FACULTY OF ADVOCATES

**Response from the Faculty of Advocates**

**To the CONSULTATION on the Review of the Corporate Insolvency Framework**

**Question 1**

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

**Response**

The question raises a general issue of policy, on which it is not appropriate for us to express a view.

Accordingly, we confine our response to these matters on which we feel qualified to comment.

First, we are aware, from the perspective of companies which are registered in Scotland, that there have been very few, if perhaps any, moratoria under Schedule A1 to the Insolvency Act 1986 ("**Schedule A1**" and "**the Insolvency Act**").

In addition, it is not clear to us what are to be the statutory grounds on which a creditor would have the right to apply to the Court for an order terminating the moratorium. The intended grounds may be those which are set out in paragraph 40(2) of Schedule A1 and which can lead to an order being made terminating the moratorium. Alternatively, the grounds could be the much wider ones which are set out in paragraph 26 of Schedule A1. In any case, the grounds must be stated more precisely than the criteria which are mentioned in paragraph 7.12, namely "*where [the creditors'] collateral or interests are not sufficiently protected*".

**Question 2**

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

**Response**

We agree that the filing with the court is more consistent with the scheme of the moratorium which is envisaged. Any court hearing would, as suggested, involve cost and delay. It is also difficult to see what the court's function would be in any hearing.

**Question 3**

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

**Response**

As regards the eligibility tests, we agree with the principle which is proposed. The appropriate wording is that in paragraph 11(a) of Schedule B1 to the Insolvency Act ("**Schedule B1**"), which is one of the tests for the making of an administration order.

As regards the qualifying criteria, we doubt whether the first is realistic, although it does reflect paragraph 24(1)(b) of Schedule A1. A large number of companies which would seek a moratorium, perhaps the majority, have cash flow difficulties which would make it impossible to meet all the liabilities, such as bank repayments, which became payable during the moratorium.

The second criterion will also have to be drafted with some care, being presumably based broadly on paragraphs 3 and 11(b) of Schedule B1 and the formulations "*likely*" (para 3(1)(b)), "*reasonably practicable*" (para 3(3)(a)) and "*reasonably likely*" (para 11(b)).

**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?*

**Response**

This question also raises a general issue of policy, on which it is not appropriate for us to express a view.

We add that it is difficult to see how the criterion of "*unfair prejudice*" which is mentioned in paragraph 7.26 would apply in relation to any creditor's challenge, as opposed to disputing the qualifying conditions had not been satisfied.

In addition, we doubt, on a very practical level, how quickly the Scottish Courts, even the Court of Session, would be able to dispose of any challenge by a creditor.

For completeness, we doubt also whether the description at paragraph 7.25 of the effect of paragraph 44 of Schedule B1 is quite accurate in referring to a challenge "*prior to the granting of the preliminary moratorium*".

**Question 5**

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

**Response**

This question also raises general issues of policy, on which it is not appropriate for us to express a view.

We comment only that a requirement of consent from all secured creditors, regardless of the amounts secured, seems unduly restrictive. It might be useful to include an alternative way of extending a moratorium, namely a court order.

In addition, it is difficult to see how a scheme of arrangement ("**a Scheme**"), under part 26 of the Companies Act 2006, could be negotiated and then sanctioned by a court, all within three months.

For completeness, we doubt whether it is appropriate, in effect, to add the period of the moratorium to the one-year period of an administration.

**Question 6**

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

**Response**

Three points.

First, it is not clear to us what is meant in paragraph 7.41 by "*relevant experience*", leaving aside the future relevance of the further reference in the footnote to an EU national.

Secondly, we do not immediately understand why the term "*nominee*" is not to be used, as it is in Schedule A1.

Finally, we assume, in any event, that the proposal envisages the consent from, and statement of, the supervisor being required, as under paragraph 7(1)(d) of Schedule A1.

**Question 7**

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

**Response**

We agree that the proposal is necessary.

**Question 8**

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

**Response**

We see significant practical issues arising from this proposal.

In particular, we are not clear as to what is envisaged by the references in paragraph 7.48 to "*reasonably request"* and "*in accordance with any legal requirements*".

It might also be appropriate to impose a requirement that only one or more creditors with a specified minimum indebtedness can request information.

**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?*

**Response**

We are not qualified to give a meaningful answer to the sub-question in the third sentence.

As regards the sub-questions in the first and second sentences, we see very significant practical difficulties in the suggested criteria and indeed in any other criteria.

On the one hand, any criteria would require to be precise in order to be workable.

On the other, the use of the emphatic word "*essential*" imposes a very strict test which may be satisfied only by few companies.

That consideration may explain what appears to be an inconsistency between, on the one hand, the reference to essential and that in paragraph 8.10 to "*absolutely necessary*" and, on the other, the reference in paragraph 8.10 to the contribution of the rescue plan.

In a similar way, the discussion in paragraph 8.14 of the meaning of essential seems to us to be inconsistent with the natural meaning of that word.

Finally, the reference in paragraph 8.15 to the supplier objectively justifying a refusal to supply confirms the difficulties of drafting a workable test or set of criteria.

**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?*

**Response**

As in reply to Question 4, we doubt, on a very practical level, how quickly the Scottish Courts, even the Court of Session, would be able to dispose of any challenge by a supplier.

We refer again in the context of this question to the reference in paragraph 8.15 to the supplier objectively justifying a refusal to supply. Tests that are appropriate for regulated utility suppliers may not be appropriate for suppliers of other services who may themselves be SMEs. In any event, we are of the view that, in order to give sufficient protection to the reasonable commercial interests of a supplier, the test, or set of considerations, would need to refer also to the supplier's usual business terms and also business practice, for example in allocating resources of materials and production between orders.

**Question 11**

*Would a restructuring plan including these provisions work better as a standalone procedure or as an extension of an existing procedure, such as a CVA?*

**Response**

We consider that there is no clear answer. On the one hand, there are disadvantages in having too many insolvency processes. On the other, there are disadvantages in making any existing insolvency process even more complicated than it already is.

Beyond that, what is proposed seems to us to be closer to a Scheme than to a CVA. Indeed, we understand that only the moratorium and the matters which are described in paragraphs 9.19 and 9.20 distinguish the proposal from a Scheme and justify the introduction of a new process. Beyond those differences, the procedure which is described in paragraphs 9.17 and 9.18 is, in effect, that which is required for a Scheme. In addition, Schemes can, and sometimes do, involve a "*cram down*".

In addition, we wonder whether the proposal takes fully into account that a Scheme does not require to be approved by a class which has no longer any economic interest in the company (see eg *Re Oceanic Ltd* [1939] Ch 41 at 47).

Finally, we observe that the establishment of any new process involves costs as companies and practitioners require to try to operate it in practice.

**Question 12**

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

**Response**

This question also raises a general issue of policy, on which it is not appropriate for us to express a view.

As regards the practical implications of what is proposed, our overall response is that the details are insufficient to enable us to raise more than general matters.

Subject to that overall point, we agree that issues of class have caused problems in Schemes. However, the Courts have adopted a pragmatic approach to classes, at least those of unsecured creditors.

In addition, we do not follow the detail in paragraph 9.20. Presumably, the expression "*each remaining class*" means the classes of prior-ranking creditors and 50 per cent refers to the number of creditors.

It is also difficult to envisage a court ever exercising the power to which paragraph 9.21 refers.

In addition, we do not fully understand how the cram down is actually to work, particularly when the rescue plan is to last for only 12 months. In that context, we mention again that a Scheme does not require to be approved by a class which has no longer any economic interest in the company.

Finally, we do not see understand why the comparison in paragraph 19.10 is only liquidation rather than liquidation or administration.

**Question 13**

*Do you consider that the proposed safeguards, including the role of the Court, to be sufficient protection for creditors?*

**Response**

We refer to the points in the previous response.

In addition, we observe that the considerations which are set out in paragraph 9.29 are those which apply to the sanction of a Scheme.

**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 creditors?*

**Response**

We doubt whether this proposal is appropriate, far less necessary. The minimum liquidation basis may be of little practical use when the alternative to the plan is administration or, and more generally, some other valuation basis is more appropriate in the particular circumstances.

**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?*

**Response**

This question also raises it its first sentence a general issue of policy, on which it is not appropriate for us to express a view. As regards the second sentence, we are not qualified to do so.

We merely query what are the perceived changes in market conditions since 2009, to which paragraph 2.10 refers. We are not aware of any potential providers of "*rescue finance*" who would differ from existing lenders, particularly banks. The basis of the belief in paragraph 10.10 is not stated.

For completeness, there is, in our view, a significant difference between two matters which are covered in the question. The overriding of negative pledges in limited circumstances is different from, and narrower than, permitting new securities to have a "*super priority*". The former change could be introduced without the latter.

**Question 16**

*How should charged property be valued to ensure protection of existing charge holders?*

**Response**

We observe that no valuation bases are suggested. In principle, the securities should be valued prudently on a basis which is appropriate in the circumstances of the company, which might be "*a going concern basis*" and perhaps subject to an additional percentage representing prudence.

**Question 17**

*Which categories of payment should qualify as for "*super priority*" as "*rescue finance*"?*

**Response**

We agree that there is no reason in principle to limit the categories of funding or credit, albeit that it would in all probability comprise that which was provided by financial institutions.

We should also comment on the suggestion in paragraph 10.26 that the court should not have a power to modify the proposed terms. We see no basis for that suggestion. That power would no doubt be rarely exercised, but that seems an insufficient reason to exclude a power which could be usefully exercised.

**Question 18**

*Are there any other specific measures for promoting SME Recovery that should be considered?*

**Response**

In so far as we might be qualified to give any response to this question, we cannot suggest any such measures.