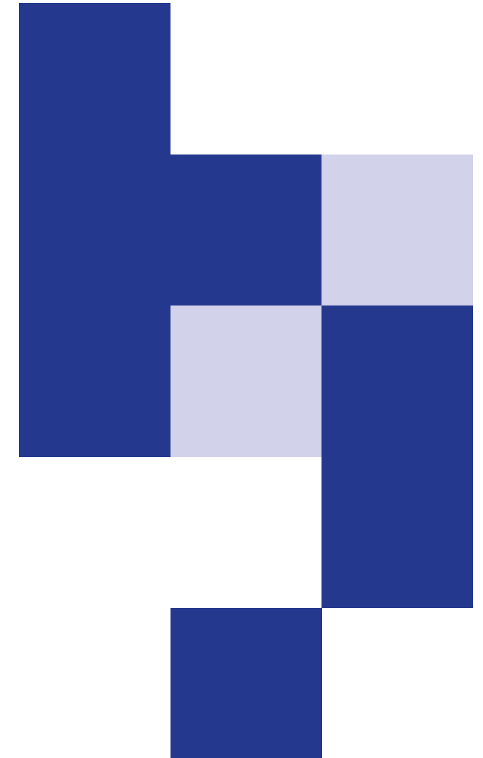
Infrastructure and Projects Authority

PFI Guidance Document

Navigating the risks of PFI project distress

Part 3 Project company insolvency



Reporting to Cabinet Office and HM Treasury

Guidance structure

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Understanding insolvency

- Project company insolvency is outside of a contracting authority's control, materially changes existing PFI contract relations and can disrupt service delivery.
- Administrators, Receivers and Liquidators operate under insolvency law and act in the best interest of creditors, not contracting authorities or subcontracted service providers. There is no certainty the insolvency practitioner will continue to provide services under the PFI contract or to pay the service providers under their contracts.
- Lenders and insolvency practitioners can *sweep* a project company's cash, including monies intended to pay service providers.
- Contracting authorities usually have contractual rights to step-in to service provider contracts on project company insolvency but in practice this can be difficult.

Part 3 is recommended for contract managers and in-house finance and legal teams wanting more explanation of insolvency in the context of PFI projects.

Insolvency is a highly regulated area and can be complex, particularly in relation to PFI projects. Contracting authorities should take appropriate advice if they believe there is a risk that financial distress could lead to project company insolvency, or if project company insolvency proceedings have commenced.

Contracting authorities should also take appropriate advice where one or more of the other material contract parties (e.g. a service provider) is at risk of, or becomes insolvent, as this could have an indirect effect on the contracting authority. An example of this was the insolvency of Carillion in 2018 – Carillion was a construction subcontractor and/or facilities management subcontractor to a large number of PFI contracts and, whilst it was the responsibility of the relevant project companies to replace them, there was an associated risk for the contracting authorities, particularly where the cost of replacement put those project companies into, or at risk of, insolvency.

What is insolvency?

Insolvency arises when a company is *unable to pay its debts when they fall due* (cash-flow test) and/or *where its liabilities exceed its assets* (balance-sheet test). If there is sufficient evidence to prove that a company fails either of these tests then it may be deemed insolvent. It should be noted that some solvent companies have liabilities that exceed their assets but, if this occurs, the directors of the relevant company will need to satisfy themselves that the company will be able to meet its future liabilities, or declare the company insolvent.

PFI project companies usually have detailed financial models, forecasting cash flows and financial statements over the full life of a project (see Part 2 for more detail), and so insolvency is likely to occur where the financial model demonstrates that one (or both) of the two insolvency tests are met.

What are the responsibilities of directors?

When a company is trading normally, the directors must act in the best interests of the company and promote the success of the company for its shareholders (along with other Companies Act duties). However, if a company becomes financially distressed (whether it is technically insolvent or not) this position changes and directors' duties become more focused on protecting the interests of creditors. The closer the company comes to insolvency (on a cash flow or balance sheet basis) the more the creditors' interests become paramount.

If a company is technically insolvent, but not yet in an insolvency process, it is possible for the directors to continue to trade on as long as it is reasonable for them to hold the belief that there is a reasonable prospect of the company avoiding a formal insolvency process. This is normally justified by the company embarking on some form of fundraising, restructuring or sales process. This may be more difficult in a PFI scenario, and the directors are likely to be relying upon existing stakeholders to inject funds to allow the company to continue or for the lenders to amend debt terms or even write amounts off.

Understanding insolvency

Directors can be personally liable in a subsequent insolvency for breach of duty (or misfeasance) and also for specific offences under the Insolvency Act 1986:

- *Wrongful trading:* when a company's directors continue to trade when they know, or should know, that there is no reasonable prospect that the company can avoid insolvency;
- *Fraudulent trading:* when directors manage an insolvent company with the intention of defrauding creditors (e.g. paying themselves salaries the company cannot afford);
- *Misfeasance:* where directors breach their *fiduciary duties*, including paying dividends when a company is insolvent or is at significant risk of becoming insolvent.

Project company directors must pay careful attention to the solvency of the project company, especially when it is under financial distress, and take appropriate action. This should include taking appropriate legal and financial advice as to their duties in financial distress and how and when the creditor duty is engaged. Directors should also keep a regular audit trail of decisions made. If they know or ought to have known that there is no longer a reasonable prospect of avoiding insolvency at a point in time or in the future, they should take all necessary steps to avoid further losses to creditors, which will likely mean filing for formal insolvency.

What is an Insolvency Practitioner?

Licensed 'insolvency practitioners' are usually appointed to conduct the insolvency process in place of management. Creditors, especially secured creditors, tend to control the proceedings, either by initiating the process or at least dictating which process will be followed and which insolvency practitioners will act.

An insolvency practitioner is someone who is licensed and authorised to act in relation to an insolvent individual, partnership or company; for example, an insolvency practitioner may be appointed as an Administrator, Administrative Receiver or Liquidator. Insolvency practitioners have to act in accordance with the law, and their work is monitored by regulators to make sure that they do.

Insolvency practitioners have a wide range of powers, depending on the form of insolvency procedure, but in essence, they take control of the company whilst they restructure it, sell its assets, pursue claims or wind it up.

Insolvency practitioners may have to deal with many competing interests, but their primary duty is to look after the interests of the company's creditors. This is very important. Once an insolvency practitioner is appointed to a project company, their overriding duty is to creditors and, typically, this means lenders. **They do not owe a duty to the contracting authority,** shareholders or subcontractors, other than as creditors of the company, and this can have a significant impact on the management of distress situations in PFI projects.

Insolvency practitioners may have little, or no, PFI experience and may need to appoint specialist advisors for support.

What are the different types of insolvency?

There are a number of different forms of insolvency proceeding – formal measures taken to deal with company debt. Some try to rescue the company, while others close the company down and break up any assets for the benefit of creditors. The table on the following page shows the types of insolvency proceeding that are most likely to occur in distressed PFI projects. However, it should be noted that the **Corporate Insolvency and Governance Act 2020 (CIGA)** introduced a number of new procedures and measures to seek to rescue companies in financial distress, including:

- Restructuring Plan under Part 26A of the Companies Act 2006
- Company Moratorium under Part A1 of the Insolvency Act 1986
- Restriction on termination clauses under s 233B of the Insolvency Act 1986[1].

Whilst these have not been fully tested to date on PFI projects, contracting authorities and their advisors should consider the potential implications of CIGA as part of any project company insolvency analysis.

1 https://commonslibrary.parliament.uk/research-briefings/cbp-8971/

Understanding insolvency

Type	Objective	Who can appoint
Administration	Administration is a formal insolvency process designed to achieve one of the three statutory objectives under the Insolvency Act 1986. These are to (1) rescue the company as a going concern (which is often not possible or viable); (2) securing a better result for creditors as a whole than would be the case in a liquidation; or (3) achieving a better result for one or more of the secured or preferential creditors. An Administrator has wide ranging powers to try and achieve the stated purpose of the Administration. They can trade the business, look to sell some or all of the business and assets or effect a "pre-pack" sale whereby the business and assets are sold immediately upon their appointment (following a sales process that is run in advance of the insolvency). Companies in Administration are protected by a statutory moratorium which prevents commencement or continuing of legal proceedings against the company (e.g. litigation or presentation of a winding-up petition).	Court The company or its directors Secured Creditors under a debenture (e.g. lenders)
Receiver or Manager	Receivers or Receiver/Managers may be appointed over certain specific assets under powers contained in an instrument or document creating a charge over those specific assets. Receivers may also be appointed under the Law of Property Act 1925. There are many different kinds of Receiver and their powers vary according to the terms of their appointment. However, a Receiver is normally appointed over a narrower class of assets than an Administrator (e.g. real estate or shares) and so it is less likely to apply in a PFI scenario.	Secured Creditors (e.g. Lenders)
Compulsory Liquidation	Compulsory liquidation, also known as involuntary liquidation or winding up, is the legal process by which a company is forced to close and sell off its assets to pay off its debts. This process is initiated by a winding-up petition presented to the Court and overseen by a court-appointed Liquidator. Compulsory liquidation is liquidation by order of the court and is the only method by which an unsecured creditor (e.g. a service provider) can initiate liquidation. Once the liquidation has been completed, the company is dissolved Upon a winding up by the court, the government Liquidator is appointed - called the Official Receiver (OR). The OR can administer the winding-up of the affairs of the company or, if the OR believes there are more complex matters to attend to in the liquidation, can appoint a private firm of insolvency practitioners to oversee the liquidation. This may be the case if there are claims around compensation on termination.	Court Unsecured Creditors Secured Creditors The company or its directors Secretary of State (for public interest)

Understanding insolvency

Who are project company creditors?

Project company creditors are individuals or companies that are owed money by the project company. Creditors are likely to include:

- secured creditors: typically banks or bond holders who have lent money to the project company or, in some cases, an insurance company that has guaranteed repayment of the debt to lenders;
- preferential creditors: project company employees (if there are any) owed arrears of wages, holiday pay etc, and, after that, certain tax debts to HMRC (PAYE/VAT etc);
- unsecured creditors: all other creditors, typically subcontractors (construction or, more likely, service providers), the management services provider and the contracting authority.

Who gets paid on insolvency?

Secured creditors get paid before other creditors (after costs and expenses of the insolvency process). Unsecured creditors generally only get paid once the secured and preferential creditors have been paid in full - there are some limited exceptions to this but these are not detailed here.

Shareholders in the project company will only receive payments once all the expenses of the insolvency process have been met and creditors have been paid in full (plus any relevant statutory interest) - although some shareholder investment in PFI projects is made as junior debt/shareholder loans and may also be secured, but the security will generally rank below the senior lenders i.e. shareholder debt will be repaid after the banks/bond holders.

It is important to note that, in PFI projects, secured creditors rarely have security over (i.e. the right to take) the physical assets themselves - e.g. the hospital, school or road - because the project company does not typically own these assets. Instead, secured creditors usually have security over the shares in the project company, its assets (mainly cash it holds) and the benefit of the project company's contracts (e.g. the PFI contract and the subcontracts). Therefore, when lenders exercise their security, they (or the insolvency practitioner) are not normally able to take control of the underlying physical asset itself, but they are able to:

- take control of any cash/other assets that the project company owns, including lifecycle reserves, and apply these to paying creditors (i.e. the lenders); and
- pursue any contractual claims the project company has against the contracting authority, subcontractors etc.

There may be limited cases where lenders do have security over the PFI assets, or over long leases on the assets, and if that is the case then you should take specialist advice.

Insolvency and events of default

It should be noted that insolvency itself, as set out in the Insolvency Act 1986, is not a trigger for contractor default termination under typical PFI Contract terms. Instead, PFI contract events of default focus on the commencement of insolvency proceedings rather than the financial status of the project company. However, as described below, loan agreement events of default tend to include more sensitive tests of whether a key party is solvent rather than just referring to the occurrence of formal proceedings.

How does standard PFI Contract drafting respond to project company insolvency?

There are specific contractor default provisions relating to the occurrence of insolvency proceedings in respect of the project company (and sometimes the holding company) which allow for immediate termination by the contracting authority without rectification (but subject to lender step-in rights).

How does a loan agreement respond to insolvency?

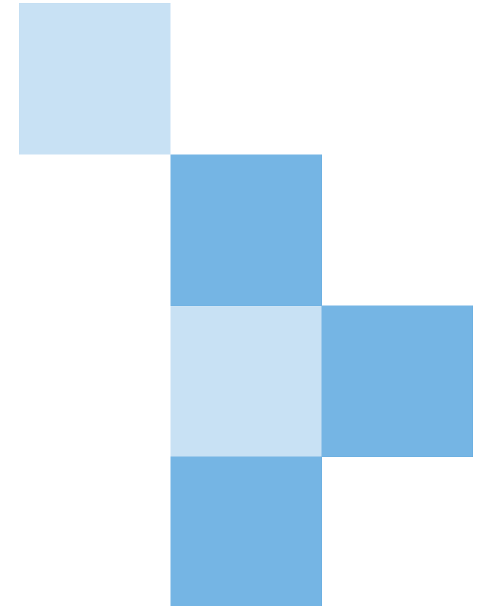
As might be expected, the loan agreement is likely to contain a range of more sensitive tests of solvency than might be included in the PFI Contract. These usually include insolvency-related events in respect of *Major Project Parties* (typically including the holding company, project company and its subcontractors). In addition, the loan agreement will contain events of default linked to deterioration in relevant cover ratios, such as the Loan Life Cover Ratio and the Debt Service Cover Ratio which are intended to provide further indicators of financial distress (see *Part 2: Project company financial stress* for more information).

Where events of default occur, the loan agreement is likely to provide a range of remedies for lenders, which will include:

- termination of all lending facilities;
- the right to declare all loans as immediately repayable;
- the right to enforce all rights under the various financing and security documents; and
- freezing the project bank accounts – meaning that sums will not be released from these without lender consent and that key subcontractors may not be paid.

From the lender perspective, a project company is likely to be placed under event of default constraints (and lock up) well before insolvency trigger levels for contractor default are met under the PFI Contract. This is an important consideration for Contracting Authorities who may wish to preserve service provider performance and continuing function of their core services.

Understanding insolvency



What is the impact of project company insolvency?

Insolvency proceedings materially change the contract relations between the parties, including the contracting authority, the project company, its shareholders, the service providers and the lenders. It can also have implications for the employees of these companies and what their future employment role(s) and prospects may be.

Under insolvency proceedings, the existing directors and shareholders no longer control the project company - the insolvency practitioner takes control and has responsibility for managing the operations of the project company. As the insolvency practitioner is usually appointed by the lenders (as the only secured creditors), and may rely on them to fund the costs of the insolvency proceedings, it is the lenders that normally influence key decisions.

The insolvency practitioner will be entitled to:

- take control of any cash that the project company has and any cash it receives in the future;
- choose whether to continue to operate the contracts, e.g. the PFI contract and the service provider contracts (depending on the termination rights and any agreements with the contracting authority and subcontractors); and
- pursue any contractual claims the project company has against the contracting authority, subcontractors etc.

The insolvency practitioner's primary duty is to look after the interests of one or more creditors (depending on the type of insolvency proceeding) - they do not owe a duty to the contracting authority or to service providers, except as potential creditors. Anything that the insolvency practitioner does which is not deemed to be in the best interest of creditors opens them up to personal liability claims and, in some cases, criminal proceedings. This means there is no certainty that the insolvency practitioner will continue to provide services under the PFI contract or to pay the service providers under their contracts. They will only do this if they believe it will result in a better outcome for creditors.

This may mean that the insolvency of the project company results in service providers being unpaid for several months, even though they are providing the services. Alternatively, the service providers may stop providing the services if they remain unpaid for extended periods of time, causing service disruption to the contracting authority. In either scenario, we recommend that the affected service providers escalate the issue of non-payment with the contracting authority, the authority's sponsoring Department and/or the IPA.

There may also be other consequences of insolvency, for example if the insolvency practitioner stops paying the project company's insurance premiums, potentially leaving the facilities uninsured.

Contracting authorities should read Part 4 of this guidance to understand:

- what happens when a PFI contract terminates for Contractor Default, including for project company insolvency;
- what rights a contracting authority typically has to step-in to service contracts under direct agreements with service provider subcontractors;
- why direct agreements are often not used in practice; and
- the risks of paying service providers directly in order to maintain service continuity.

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