Law Society of Scotland

Briefing for Second Reading Debate

Corporate Insolvency and Governance Bill 2020

2 June 2020

Introduction

The Law Society of Scotland is the professional body for over 12,000 Scottish solicitors. With our overarching objective of leading legal excellence, we strive to excel and to be a world-class professional body, understanding and serving the needs of our members and the public. We set and uphold standards to ensure the provision of excellent legal services and ensure the public can have confidence in Scotland's solicitor profession.

We have a statutory duty to work in the public interest, a duty which we are strongly committed to achieving through our work to promote a strong, varied and effective solicitor profession working in the interests of the public and protecting and promoting the rule of law. We seek to influence the creation of a fairer and more just society through our active engagement with the Scottish and United Kingdom Governments, Parliaments, wider stakeholders and our membership.

Our Banking, Charity and Criminal Law Committees welcomes the opportunity to consider and provide briefing in relation to the Second Reading debate for Wednesday 3 June 2020 on the Corporate Insolvency and Governance Bill 2020 (the Bill)[1]. The committees have the following comments to put forward for consideration.

General

The Bill was introduced in the House of Commons on 20 May 2020 and is expected to be expedited as the Bill's objectives are to support businesses during the COVID-19 pandemic emergency. The Bill has several clauses on which we comment, including:

- Moratorium
- Suspension of Winding Up
- Wrongful Trading
- Power to amend corporate insolvency or governance legislation
- Meetings and Filings

We understand that the Government consulted[2] in April 2018 on the changes to the insolvency law prior to the commencement of COVID-19. Given the urgent implementation, there is a significant lack of detail provided in the Bill.

We are very concerned about the use of the expedited parliamentary processes to bring in the permanent changes described as a "new corporate restructuring package to insolvency law."

1 https://publications.parliament.uk/pa/bills/cbill/58-01/0128/cbill_2019-20210128_en_1.htm

2 The Government previously consulted on changes to the corporate insolvency regime and in August 2018 announced plans to introduce new insolvency restructuring measures. https://commonslibrary.parliament.uk/research-briefings/cbp-8922/

The use of emergency powers should be limited to those measures which are required to address the flexibility required by businesses at this time of COVID-19. The additional measures which are not related to the COVID-19 emergency should be given proper parliamentary time and effective scrutiny of such major changes.

Moratorium

Clauses1- 6 of the Bill refer to Moratorium in inserting various chapters into the Insolvency Act 1986.

We have the following observations to make:

Subparagraph A6(1)(e): This refers to "*a statement from the proposed monitor that, in the proposed monitor's view, it is likely that a moratorium for the company would result in the rescue of the company as a going concern."* For the period from the date of commencement of the Bill until 30 June (or one month after commencement), does that statement regarding the worsening of the financial position relate to the relevant period as at the time of the moratorium or during the entirety of the moratorium?

It would be helpful to understand what is intended in this regard, or, for there to be some clarity around it.

Guidance: Insolvency Practitioners (IP) have expressed concern at the onus which the process puts on the Monitor being able to state that the rescue of the company (not the business) as a going concern is likely to be achieved. While there is provision that the Monitor can rely on information supplied by the directors, there would need to be some clear pre-planning undertaken in assessing:

- what are the pre-moratorium debts for which there is a payment holiday?
- what would otherwise be non-moratorium debts (see below comments on excluded contracts given the broad definition of financial service contracts).

We would suggest that there is amendment to the wording or a commitment to publishing guidance regarding the issue.

Whether, in reality, it will actually be accessible to small companies and/or certain SMEs, whilst the process of appointment is straightforward and may not be costly, the pre-appointment planning process could be both costly and time-consuming given the nature of the statements and the consequences for directors / the Monitor. In the context of a Company Voluntary Arrangement (CVA), there will now be no protection in terms of the small company moratorium. Small company moratorium is not largely used as CVAs are less prevalent in Scotland, the moratorium could be used to achieve a CVA which otherwise may not have been an option. However, based on the current statements that are required, it may be more challenging for IPs to accept an appointment as a Monitor as suggested above.

In terms of the obligations of the Monitor during the moratorium period, it is unclear exactly as to how the duty to Monitor is to be discharged i.e. frequency / extent of involvement etc. Again, given the implications

for the Monitor in terms of challenges to their actings, guidance is required. An indication on how this can be achieved needs to be provided.

There is no provision for pre-appointment costs to be met as a moratorium debt and/or given any priority in any subsequent insolvency whereas other moratorium debts are. Again, depending on the approach of the IP / the circumstances, this could affect the views of an IP to act as Monitor.

Definitions: In terms of some excluded categories of debt from the moratorium, the definition of "contract or other instrument involving financial services" is very wide. This will catch non-financial institution lending and could catch connected party loans and other unsecured loans such as director loans etc. There is also the issue of contract formation which could include any form of contract such as written, oral, email communications etc. This could have serious consequences such as:

- the debts under these contracts could in theory be accelerated or crystallised requiring a much higher figure to be paid during the moratorium period and/or at the point of extension
- if such debts are accelerated, this could provide those unsecured creditors and secured creditors in respect of those moratorium debts with a much higher level of protected moratorium claim
- that claim would rank ahead of all other claims in a subsequent insolvency, including the fees of the IP and the floating charge creditors. Sub- paragraph 64A of Schedule B1 of the Bill would suggest that these debts are paid ahead of floating charge creditors (as the definition of financial contract appears to catch secured debt). It is unclear how that the provision works, given the moratorium debts / the pre-moratorium debts which have no payment holiday, need to be paid in priority to floating charge creditors
- These moratorium debts cannot be compromised. If payments are accelerated resulting in higher levels of moratorium debt, those processes may be unworkable.

It appears that before a monitor recommends a moratorium, they should be aware of, and have reviewed, every potential contract of financial services to ensure there was nothing in any of them that could trigger such a liability that:

- could impact on the viability of the company and qualification for the moratorium and
- could, if the moratorium fails, significantly prejudice other creditors in the event of insolvency in the 12 weeks after the end of the moratorium.

The costs and timescales involved in undertaking that exercise could be problematic particularly for SMEs who require the protection sooner rather than later.

Suspension of Winding Up

Clauses 8 and 9 of the Bill deals with winding up petitions.

In Scotland, the compulsory winding up process is faster than in England and Wales.[3] Provisional liquidation is also more commonly sought and can be granted within a very short timescale after presenting a petition and there may not be a hearing (although that is more likely in a director petition than a creditor petition).

Whilst the presentation of petitions has slowed over the last few months, the courts have not embargoed creditor winding up petitions in Scotland. Rather, the approach taken was to deal with urgent and essential court business which could on cause shown include winding up petitions. Winding up petitions in Scotland will either be submitted to the Court of Session or the relevant local Sheriff Court (although these have been restricted to the hub courts running in view of lockdown.)

The Court of Session has been relatively responsive in relation to dealings with winding up petitions following the lockdown. However, the Sheriff Courts have been less predictable with less access. They seem to be dealing with cases in a queue as opposed to prioritising. Where some petitions have been presented either before or after lockdown, the status of them are unclear. A number of winding up petitions presented pre or post 27 April 2020 could remain outstanding or where orders were granted before this legislation comes into effect. We are unaware just how many petitions presented / winding up orders granted will be affected by these provisions in Scotland. There is potential for the numbers to be higher than in England and Wales in view of the differences in process/timescales.

We have the following observations:

- The suspension deals with petitions **presented** on or after 27 April 2020 and/or after the commencement of the Act. It does not cover petitions presented prior to 27 April 2020 for which a winding up order was granted before, on or after 27 April 2020. This is of significance in relation to a petition which proceeded on the basis of an expired statutory demand. For example, if a statutory demand was served on 2 March, the 21 day period will have expired as at the end of 23 March and a petition could have been presented before 27 April 2020 with the winding up order in Scotland being granted either before or after 27 April 2020.

- A creditor can have validly petitioned based on a statutory demand served after 1 March 2020 where the petition was presented prior to 27 April 2020 with an order granted either before or after 27 April 2020. Whilst we understand that the 27 April 2020 is linked to the date on which the UK Government announced a proposed ban on statutory demands, that announcement was specifically directed at protecting tenants from aggressive action being taken by landlords as opposed to wider debtor protection. We consider that in instances where a petition has been presented pre 26 April 2020 on the basis of an expired demand and an order granted whether before or after the 27 April 2020 that this could result in an unfair outcome for the relevant debtor company in comparison to those debtors who gain the protection under the new provisions.

[3] After the first orders have been granted, a winding up order can be sought 8 days after intimation, service and advertisement has occurred and the Court may proceed to grant the order where undefended without the need for a hearing if it is satisfied the order should be granted.

- In relation to creditor petitions other than based on a statutory demand, the provisions appear not catch a petition which was presented prior to 27 April 2020 but after lockdown began, where that order is granted after 27 April 2020. This appear to be an unfair outcome for debtors who were subject to a petition between lockdown and before 26 April 2020.

- For liquidation cases, where a petition has been presented after 27 April 2020 whether before or after commencement of legislation, unless the creditor /the IP can be satisfied the criteria[4] can be met those petitions should be withdrawn or otherwise dismissed by the court. It is unclear how many petitions could fall within this category in Scotland. From a practical perspective in Scotland, consideration needs to be given as to how to establish across the Court of Session and the Sheriff Courts the number of petitions currently pending to ensure that the relevant petitions which remain outstanding can be dismissed withdrawn and on an expedited basis.

- If the petition was presented after 27 April 2020 and before this legislation comes into force and the Court is not satisfied the relevant criteria have been met for an order to have been/ be granted, the Court has wide discretion in making restorative orders. It would appear any winding up order granted is treated as void. Further, in these cases, where the interim liquidator is in office, the onus is on the interim liquidator to establish whether the winding up criteria set out in paragraph 2 of Schedule 10 of the Bill have been met and to refer the matter to court. This seems unreasonable given that the IP will be in-gathering information and may not be able to confirm whether COVID-19 had a financial effect on the company. In the absence of any guidance, we would expect the IPs will simply have to refer the matter to Court and ask the Court to confirm which will undoubtedly place additional burden on the courts, particularly the Sheriff Courts in Scotland. While the discretion of the Court is wide in making restorative orders and allowing the liquidator to seek directions, it is unclear how the liquidator's fees will be dealt with and what the position would be if assets have been sold in good faith and there is no underlying business / assets remaining. This could place a lot of additional work at the door of the Court when they are already on a reduced service. As above, it will be important to establish how many orders have been granted and to ensure that any application required to address those orders can be dealt with on an expedited basis.

- Where a petition is presented on or after 27 April 2020 and the court grants / has granted a winding up order on the basis that the relevant criteria are met, there are also adjustments to be made in terms of paragraphs 8 – 18 which include altering the date of commencement. In some cases, the interim liquidator may already be in office and will already have undertaken certain actions based on the date of the liquidation i.e. the date of presentation, not the date of the winding up order. Whilst the Court's discretion is very wide, this could give rise to several practical and case

[4] The criteria are that COVID-19 has not had a financial effect on the company, or, the facts by reference to which the relevant ground on which the petition has been presented would have arisen even if COVID-19 had not had a financial effect on the company.

management difficulties for any appointees. Should the liquidator ask the court to use its discretion or will further guidance be issued?

There is no requirement for specific drafting to be added if it is intended that petitions presented prior to 27 April 2020 are to be excluded regardless of whether they are based on a statutory demand or other inability to pay debts and irrespective of whether they relate to landlord / tenant action. If there are to be no changes to the Bill, this will become an issue in terms of the court's engagement in terms of identifying affected petitions and assessing the extent to which the courts will require to address those petitions / any extra burden that it places on the Court service.

Wrongful trading

Clauses 10 and 11 of the Bill deals with wrongful trading. We have the following comments to make regarding clause 10 of the Bill regarding charitable companies.

The impact of the "wrongful trading" is particularly significant for those who serve on the boards of charitable companies since in many cases there will be a strong commitment to do everything possible to maintain services for the benefit of those who depend on the charity for support. The more the board squeezes the company's finances to do so, in line with that strong sense of moral duty, the greater the risk of personal liability for the directors under wrongful trading. We welcome clause 10 of the Bill but we have concerns:

(a) Clause 10 states that the directors will not be responsible for any worsening of the financial position of the company or its creditors "*during* (our emphasis) the relevant period." The requirement under clause 214 of the Insolvency Act 1986 is to take "every step with a view to minimising the potential loss to the company's creditors." Notwithstanding the Bill, liability can arise under "wrongful trading" where the directors failed to act during the relevant period which led to loss to creditors after the period had expired. Directors should be exempted from liability in respect of any step which they take/fail to take during the relevant period, irrespective of when the relevant loss (or worsening of the financial position is suffered.

(b) the "relevant period" is defined as the period which begins with 1 March 2020 and ends with "30 June 2020 or one month after the coming into force of this Act, whichever is the later". It would be safe to assume that the relevant date for the expiry of this period will be one month after this Act comes into force. This seems far too early for the relaxation to lapse on the basis of current predictions of when the COVID-19 pressures will ease (unless it is anticipated that the Act will only come into force two or three months from now, which of course would be highly undesirable for other reasons). It is widely anticipated that flexibility to satisfy social distancing and disinfection measures will be required until at least the end of this calendar year. The financial impact on many charities (particularly those where their services or other activities involve close interaction with service users and/or large gatherings of people) is such that many boards in the charity sector will continue to be walking a tightrope in seeking to maintain the charitable company's solvency while maximising service delivery. It is inequitable that directors of charitable companies (who receive no remuneration for serving on the board, other than in a few exceptional cases)

should find the risk of personal liability for wrongful trading coming only one month after this Act comes into force.

Power to amend corporate insolvency or governance legislation: Great Britain

Clauses 18- 25 of the Bill refers to the power to amend corporate insolvency or governance legislation.

The ability to amend legislation in order to reduce the incidence of insolvencies, or to ensure that duties/liabilities of directors take due account of the effects of COVID-19, is limited to "corporate insolvency or governance legislation." That expression, as defined in clause 25(1) of the Bill does not include the legislation which governs insolvency in the context of Scottish charitable incorporated organisations (SCIOs). Given the intention behind the legislation, it would seem appropriate that that definition should be extended to include reference to the Scottish Charitable Incorporated Organisations (Removal from Register and Dissolution) Regulations 2011 and those provisions of the Bankruptcy (Scotland) Act 1985 which apply in the context of sequestration of the estate of a SCIO.[5]

Arguably, the rationale underlying clauses 18 and 19 (more specifically the purpose referred to in clause 19(2) of the Bill) would also point to a further extension of the definition of "corporate insolvency or governance legislation" so as to encompass the duties of charity trustees under the Charities and Trustee Investment (Scotland) Act 2005 (and the sanctions attaching to breach of those duties, including suspension/disqualification from acting as a charity trustee – corresponding with the reference in the definition of "corporate insolvency or governance legislation" to the Company Directors Disqualification Act 1986).

Meetings and Filings

Clauses 35 -38 deal with meetings and filings.

Clause 35 of the Bill (and Schedule 14) refer to meetings of companies and other bodies. Annual general meetings (AGM) are of importance to charities and other third sector bodies as the majority operate based on a governance model under which the membership (usually drawn from the key stakeholder group or groups) participate in annual election/re-election of board members at the AGM. They also hold the board to account at the AGM through the ability to raise questions on the accounts and generally challenge the board on points of concern. The requirement for amendments to the constitution and other major decisions to be taken by the wider membership at general meetings, rather than by the board, is also a significant feature of the governance model. While it is recognised that there is a need to adapt formal procedures for

[5] "Enactment" is defined in clause 25(1) of the Bill in such a way as to include Acts of the Scottish Parliament and instruments made under any Act of the Scottish Parliament; and that clause 20(4) states that Regulations under clause 18 may not make provision that could be made by an Act of the Scottish Parliament unless the Secretary of State has first consulted the Scottish Ministers.

AGMs in order to minimise risks to public health during COVID-19, democratic accountability should not be undermined more than necessary.

We would suggest that Schedule 14 subparagraph 3(5) should be adjusted to clarify that the quorum requirements under an existing constitution should continue to apply subject to the qualification that any reference in the quorum provisions within the constitution to being "present" or "present in person" at the AGM should be satisfied by participation (by remote means such as video and/or audio link). This would be the same for representatives of members which are corporate bodies.

For Schedule 14 (in line with the position which applies under the Companies Act 2006 in relation to companies) that, in the case of all organisations *irrespective* of legal form, there would be a right for members to vote by proxy (including submission of proxies by electronic means) irrespective of whether that was permitted by the constitution, An example is that members of SCIOs do not have a right to vote by proxy unless that happens to be specified in the SCIO's constitution (and it is quite common for SCIOs not to include such provisions). To Schedule 14 should beaded that any member who has appointed a proxy should be deemed to be "present" or "present in person" for the purposes of any quorum requirement within an existing constitution.

Schedule 14 subparagraph 3(6) goes too far (without supplementary provisions) in removing members' rights in relation to an AGM held within the relevant period. We recognise that it would be inappropriate for the right to attend and/or vote in person to remain in force during this period but there should be a further provision to the effect that the board would, notwithstanding paragraph 3(6), be under an obligation to take reasonable steps to facilitate participation by members by remote means such as video and/or audio links (including a requirement for the arrangements for remote participation to be specified within notices of general meetings). They should ensure that those who have difficulties in participating remotely are encouraged to participate by submission by post or email of proxy forms and written questions etc in advance of the AGM.

It would also be helpful if wording similar to that contained in paragraph 3 were to be included in Schedule 14, covering *board* meetings (to include meetings of management committees, trustees etc). This would dispel the current uncertainties among charities and other third sector organisations regarding the potential for technical challenge where board meetings are held using video and/or audio links. If that were done, it would be important to include an obligation to take reasonable steps to facilitate participation by board members, in line with what is suggested in the preceding paragraph regarding participation by members.

For those charities which have a relatively small membership, an alternative to holding general meetings by video or audio links is to use the written resolution procedure where that is permitted by the constitution or (in the case of companies) permitted under the Companies Act 2006.

One anomaly under the Charities and Trustee Investment (Scotland) Act 2005 is that a written resolution to amend a SCIO's constitution requires all members to agree the resolution, whereas in the case of a company only 75% of the membership would need to indicate their agreement to a resolution amending the Articles of Association. The provisions of schedule 14 could be extended to reduce the threshold to

75% during the relevant period so that there was more scope for SCIOs to use the written resolution procedure in the context of amendments to their constitution (and, incidentally, this could usefully be extended to include resolutions for amalgamation of SCIOs or transfer of a SCIO's undertaking) during the current pandemic.

Many charities take the form of unincorporated associations, and there are others which have a legal form falling outside the definition of "qualifying body" in Schedule 14 paragraph 1. The technical issues associated with holding members' meetings (and board meetings) under current circumstances are causing difficulties right across the Scottish charity sector and not just for those who have adopted the legal forms specified in paragraph 1. The definition in paragraph 1 of "qualifying body" should be extended to include any charity entered in the Scottish charity register, irrespective of its legal form.

We recognise that paragraph 4 of Schedule 14 allows Scottish Ministers to make regulations for the purposes of, or in connection with, paragraph 3. That power would, however, be limited to general meetings (and class meetings etc) and would therefore not address the points above in relation to board meetings or written resolutions. We consider it preferable that the provisions of paragraph 3 be amended in line with the comments set out above. It is important that regulations of this kind can be put in place in relation to all charities operating in Scotland, and not just those which have taken the legal forms specified in paragraph 1.

Assuming the intention is that regulations made by the Secretary of State can extend into matters which would normally fall within the devolved powers of the Scottish Parliament (on the face of it, clauses 37(4) and (5), read together, allow for the possibility of regulations amending an Act of the Scottish Parliament or an instrument made under an Act of the Scottish Parliament; and clauses 44 and 45 similarly support that position), it would seem appropriate that the list in clause 38 of statutory provisions to which the power to extend various time periods/deadlines under clause 37 is to relate, should be extended to include those laid down by the Charities and Trustee Investment (Scotland) Act 2005. We appreciate that OSCR has stated that it will take a proportionate approach in the context of failure to meet deadlines under the 2005 Act where this arises from COVID-19 difficulties; but it is more satisfactory to tackle the issue directly by extending those deadlines; and, incidentally, relieving the pressure in this regard not just for charities which take the form of companies or SCIOs but for charities in general irrespective of legal form.

Law Society of Scotland

For further information, please contact:
Gillian Mawdsley
Policy Executive
Law Society of Scotland
DD: 01314768206
gillianmawdsley@lawscot.org.uk