process outlined above in this document or the restructuring plan process outlined below. Suppliers will have to continue to fulfil their commitments under their contract with the debtor company. This will help businesses trade through the rescue and restructuring process, permitting a degree of stability in their operations so that rescue will be more likely.

5.99 Suppliers will retain the ability to terminate contracts on any other ground permitted by the contract. These would include:

- 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

[28] i.e. a corporate insolvency procedure provided for in the Insolvency Act 1986, such as administration, liquidation or CVAs.

- 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.

5.100 There would be no effect on ordinary contract termination based on time, i.e. if a fixed term contract expired during a moratorium, restructuring plan, or insolvency procedure, the supplier would not be compelled to continue nor renew the contract.

Exemptions

5.101 Some consultation respondents commented that they thought certain types of supplier, particularly those in the financial sector should be exempted from the effects of the proposal.

5.102 Some stakeholders thought that if finance providers were not exempted, it would lead to them withdrawing their products and services much earlier, perhaps at the first sign of financial difficulties and far in advance of the directors considering options such as entering a moratorium. This could have the effect of placing more companies at risk including ones that would not otherwise experience significant financial distress. **The Government acknowledges that certain types of financial products and services represent special cases and therefore accepts that there are grounds for exempting such products and services.**

Licences

5.103 The issue of licences was also raised in responses to the consultation. During further discussions with stakeholders members of the insolvency profession strongly emphasised the importance of licences, memberships and certification to certain types of businesses. This extended to suggesting overriding certain statutory requirements if insolvency had no bearing on the company's ability to act in accordance with the relevant provisions.

5.104 **The Government intends that contractual licences, such as for use of software or patents, will be covered by the '*ipso facto'* provisions, acknowledging the importance of these to certain businesses and sectors. The Government does not, however, think that licences issued by public authorities should be affected and there may be legitimate public policy grounds for revoking such licences on the insolvency of a company, which should be allowed to take effect. Existing rules relating to particular licensing regimes will therefore remain unaltered.**

Hardship

5.105 As the consultation responses highlighted, provisions aimed at helping a financially distressed company to trade through the rescue and restructuring process, may have the effect of disadvantaging the suppliers whose contractual rights are interfered with by operation of statutory provisions. The Government acknowledges there must be strong justification for doing so and believes that improving the prospects of company rescue and therefore preserving viable businesses and jobs meets this test. The consultation proposal only affected those designated as essential suppliers by the company. The modified approach outlined above will affect all suppliers (with the exception of those that are exempted).

5.106 In administration, liquidation and the moratorium, suppliers have the protection of high priority under the rules on expenses meaning that they are unlikely not to be paid for any supplies they provide should a debtor company enter one of those procedures.

5.107 **The Government thinks that the risks to suppliers contained in the original consultation proposal are much reduced by the revised approach adopted. However, as a safeguard of last resort, in rare cases where a supplier will be in a position that it is significantly adversely affected by not being able to rely on a contractual termination clause, it will be allowed to exercise such a right on the grounds of undue financial hardship.**

5.108 **The supplier will need to seek permission from the court in order to terminate supplies. The court, in considering any such application, will consider whether or not in being compelled to continue supply, that supplier would be more likely than not to enter an insolvency procedure as a consequence. In addition, the court will also have to consider if exempting the supplier from the obligation to supply is reasonable in the circumstances, having regard to the effect of non-supply on the debtor company and its prospects of rescue.**

5.109 **The issues of timing and the costs of court challenge that surrounded the original consultation proposals cannot be eliminated in this modified approach, but the Government is of the view that a financial hardship provision is justified as a safeguard in extreme cases. The threshold for being exempted by the court is set purposefully high so that a supplier should only resort to court if continued supply threatens its own solvency. This should mean relatively few applications are made.**

Personal guarantees

5.110 The issue of personal guarantees was addressed by a number of respondents to the consultation. On one hand, some thought that personal guarantees should have to be given by the directors (in a moratorium) or insolvency office-holders (in insolvency procedures) while on the other, some argued that this should not be the case.

5.111 The matter was considered at some length during further discussions with stakeholders following the consultation, including in the context of the proposed revised approach. Stakeholders still held contrasting views with some, particularly creditor representatives, thinking that requiring directors to give personal guarantees in a moratorium would focus minds and deter abuse. Others thought requiring personal guarantees would deter directors from using a moratorium, and therefore fail to achieve the Government's objective of improving company rescue. Another argument made was that many directors may have already given personal guarantees, exposing them to liabilities in excess of their personal assets, so giving further personal guarantees would be worthless and may only offer false comfort.

5.112 The insolvency profession was very clear that it did not think the monitor should have to give personal guarantees.

5.113 **While opinion was divided, on balance the Government thinks personal guarantees should not be required where a supplier continues supplies, due to not being able to rely on insolvency-related termination clauses. The concept of limited liability is a key aspect of the UK's corporate framework encouraging entrepreneurship and growth. Encroaching upon limited liability should not be done lightly and, in this case, the Government does not think the potential advantages outweigh the many disadvantages. As set out above, an insolvency office-holder will be able to bring an action against a director for wrongful trading during a moratorium (as unlikely as that should be) and suppliers who are prevented from relying on contractual insolvency-related clauses will have super priority for supplies made during the moratorium period in the event of a subsequent insolvency. The Government thinks these protections are sufficient not to require personal guarantees.**

Developing a flexible restructuring plan

5.114 The Government proposed introducing a new restructuring procedure that would allow a company to bind all creditors, including junior classes of creditors even if they vote against the plan, through the use of a cross-class cram down provision. Such cram down could be imposed provided dissenting classes of creditors were no worse off than they would be in liquidation. The classes of creditors would be proposed by the distressed company on a case by case basis. For a class to vote in favour, 75 per cent of a class by value, and more than 50 per cent by number, would have to agree to the plan.

Question 11 – *Would a restructuring plan including these provisions work better as a standalone procedure or as an extension of an existing procedure?*

5.115 Many respondents to this question, also stated whether or not they thought such provisions were needed, or if they agreed with the principles underpinning them.

5.116 There were a small number of respondents who were opposed to the proposal. The main reason for this opposition was that those respondents felt the proposals were so similar to existing provisions in company law and insolvency law that they were not needed and would add further complexity to the framework. Some also thought that the proposal featured disadvantages the existing provisions, particularly schemes of arrangement, did not suffer from. This included reduced stigma associated with schemes and the wider jurisdictional test that allows non-UK based companies to use the English court providing they have sufficient connection with this jurisdiction.

5.117 Most respondents, however, agreed with the assertion that provisions of this type were needed. Respondents thought there were shortcomings in the existing insolvency framework and with schemes of arrangement, such as the inability to involuntarily bind secured creditors to a CVA and the lack of cross-class cram down in schemes of arrangement, which necessitated either modifications to those procedures or a new one.

5.118 Turning to the specific question posed in the consultation document, some of those who answered this question favoured a new standalone procedure. These respondents suggested that this would, among other things, have fewer negative associations with existing procedures, promote flexibility and allow a wider range of companies to benefit from a restructuring plan.

5.119 There were a small number of respondents who thought the better option was to incorporate the proposals into the existing CVA framework. In addition to these there were a number of responses in which respondents thought improving the CVA framework in other ways would be more productive.

5.120 A number of respondents thought modifying the existing scheme of arrangement framework was a better option, noting the similarity between the proposals and schemes of arrangement including class formation and the ability to bind secured creditors.

5.121 Some respondents expressed concerns that the proposal would mean interference with the existing scheme of arrangement provisions noting that they work well and are well regarded internationally.

5.122 A number of respondents thought a restructuring plan was most suited to use by large companies with complex capital structures, some stating that the procedural need to have two court hearings would involve considerable cost thereby making it a less viable option for smaller companies. Many of these respondents thought this was appropriate, stating that they thought CVAs were better suited to smaller companies, and arguing that the CVA procedure should therefore be retained.

5.123 **The Government has listened to the views of respondents, and remains firmly of the view that measures of the type consulted on are necessary to support company rescue and fill an existing gap in the company and insolvency frameworks. The proposed restructuring plan will allow the cross-class cram down of a company's restructuring proposals onto both secured and unsecured creditors. The Government's intention to proceed with its moratorium proposals also means that a statutory moratorium will be available, subject to eligibility, to protect a company while it prepares its proposal to creditors, rather than the**

company having to rely on judicial discretion for such protection as under a scheme of arrangement.

5.124 **There was more support for introducing the proposals as a standalone procedure than for any other option. The Government agrees this is the best way to proceed.**

5.125 It was clear that there were concerns around the possibility of modifying the existing framework for schemes of arrangement which respondents said works well. The **Government is aware of the importance of schemes of arrangements to facilitate the restructuring of large international companies and as a result does not propose to make any changes to the existing law of schemes.**

5.126 A number of respondents disagreed with the assertion that CVAs are limited as a tool for company rescue due to their inability to bind secured creditors. Respondents said that CVAs often fail due to the directors' proposals being overly optimistic, and their failure to properly address the underlying economic problems in the company's business model (rather than just the immediate financial problems presented by the company's indebtedness).

5.127 **The Government has noted these views but concludes that CVAs are a useful tool in the right circumstances and represent what can be a relatively low cost restructuring option.**

5.128 A number of respondents commented that they thought this proposal was aimed at larger companies, with some advocating threshold tests should be introduced to restrict the use of restructuring plans to companies above a certain size. **The Government believes the restructuring plan should be available to all companies as there may be circumstances where a smaller company may better effect a rescue via a restructuring plan than by using a CVA.**

Further details of the restructuring plan provisions

Eligibility

5.129 **As set out in the consultation document, the Government does not intend to make the restructuring plan available to all companies.** In line with the moratorium provisions, the type of companies currently excluded from eligibility for the small company CVA moratorium[29], namely those involved in specific financial market transactions, and any similar undertakings, will also be excluded from these provisions. This is to avoid interfering with the proper functioning and integrity of those markets.

[29] Schedule A1, Insolvency Act 1986

5.130 No financial conditions will be set in order to qualify for a restructuring plan. This means both solvent and insolvent companies will be able to propose restructuring plans to their creditors.

5.131 **The Government believes allowing solvent companies to address emerging financial difficulties will reduce stigma and encourage earlier action on the part of directors, thereby avoiding value-destructive action and leading to better outcomes on the whole for creditors and other stakeholders in a company. The protections built into the proposals will safeguard creditors from unfair detriment where their contractual rights are interfered with by the effect of a restructuring plan.**

5.132 **As there will be no financial entry criteria, a company in an insolvency procedure, acting through the insolvency office-holder, may propose a restructuring plan to creditors. This is in line with existing provisions in the framework such as the ability of a liquidator to propose a CVA. While the Government does not think this would happen often, maximum flexibility is desirable to ensure viable businesses do not fail unnecessarily.**

5.133 The issue of jurisdiction was discussed with stakeholders following the consultation, a number of whom thought that the restructuring plan provisions should be accessible to companies that do not have their centre of main interests in the UK. This would mean taking a different approach to the current jurisdictional conditions for entry into administration, in line with schemes of arrangement, which use the broader test of whether or not a company has sufficient connection with the relevant court of the UK. The Government will continue to consider the issue of jurisdiction in the context of the UK's departure from the European Union.

Process

5.134 Consultation responses and discussions with stakeholders have persuaded the Government of the benefits of modelling the restructuring plan procedure on that of schemes of arrangements. As well as familiarity, this will have the advantage of providing a long-established and tested body of jurisprudence that courts will be able to draw upon when dealing with the new restructuring plan and considering matters such as class formation. Respondents also made very clear that the restructuring plan provisions ought to be as flexible as possible to cater for the widest range of restructuring outcomes.

5.135 **The process will therefore closely resemble that for schemes. A restructuring plan proposal will be sent to creditors and shareholders and filed at court. At a first hearing the court will examine the classes of creditors and shareholders as defined by the company. Creditors and shareholders may challenge class formation if they think the company's classes do not accurately reflect the rights and interests of different classes. If satisfied, the court will confirm that a vote**

on the proposal may be conducted on a specified date ahead of a second hearing if required. Necessary information would be anything that creditors need in order to make a decision whether or not to support the proposal, with the Government prescribing certain mandatory matters that must be covered in all cases. This may take the form of something like the explanatory statement used in schemes.

5.136 The Government thinks it unlikely that viable proposals could be put forward (in the first place) by anyone other than the company acting through its directors (or a statutory office-holder acting in an insolvency procedure). The proposal will need to contain information, such as detailed valuation data, that others would not have access to (for both legal and commercial reasons). Accordingly it will only be possible for the company to instigate a restructuring plan proposal. Creditors and shareholders will, however, have the ability to submit a counter-proposal if they disagree with the directors' proposal and the court may permit any such counter-proposal to be put to creditors and shareholders.

5.137 **If no challenges are brought or no counter-proposals permitted by the court then creditors and shareholders will vote on the proposal. The Government intends to encourage the use of electronic voting and communication more generally in line with recent legislative initiatives aimed at streamlining and reducing the cost of administering insolvency proceedings.[30] Voting is discussed further below.**

5.138 **Subject to the requisite voting thresholds being met and the rules for imposing a cross-class cram down being complied with (discussed below), the court will then schedule a second hearing at which it will consider if the necessary requirements have been met and will make a decision whether or not to confirm the restructuring plan and make it binding on affected creditors and shareholders.**

5.139 **Several stakeholders asked if a 'supervisor' was needed to oversee the implementation of a restructuring plan confirmed by the court. The Government thinks that in some circumstances it may be beneficial to have a person responsible for this role (such as a 'chief restructuring officer') but, as this may not be necessary in every case and to avoid imposing unnecessary cost, does not intend to prescribe such a role. This approach allows maximum flexibility and if, for example, creditors demand some form of supervision as a prerequisite for their approval of a restructuring plan, it may be provided for in the terms of the proposal. Such a person would not be subject to any specific qualification requirements as this would be a matter for the parties to decide.**

[30] See the Insolvency (England and Wales) Rules 2016 – in particular the use of websites and new provisions on decision making in insolvency proceedings.

Terms and effect of a restructuring plan

5.140 **The Government thinks that to be an effective rescue tool, there should be a minimum of prescription as to what type of proposal may be made to creditors and shareholders. It will be for the company to propose terms that it thinks will be agreeable to creditors and therefore capable of being confirmed by the court. This will allow a restructuring plan to address various aspects of a company's difficulties including economic as well as financial ones. A restructuring plan may therefore provide for debt write-down or debt postponement as well as other matters such as a change in the management team or selling off loss-making parts of the company. This will allow maximum flexibility to support the best interests of both the company and its creditors.**

5.141 There was strong opposition from a small number of respondents regarding the consultation proposal to limit the restructuring plan's duration to 12 months.

5.142 **The Government accepts that imposing a 12-month time period would unnecessarily restrict company rescue and will therefore leave it to the parties to a restructuring plan to determine what the appropriate time period should be. Creditor interests are safeguarded in other ways - if creditors think a proposed plan duration is too long, they need not vote in its favour (and may present a counter proposal of shorter duration). This fits in with the Government's intention to make the restructuring plan procedure as flexible as possible and mirrors the approach in CVAs and schemes, which do not have a fixed statutory length.**

5.143 A restructuring plan confirmed by the court will be binding on all affected parties. Parties' rights following confirmation of a restructuring plan will be as provided for in the plan. Any previous rights will be extinguished by the plan being confirmed by the court. Were a company to enter an insolvency procedure following the failure of a restructuring plan, the rights and claims of any creditors bound by the failed plan would be as under the plan. By way of example, if a creditor was owed £1m before a plan was agreed and retained a debt of £500,000 under the agreed plan, in the event the debtor company subsequently failed and entered formal insolvency, the creditor would only be permitted to claim £500,000 in the insolvency proceedings.

Question 12 - ***Do you agree with the proposed requirements for making a restructuring plan universally binding in the face of dissention from some creditors?***

Question 13 - ***Do you consider the proposed safeguards, including the role of the court, to be sufficient protection for creditors?***

5.144 The majority of responses agreed with the basic principle that a court-approved cross-class cram down should bind dissenting classes of creditors to the terms of a restructuring plan.

5.145 A number of respondents referred to problems that can be caused by ransom or hold-out creditors[31] and that cross-class cram down is a useful method to resolve such issues. Other respondents also expressed the view that having such provisions would encourage more consensual restructurings if creditors knew the debtor company had the option of a cross-class cram down in a restructuring plan.

5.146 There were also a small but significant number of respondents opposed to the proposals including a number of creditor representatives. These responses commented on issues such as the cost resulting from the level of court involvement, the potential impact on small businesses, and potential impact on lending practices.

5.147 A common issue noted by many, including both those broadly in favour and those opposed, was the importance of choosing the right valuation standard to ensure dissenting creditors affected by a cross-class cram down were adequately protected. Many respondents, including those in favour of the principle of cross-class cram down, thought the liquidation standard set out in the consultation proposal was the wrong standard. This is discussed further below.

5.148 **The Government agrees with the majority of respondents that a procedure that allows for the cross-class cram down of dissenting classes of creditors, subject to safeguards, would be a useful addition to the UK's business rescue tools. The introduction of such provisions will help the UK maintain its position as a leading global restructuring hub. The restructuring plan will represent a streamlined procedure in which dissenting classes of creditors, most importantly those who are 'out-of-the-money' (i.e. those who, under the order of priority for creditor repayment in administration or liquidation, would not receive any dividend), may be bound to an arrangement that is in the best interests of all stakeholders. The Government also agrees with those respondents who opined that the existence of such a procedure may well encourage more consensual restructurings.**

The role of the court

5.149 The Government has set out above the procedure for restructuring plans. The court will safeguard creditor and shareholder rights at the points of:

- examination of class formation after a restructuring plan has been filed at court, before permitting a debtor company to arrange a vote;
- confirmation of the restructuring plan, if creditors and shareholders have approved the proposal including applying a cross-class cram down of dissenting classes; and

[31] Certain creditors may seek to disrupt a restructuring process to improve their own treatment under the restructuring proposals. This is likely to come at the expense of other creditors.

- on appeal by any creditor or shareholder following confirmation of the restructuring plan.

5.150 Class formation was generally viewed by many respondents as a sensible way to separate creditors for the purposes of voting. The existing regime for schemes of arrangement in this regard was regarded as a strength of the scheme provisions. A number of respondents also stressed the importance of creditors being able to challenge class formation prior to voting on the proposal.

5.151 **The Government's intention is to make provisions closely resembling schemes of arrangement so that jurisprudence on class formation that has been built up over many years can be used to guide courts in their examination. This should address the concerns of the small number of respondents who thought the method of class formation should be prescribed in legislation as courts would struggle otherwise. The Government notes comments made by several respondents about the potential for litigation, and accepts that there will be cases where creditors challenge the classes put forward by the company. The Government believes that the overall aim of facilitating more company rescues justifies this approach. The experience of schemes supports this decision.**

5.152 Some respondents considered that the court should have absolute discretion whether or not to confirm a restructuring plan and that this was an important safeguard for creditors and shareholders. **The Government agrees and will provide for this and that there be a right of appeal to court following confirmation of a restructuring plan.**

Voting thresholds

5.153 **The Government intends to proceed with the voting threshold set out in the consultation document requiring 75 per cent in value (measured by value of gross debt) of the creditors within each class (who vote) to vote in favour of a restructuring plan. No respondent advocated an alternative threshold.**

5.154 There were, however, a number of respondents and stakeholders who argued against the second requirement contained in scheme legislation that a majority in number also be required.

5.155 **While attracted by respondents' reasoning on why a majority in number of creditors should not be needed to approve a restructuring plan, the Government was concerned that minority creditor interests be adequately safeguarded. To ensure adequate protection is maintained, the restructuring plan will feature a modification of the connected party[32] voting provisions used in the existing**

[32] Section 249 Insolvency Act 1986 provides that a person is connected with a company if - (a)

insolvency framework[33]. The voting threshold of 75 per cent in value will be supplemented by the additional provision that more than half of the total value of unconnected creditors vote in support.

Cross-class cram down

5.156 Many responses highlighted the need for safeguards and requirements for a cross-class cram down to be imposed upon dissenting classes of creditors. A number of responses expressed concerns in respect of the consultation proposal that secured creditors be granted absolute priority on repayment of debts and that junior creditors should not receive more than creditors more senior than them.

5.157 As was pointed out by a number of respondents, the proposal was similar to the 'absolute priority rule' (APR) contained in Chapter 11 of the US Bankruptcy Code as well as in the restructuring procedures of a number of other countries. Though subject to variations, the APR generally provides that the claims of a class of creditors must be paid in full before any class of creditors junior to that class may receive or retain any property in satisfaction of their claims, unless the more senior class consents to any departure from this principle. This is often supplemented with the added condition that no class of creditors should receive more under a restructuring proposal than they are owed.

5.158 Some respondents highlighted the importance of the absolute priority status of secured creditors set out in the consultation proposal, while another expressly referenced the need for an APR.

5.159 Although the APR is used in a number of restructuring regimes around the world, the Government has concerns about the lack of flexibility it provides.

5.160 The UNCITRAL Legislative Guide states, *'the limitation of this approach, however, is that it may reduce the chances for a successful reorganization where the encumbered assets or modification of the rights of such creditors are key to the success of the plan.'*[34] The European Law Institute's recent *Rescue of Business in Insolvency Law* paper also notes considerable criticism of the inflexible nature of the rule, referencing the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 (2014) in which the absolute priority rule is described as, *'inflexible and often a barrier to a debtor's successful reorganization'*[35].

5.161 As was noted, there may be very good reasons to deviate from an APR. A company may, for example, require the continued support of an essential supplier, which may

he is a director or shadow director of the company or an associate of such a director or shadow director, or (b) he is an associate of the company. "Associate" has the meaning given by section 435.

[33] See for example Rule 15.34(4), the Insolvency (England and Wales) Rules 2016.

[34] http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf at p220.

[35] http://www.europeanlawinstitute.eu/fileadmin/user_upload/p_eli/Publications/Instrument_INSOLVENCY.pdf at p324

only be agreed in the longer term on condition of treatment over and above what other creditors in the same class or even a more senior class may be receiving under the restructuring plan.

5.162 US experience has highlighted the potential for abuse of the APR whereby sophisticated parties seek to benefit at the expense of others. The trend of predatory market players cheaply acquiring junior secured debt as existing bondholders sell out, and then using restructuring negotiations to extract maximum value for themselves, regardless of the interests of other creditors or the rescue of the debtor, is well documented. Allowing opportunistic creditors to exploit restructurings by blocking restructuring plans that the majority of creditors support, until they are given unreasonably favourable treatment, would not assist the Government's aim of improving the prospects for company rescue.

5.163 **The Government thinks that strong creditor protections are essential to create the right conditions for business lending and trading. Where a cross-class cram down is to be applied, a requirement is needed to safeguard creditor interests that respects and applies the ordinary order of priority in liquidation and administration. The restructuring plan legislation will 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.**

5.164 **The Government wants to inject flexibility into the APR, given the criticisms of US approach. The ability to act flexibly and pragmatically are not just desirable features in a restructuring procedure, but essential ones if the framework is to facilitate business rescue. The Government intends to permit the court to confirm a restructuring plan even if it does not comply with this rule where non-compliance is:**

- **necessary to achieve the aims of the restructuring; and**
- **just and equitable in the circumstances.**

5.165 **This two-stage test for permitting non-compliance creates a high threshold. The basic principle that a dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution will, in most cases, be followed. But there is sufficient flexibility to allow departure from it (with the court's sanction), where the departure is vital to agreeing an effective and workable restructuring plan. This will provide adequate protection for creditors while also achieving the best outcome for stakeholders as a whole.**

5.166 **The Government wishes to clarify that this test for the application of a cross-class cram down is in addition to the court's absolute discretion whether or not to confirm a plan on just and equitable grounds.**

5.167 **As an additional safeguard to ensure creditors are adequately protected, the Government intends that at least one class of impaired creditors (that is, creditors who will not receive payment in full under the restructuring plan) must vote in favour of the restructuring plan in order for a cross-class cram down to be confirmed by the court.**

5.168 **A number of categories of debt are not provable in administration and liquidation, such as fines and confiscation orders. The Government intends to prevent certain categories of debt from being crammed down in a restructuring plan on similar public policy grounds to those in administration and liquidation.**

Question 14 - ***Do you agree that there should be a minimum liquidation valuation basis included in the test for determining the fairness of a plan which is being crammed down onto dissenting classes?***

5.169 Valuation in a restructuring plan was, as a number of respondents commented, one of the most challenging and complex issues contained in the consultation document.

5.170 Many of the respondents who answered this question agreed with the proposal that there should be a minimum liquidation value test for determining the fairness of a plan which is being crammed down onto dissenting classes.

5.171 While there was a lot of support for the proposal, a majority of respondents argued that liquidation was not the right comparator. Some thought a more appropriate comparator would be the ‘next best alternative’ to the restructuring plan or some similar formulation, noting that in many cases, were a restructuring plan to be rejected, administration would be most likely to follow thereafter. Some respondents thought the appropriate standard was what would happen in a particular case were the restructuring plan not to proceed. Other ideas, such as the midpoint in a range of values, were also proposed.

5.172 Many respondents noted how contentious valuation can be, both in the UK’s schemes of arrangement and the US’s Chapter 11 proceedings. The Government acknowledges that disputes over valuation may result in costs and delay to restructuring plans being confirmed or not. The responses received indicate that it is highly unlikely that any standard chosen would completely remove the potential for dispute given the importance of the valuation in determining who may be crammed down. Even if a straightforward option, such as liquidation value, was used, that would not eradicate the possibility of creditors challenging a valuer’s assessment based on factors such as valuation method employed. As a number of respondents pointed out, there are many valuation methods in common use so there will be different opinions as to which is the most appropriate, and creditors can challenge if they do not agree with the company’s choice. Assets, such as intellectual property or goodwill, are difficult to value objectively and may lead to further dispute when valued for a restructuring plan. The Government’s objective is to minimise the likelihood of challenge so far as is possible, whilst providing the underlying protection to creditors that such a safeguard is meant to offer.

5.173 As a number of respondents pointed out, a risk of the minimum liquidation valuation (i.e. that the valuation used can be no less (but may be more) than would be the case on a liquidation) was that the nuance of 'minimum' may be lost and a liquidation value may become the default option. As many pointed out, administration would typically be a more likely alternative result were a restructuring plan to be rejected. This is because a restructuring plan would probably only be considered if a business was viable. If a business is viable, administration is a more likely insolvency destination than liquidation if a restructuring plan is not approved. Creditors could be justified in expecting a higher level of return in administration rather than liquidation, so might challenge a valuation based on liquidation value.

5.174 **The Government agrees administration would often be a likely outcome were a plan to be rejected, and notes the minimum liquidation valuation basis would allow a valuation based on administration (as the valuation is a minimum, not a ceiling). However, this nuance may be lost and a lower liquidation valuation might be used instead. The Government has concluded that the next best alternative for creditors if the restructuring plan was not to be agreed is the best alternative valuation basis.**

5.175 **The next best alternative for creditors is a flexible protection, as it will fit the circumstances of the particular case in question. Administration will often be the next best alternative for creditors, but in some cases administration might not be a realistic option meaning liquidation is the only alternative that can be used. In the event of challenge the court will decide, based on the evidence put before it, what the next best alternative is.**

5.176 **The Government's chosen approach is intended to achieve the best possible balance between protecting creditors' interests and avoiding disputes. In practice the Government believes that in many cases the process of dialogue and negotiation between the company and its creditors will serve to narrow differences on the perceived value of the company to the point where such challenges can be avoided.**

Rescue finance

5.177 The Government proposed a number of options aimed at encouraging lenders to provide rescue finance. The options were to re-order the current priority of administration expenses and to introduce (during administration and debtor in possession rescue) provisions permitting companies to grant security to new lenders over company property already subject to fixed charges, which would rank as a first or equal first charge or an additional but subordinate charge on the property. In the case of the latter, this meant negative pledge clauses, contractual clauses which permit a lender to block further security over assets, could be overridden. In such cases safeguards would be required to protect existing lenders.

Question 15 – *Do you think in principle that rescue finance providers should, in certain circumstances, be granted security in priority to existing charge holders, including those with the benefit of negative pledge clauses? Would this encourage business rescue?*

Question 16 - *How should charged property be valued to ensure protection for existing charge holders?*

Question 17 - *Which categories of payments should qualify for super-priority as 'rescue finance'?*

5.178 There was some support for the options suggested in the consultation document with respondents identifying the proposal to override negative pledge clauses in lending agreements as containing particular merit in some circumstances. Many of these responses posed questions as to how a number of issues would be overcome or warned about potential negative impacts on lending.

5.179 A large majority of respondents were opposed to the rescue finance proposals. Many respondents thought that the existing framework already has options to encourage the provision of new financing in rescue scenarios, for example the statutory ranking of the costs of finance in the administration expenses hierarchy.

5.180 Many respondents expressed the view that such proposals were not needed as the UK already had a satisfactory market for rescue finance. Respondents noted:

- the tendency for existing lenders to provide new lending;
- the common use of inter-creditor agreements in consensual negotiations where additional security is to be provided; and
- a small number of respondents referred to experience of dealing with newer sources of rescue funding such as crowdfunding.

5.181 There was a fairly widespread assertion that viable businesses did not struggle to secure rescue funding, where a business could not obtain such funding, it was thought to be primarily due to the fact that lenders had made a commercial judgement that the business had a low probability of avoiding insolvency.

5.182 A number of respondents drew comparisons with US experience, noting the differences between the US and UK frameworks and markets, often commenting that transplanting US provisions into UK law was a task that would encounter significant problems. One respondent highlighted recent trends in US practice, noting the declining market for rescue finance, possibly due to the recent emergence of arrangements not too dissimilar from floating charges.

5.183 Additionally, there were many responses that voiced strong concerns over the likely impact of introducing measures such as those proposed. A common theme was that the proposals might have a detrimental effect on existing lenders and therefore affect lending practices in the general lending market, causing access to and the price of credit to be adversely affected.

5.184 A number of respondents thought it would be very difficult to introduce a framework that both, offered adequate protection to existing lenders, and would not give rise to litigation in large volumes. Respondents focused on issues such as the value of charged assets as providing ample potential for dispute. One respondent also noted the possibility of existing lenders trying to improve their own position at the expense of other creditors through the use of roll-ups and cross-collateralisation which may therefore result in challenge, as is common in US Chapter 11 proceedings.

5.185 **The Government acknowledged in the consultation proposals that rescue finance was a complex matter, and that it was wary of introducing changes that may have adverse effects on the general (non-distressed) lending market.**

5.186 **While there was some support for the proposals, much of it qualified, the Government was persuaded by the arguments put forward by the large majority of respondents who were opposed to the measures. In particular, respondents' experience that such measures were not necessary, as the market already functioned well in offering rescue finance to viable businesses, and the potentially serious and negative consequences on lending if measures were introduced, provided compelling reasons not to legislate in this area. Few, if any, respondents expressed confidence that the proposed safeguards would be without problems, with many suggesting that the potential for litigation would be considerable. The Government has therefore decided not to proceed with the rescue finance proposals at this time, but will keep the issue under review.**

Impact on small and medium enterprises

Question 18 – *Are there any other specific measures for promoting SME recovery that should be considered?*

5.187 There were a wide range of suggestions made in response to this particular question. Certain themes cropped up in a considerable number of responses. These included: the failure rate of CVAs, director misconduct and abuse; successive company failures, the cost of insolvency proceedings and advice; and encouraging early action by directors in circumstances of distress.

5.188 A number of respondents stated that they thought the proposals were not well suited to SME's suggesting that the costs would be too high for many smaller companies. Some respondents stated that they thought this should not deter efforts that will fill gaps in the existing framework, and noted that some companies were of a size that made professional advice disproportionately costly.

5.189 The Government wishes to thank respondents for these comments which provided helpful insights in shaping the refinements to the consultation proposals. The Government believes that the package of reforms, as a whole, will significantly improve chances of rescue for SMEs as well as larger companies.

Annex A – List of respondents

Ablewell Ltd
Ashurst LLP
Association of Pension Lawyers
Avon & Bristol Law Centre
BDO LLP
BM Advisory LLP
BPC Judges
British Chambers of Commerce
British Property Federation
BVCA – British Private Equity & Venture Capital Association
Chartered Institute of Credit Management
Church Commissioners for England and the Church of England Pensions Board
City of London Law Society
City of London Law Society's Insolvency Law Committee
Clifford Chance LLP
CORE Coalition
Council of Institutional Investors
Deloitte LLP
DKF Insolvency Ltd
DLA Piper UK LLP
ECA/BESA (Joint Response)
Endless LLP
Ernst & Young (EY)
Federation of Small Businesses
Freshfields Bruckhaus Deringer LLP
Front Foot Development Limited
GC100
Grant Thornton
Herbert Smith Freehills LLP
Hermes Investment Management
I E Legal Solicitors Limited
ICAEW
ICAS
ICSA
Insolve Plus
Insolvency Lawyers' Association (ILA) Technical Committee
Insolvency Practitioners Association
Institute of Business Ethics
Institute of Directors
KPMG LLP
Legal & General Investment Management
McTear Williams & Wood Limited
MK Containers
Morrison & Foerster (UK) LLP

Norfolk Trading Standards
Office of the Director for Labour Market Enforcement
PBC Business Recovery & Insolvency
Pension Protection Fund
Pensions and Lifetime Savings Association
Price Bailey LLP
R3
Revo
Royal London Asset Management
ShareAction
Specialist Engineering Contractors' (SEC) Group
St James's Place
The British Constructional Steelwork Association Limited
The City UK
The International Corporate Governance Network
The Investment Association
The Investor Forum
The Law Society
The Law Society of Scotland
The Pensions Regulator
The Society of Pension Professionals
TUC
UK Finance
UK Shareholders Association
Wilkins Kennedy

The remaining responses were from individuals, including insolvency practitioners and academics.

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