



Insolvency of contractors to the public sector:

topical issues and practical solutions

19 July 2011

Introduction

- Context
- Insolvency basics
- Employment issues
- Pensions issues
- Case study
- Questions



Context

- 22% of local authorities' operating expenditure in 2008-09 was spent on local government services being provided by private and third sector contractors (source: Financial Times)
- Government is cutting central funding which will result in each local authority losing on average 4.4% of its funding
- Knock-on effect on contractors and service providers
- Consequential distress/insolvency issues



Insolvency?

- No universal definition
- Inability to pay debts (section 123 Insolvency Act 1986)
 - Balance sheet test (Re *Eurosail*)
 - Cash-flow test (Re *Cheyne Finance plc*)
 - Statutory demands



Directors' duties on insolvency

- Normal course duties (now codified in Companies Act 2006)
- Shift in duties on insolvency (emphasis on creditors)
 - Duty to company to act in its creditors' best interests (common law)
 - Wrongful trading (section 214 Insolvency Act 1986)
 - Fraudulent trading (section 213 Insolvency Act 1986)
- Potential consequences of getting it wrong
 - Personal liability
 - Disqualification
 - In the case of fraud, criminal sanctions
- Local authority beware of shadow directorship issues



Main corporate insolvency processes

- Company voluntary arrangement
 - *A contractual plan agreed with creditors for a compromise of debts or scheme of arrangement of the company's affairs, with the assistance of a supervisor, with the aim of avoiding an insolvent liquidation*
- Administration
 - *A procedure which ring-fences the company from claims against it, while an administrator formulates and implements proposals, ideally to rescue the company, but if that is not practicable, to achieve a better realisation of the company's assets than if there were an immediate winding up. Now also a method of enforcement for qualifying floating charge-holders.*
- Receivership
 - *The method of enforcement of security by a charge-holder, whereby a receiver is appointed over the secured assets, whose job it is to realise these assets and use the proceeds to discharge the debt due to the charge-holder*
- Liquidation
 - *The winding-up of a company by a liquidator, whose job it is to realise all of the company's assets, assess claims against it, and use surplus realisations to discharge those claims in accordance with the prescribed order of priorities*



Company voluntary arrangement (“CVA”)

- Directors’ proposals
- Nominee report to court (no court determination)
- Meetings of creditors and shareholders
- With requisite majority approvals (75% by value of creditors and 50+% shareholders) CVA becomes binding on all unsecured creditors, without a court determination
- No compromise of secured and preferential rights without express consent
- 28 day window for appeal on grounds of material irregularity or unfair prejudice
- Nominee becomes supervisor to oversee implementation of CVA in accordance with its terms
- No automatic change in directors/management. Typically directors continue to run the business, subject to CVA terms
- Interim moratorium available to “small” companies
- In practice, increasingly used to restructure large retail groups with onerous lease liabilities



Administration

- Administrator appointed to company at request of directors, shareholders, or qualifying floating charge-holder, by simple court filing (no court determination) or application to court (followed by court hearing)
- Unsecured creditors can only appoint by way of application to court (followed by court hearing)
- Administrator has benefit of statutory moratorium, which prohibits a range of enforcement action without consent of administrator or court
- Administrator charged with achieving statutory objective of (1) company rescue, or if that is not practicable, (2) a better realisation than on immediate liquidation, or if that is not practicable, (3) a realisation for secured or preferential creditors
- Directors not automatically dismissed, but no power to act unless sanctioned by administrator. Administrator has wide ranging statutory powers
- In practice, commonly used for business rescue through going concern business sale, rather than company rescue



Receivership

- Receiver appointed over secured assets by secured creditor by way of contractual deed of appointment (no court determination)
- Not a collective process. Receiver's primary duty to appointer, to realise value from the secured assets and apply against secured indebtedness
- Only residual duty to other stakeholders, to obtain best price reasonably obtainable at time of sale of secured assets
- No statutory moratorium
- Fixed charge receivership v administrative receivership (not to be confused with administration)
- Directors not automatically dismissed, but lose control of secured assets to receiver. Receiver's powers typically derive from combination of security, statute and appointment
- In practice, post Enterprise Act 2002, phased abolition of administrative receivership, but still possible where pre-15 September 2003 floating charges and in other excepted cases. Fixed charge receiverships prevalent where company's principal asset is completed real estate



Liquidation

- Liquidator appointed to company to liquidate / wind-up up its affairs
- Voluntary liquidation
 - 75% shareholder resolution
 - private practice liquidator appointed
- Compulsory liquidation
 - court petition and determination
 - Official Receiver appointed (a liquidator; not a receiver!)
- No statutory moratorium
- Directors displaced by liquidator. Liquidator has wide ranging statutory powers, but some only exercisable with sanction
- Investigations, reporting and avoidance actions...



Employment - TUPE

- Transfer of Undertakings (Protection of Employment) Regulations 2006 (“**TUPE**”):
 - Applies on a business transfer or service provision change
 - Operates to transfer the employment contracts of employees assigned to the business/services from current owner/provider to new owner/provider
 - Almost all existing liabilities transfer
 - Exceptions for old age, invalidity or survivors benefits in an occupational pension scheme

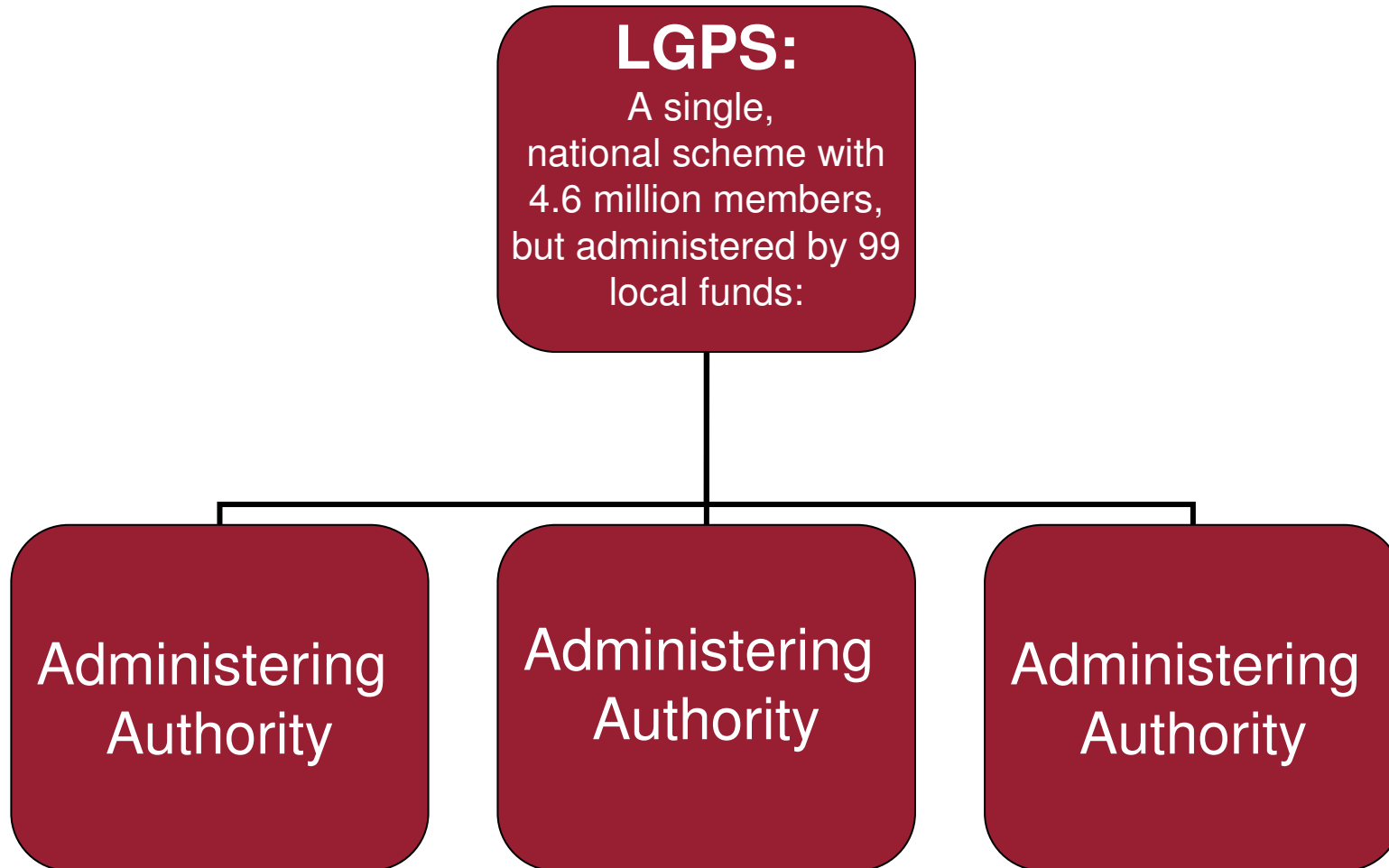


TUPE: obligations and restrictions

- Prohibition against dismissal by reason of the transfer
- Duty to inform and consult:
 - Outgoing owner/provider must (1) inform appropriate representatives of affected employees and (2) consult about measures the incoming owner/provider intends to take
 - Incoming owner/provider must inform outgoing provider about measures it intends to take
- Changes to terms and conditions:
 - Employees must continue to be employed under their existing terms and conditions
 - Changes by reason of the transfer will be void, even if agreed



Pensions - What is the LGPS?



Joining the LGPS

- Pension fund for:
 - Scheme Employers (Schedule 2, Administration Regulations): statutory right to participate
 - Eligible non-Scheme Employers:
 - Community or transferee admission body (Regulations 5 and 6, Administration Regulations)
 - Admission agreement with relevant Administering Authority: contractual right to participate as an “admitted body”



LGPS admittance and risk allocation

- Increasing number of contractors choosing to seek admission to the LGPS rather than make alternative pension arrangements.
- Risk allocation mechanisms:
 - Pass through arrangements
 - All costs pass straight to the authority
 - Cap
 - Limit on the contributions the contractor pays to LGPS
 - Expressed as percentage of payroll
 - Authority pays the excess = ongoing liability
 - Collar
 - Contractor pays difference between the collar and actual contribution rate (if lower), to the authority
 - Careful consideration needed re transfer of liabilities



Case Study – key facts

- Several local authorities engaged a contractor to provide critical care services to the local community
- Contractor experiences financial difficulties which impact on its ability to continue to operate and provide the services
- Contractor considers its position and the possibility of it entering a formal insolvency process
- Local authority considers its position and the options available to it



Different stakeholders' perspectives

Contractor and its directors/trustees	Local authority
<ul style="list-style-type: none">• Cash-flow constraints• Directors' duties• Wrongful trading• Personal liability• Reputation• Conflicts	<ul style="list-style-type: none">• Duty of care<ul style="list-style-type: none">– Continuity of service provision– Budget constraints/control• Reputational concerns• Lack of information and control• Internal processes<ul style="list-style-type: none">– Decision chain– Procurement issues



Potential outcomes

Contract termination and local authority assumption of service provision	Contract novation to a replacement service provider	Contract termination and new contract with new service provider	Allow contractor to fail and operations to cease
<ul style="list-style-type: none"> • TUPE transfer of employees and accrued liabilities to local authority 	<ul style="list-style-type: none"> • TUPE transfer of employees and accrued liabilities to replacement service provider 	<ul style="list-style-type: none"> • TUPE transfer of employees and accrued liabilities to replacement service provider 	<ul style="list-style-type: none"> • No TUPE transfer of employees and accrued liabilities to local authority
<ul style="list-style-type: none"> • Service provider ceases to be an admission body in LGPS and termination deficit triggered 	<ul style="list-style-type: none"> • No novation of admission agreement. Therefore service provider ceases to be an admission body, termination deficit triggered, and replacement service provider admitted as new admission body in LGPS 	<ul style="list-style-type: none"> • Service provider ceases to be an admission body in the LGPS and termination deficit is triggered. New service provider becomes new admission body in LGPS 	<ul style="list-style-type: none"> • Service provider ceases to be an admission body in the LGPS and termination deficit is triggered. Potential additional strain on fund due to enhanced redundancy benefits payable
<ul style="list-style-type: none"> • Lower due diligence requirements (no new service provider) 	<ul style="list-style-type: none"> • Due diligence requirements (on new service provider) 	<ul style="list-style-type: none"> • Due diligence requirements (on new service provider) 	N/A
N/A	<ul style="list-style-type: none"> • Procurement requirements (although less than on outcome 3) 	<ul style="list-style-type: none"> • Procurement requirements (greater than on outcome 2) 	N/A
<ul style="list-style-type: none"> • Highest cost 	<ul style="list-style-type: none"> • Lowest cost 	<ul style="list-style-type: none"> • Opportunity to re-negotiate terms 	<ul style="list-style-type: none"> • See pensions position above



Practicalities and managing the risk

Practical issues	Practical solutions
<ul style="list-style-type: none"> • Shortage of information about contractor's business operations, in particular issues beyond local authority's own contract 	<ul style="list-style-type: none"> • Early warning system. Incorporating <u>and</u> utilising meaningful monitoring rights
<ul style="list-style-type: none"> • Access to key/core documentation 	<ul style="list-style-type: none"> • Robust document management system
<ul style="list-style-type: none"> • Access to specialist advice. Knowing who to call? 	<ul style="list-style-type: none"> • Ensuring panel appointment process incorporates relevant specialisms
<ul style="list-style-type: none"> • Identifying the appropriate decision chain and procurement process (if applicable) 	<ul style="list-style-type: none"> • Early contingency planning
<ul style="list-style-type: none"> • Shadow directorship issues 	<ul style="list-style-type: none"> • Knowing where to draw the line on level of involvement
<ul style="list-style-type: none"> • Understanding contractual powers (or lack of) 	<ul style="list-style-type: none"> • Building in protection at an early stage or (if not already incorporated) at contract review stage



Any questions?



Contacts



Glen Flannery
Partner
Banking, Finance & Restructuring
T: +44 (0)20 7524 6867
M: +44 (0)78 2542 0558
F: +44 (0)20 7868 3867
E: g.flannery@nabarro.com



Nishi Gandesha
Associate
Banking, Finance & Restructuring
T: +44 (0)20 7524 6721
F: +44 (0)20 7868 3721
E: n.gandesha@nabarro.com



Verity Sayers
Associate
Employment
T: +44 (0)20 7524 6087
F: +44 (0)20 7868 3087
E: v.sayers@nabarro.com



Nina Sharkey
Associate
Pensions
T: +44 (0)20 7524 6594
M: +44 (0)77 7502 5344
F: +44 (0)20 7868 3594
E: n.sharkey@nabarro.com

