

Moveable Transactions (Scotland) Act 2023

Consultation – Definition of Insolvency

Response – November 2023

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Question One – should the relevant definitions of insolvency capture insolvency procedures or the state of being insolvent? Please provide reasons for your views.

We consider that the relevant definitions of insolvency should capture insolvency procedures, rather than the state of being insolvent. This is primarily because insolvency procedures involve a significantly greater level of certainty and clarity as to what will constitute insolvency within the legislation. More certainty will be preferable for parties dealing with the debtor or interested in relevant property. The alternative would mean that such parties could not be certain of the legal status of the purportedly assigned or pledged items at a particular moment. They may not have access to the relevant information to allow an assessment of the debtor's state of solvency/insolvency to be made at any given moment and indeed this may vary from moment to moment. This could hinder the raising of finance and other transactions and create disputes, which may lead to litigation. Although there are clearly difficulties in determining which procedures should be included within the definition of insolvency, the state of being insolvent would also require consideration of which insolvency tests would constitute insolvency for these purposes, such as absolute insolvency and/or practical insolvency (and even apparent insolvency).

If the insolvency procedures approach is adopted, the state of insolvency may still play a role in the wider applicable law and what ultimately happens to the property in question. If property is only acquired by the cedent/pledgor after they become factually insolvent, but before the commencement of one of the insolvency procedures in the definition, then a pre-existing assignation or statutory pledge would still enable the property to be transferred or encumbered. However, it is possible that such a transfer or encumbrance of the property could be challengeable as, for example, a gratuitous alienation or unfair preference (whether under the Insolvency Act 1986, ss 242-243, Bankruptcy (Scotland) Act 2016, ss 98-99, or at common law). But this would depend on meeting other conditions for such a challenge, including in the case of the statutory provisions a relevant insolvency procedure commencing within the necessary timescales, and insufficient consideration having been given for the assigned claim or there being no reciprocal obligations where security has been created. It should be noted that in terms of the statutory provisions, the point when a gratuitous alienation takes place or an unfair preference is created is when the transfer or preference becomes "completely effectual" (Insolvency Act 1986, ss 242(3) and 243(3); Bankruptcy (Scotland) Act 2016, ss 98(3) and 99(4)), which would be when the property actually transfers to the assignee or the acquired security becomes

encumbered. These issues are, however, separate from the 2023 Act and the challengeability would not affect the effectiveness of the transfer or security in the meantime.

Question Two – please provide your views on the current definitions of insolvency in the Act and highlight any circumstances which are unnecessary or alternately are missing. It would be helpful if you could provide reasons and/or examples for your views.

It may not be possible to achieve a wholly consistent position here, given the complexity of insolvency law, the overlaps between features of different procedures, the potentially different nature of some procedures depending on the circumstances and the fact that in certain contexts some processes are recognised as insolvency procedures, while in other contexts they are not.

The most appropriate approach largely depends upon whether the policy preference is to prioritise the potential assignee/pledgee (on the basis of the agreement to assign/create security, and the potential for obtaining the property or security, as well as its support for finance from that party) or the creditors more generally (due to the intervention of the insolvency procedure, the absence of a real right held by the assignee/pledgee at that stage, and the desire to protect other creditors) or even the distressed debtor (in the context of the rescue culture/fresh start). If the policy preference is either (or both) of the last two, which it currently seems to be, then a wide approach encompassing a larger number of procedures (such as CVAs and restructuring plans) is desirable and logical to achieve this objective. Alternatively, if the policy preference is to support financing from an assignee/secured creditor, then it would seem preferable to adopt a narrower approach limited to a small number of procedures. On balance, our preference is in favour of the wider approach.

Nevertheless, there are technical reasons available for distinguishing between different procedures, which could be used to support a narrower approach. Some procedures involve all (or almost all) of a debtor's estate, with the appointment of a third party to take control of assets, and could be considered to most justify the protection of other creditors. In corporate insolvency law, liquidation, administration and administrative receivership are in this category. In non-corporate insolvency law, sequestration, bankruptcy and a trust deed over all or substantially the whole of the debtor's property would qualify. By contrast, there are other procedures which are primarily debt-oriented and do not necessarily impact directly upon the debtor's property, and may not involve the appointment of a third party to take control of the estate. In corporate insolvency law, CVAs and restructuring plans are in this category (as are schemes of arrangement, which are not currently included). For non-corporate insolvency, trust deeds for creditors that affect only limited assets, compositions, arrangements, and debt payment programmes would qualify.

Distinguishing between procedures on other grounds can be more challenging. For example, if the intention is to focus on procedures where insolvency is a pre-condition, this would technically exclude e.g. administration, administrative receivership, and CVAs (at least in some instances for each of these procedures) among other procedures. A specific condition could be included whereby procedures will only be included if the debtor is factually insolvent, which could thereby incorporate insolvent

administrations, administrative receiverships and CVAs and so on, but that would create undesirable uncertainty. Nevertheless, the absence of a requirement for financial distress or insolvency may be a factor to take into account and which, combined with other factors, may serve to exclude a process, such as schemes of arrangement under Pt 26 of the Companies Act 2006, which can be contrasted with Pt 26A restructuring plans, as the latter require financial distress. As noted in R Mokal, “What is an Insolvency Proceeding? *Gategroup* Lands in a Gated Community” (2022) 31(3) *International Insolvency Review* 418, schemes of arrangement may be considered insolvency procedures in some scenarios, but we are willing to accept their omission in the current context, not least because of the absence of a general requirement for financial distress, the potential complexity of how to adequately include relevant schemes and the unlikelihood of this happening at the present stage.

While there may be some fears about debtors or other creditors initiating certain insolvency procedures to defeat the interests of a potential secured creditor or assignee, that risk may be overplayed, as a party is unlikely to take the step of entering into an insolvency procedure lightly. In addition, if only some insolvency procedures are included, this may incentivise excluded procedures for the potential secured creditor or assignee to protect their own interests, albeit that there may be difficulties for them to directly initiate at least some of these. The voting and approval mechanisms that exist in procedures such as CVAs and restructuring plans do give some protection to creditors generally and special protection to secured creditors (subject to e.g. cross-class cramdown for Pt 26A plans, but which may be unlikely for such creditors). Where there is an assignation or pledge of future property and the property is not yet acquired by the cedent/pledgor by the time of an insolvency procedure, then the counterparty is only a potential assignee or potential secured creditor at that point. (However, if, for example, a statutory pledge has been created over present property too then they will be a secured creditor in relation to that property.) This seems to further legitimise the view that a range of insolvency procedures can justifiably determine that the property is not ultimately assigned or encumbered. There are protections for a secured creditor in insolvency procedures (as noted) but these would be limited to where a party already holds a security right, rather than a potential security right. As noted, unsecured creditors participate in approval of CVAs and restructuring plans too but with a more limited ability to affect the outcome compared to secured creditors.

It may be contested that for liquidation (winding up), only creditors voluntary liquidations (CVLs) and compulsory liquidations should be included, as the company is declared solvent in members voluntary liquidations (MVLs). However, it may be noted that not all compulsory liquidations are insolvent liquidations, and if there is an MVL or solvent compulsory liquidation, the parties should all receive payment in full anyway, so the effect of the provisions will matter little. As such, it is probably fine to retain the current wording regarding liquidations.

For the administrative receivership provisions, it could be queried whether the reference to “being a part which includes the claim” etc relates should remain. There could conceivably be a situation (albeit highly unlikely) in which an administrative receiver is appointed over property that does not include the claim/property in question. In such a scenario, should the interests of the potential assignee/secured creditor have priority over other creditors? Perhaps such a priority could be justified as

receivership is an enforcement mechanism for a floating charge, and is not for the benefit of the other creditors or the rescue of the company. It may also be more straightforward at this stage to keep the provisions as they are, particularly since receiverships are very rare nowadays.

Question Three – should all trust deeds be included in the definition of insolvency for individuals? Please provide reasons for your answer.

We acknowledge that there may be an argument in favour of limiting the definition to protected trust deeds, due to the element of publicity provided by registration of such deeds (and potentially with registration being the relevant trigger). It could be contended that the law should be amended to require the registration of other trust deeds for creditors but that does not seem to be a realistic possibility in the near future.

We note that the number of unprotected trust deeds for creditors appears to be very low and this may make a difference as to whether all such deeds are included. There is also the possibility that a trust deed is originally intended to become protected but never does. It may be reasonable to include the grant of such deeds in the definition. Also, drawing a distinction between protected and unprotected trust deeds may incentivise protected trust deeds for some parties, while incentivising unprotected trust deeds for others.

It could be said that with a trust deed generally it is up to the creditors to determine how the property should be dealt with, and creditors do not have to be bound by it, but that is less so with protected trust deeds, as dissenting creditors are bound. This could arguably justify separate treatment here. Then again, given that the purpose of any trust for creditors in this context is to transfer assets to a trustee, we can see the logic in including any grant of a trust deed for creditors.

Trust deeds are valid from the point at which they are granted, and so this can justify using the grant of such a deed as the relevant point in the definition of insolvency. This is particularly apposite if unprotected trust deeds are to be included, as there is no obvious alternative point such as registration.

If all trust deeds for creditors are included, there could be an argument for limiting the effect of the provision to where the property in question is included in the trust. If the trust deed is only partial and relates only to other items of property, it may be wondered why it should be treated as an insolvency trigger for the relevant claims/property and thus deprive the potential assignee/secured creditor.

Question Four – should the terms composition and arrangement be excluded from the definition of insolvency for individuals? Please provide reasons for your answer.

There is an argument for retaining the terms composition and arrangement in the definition of insolvency. While judicial composition in sequestration has been repealed, that was a specific example of composition and there is still the possibility (at least in theory) of a composition at common law. In addition, consideration is being given to reintroducing a form of statutory composition for sequestration and trust deeds,

although of course this may or may not happen. In any event, composition retains meaning and composition and arrangement is a term used in other contexts.

Assuming that unprotected trust deeds are not excluded due to the absence of publicity, then composition and arrangement should probably still remain. However, if the trust deeds included are protected trust deeds only, due to the publicity aspect, there is a stronger argument in favour of omitting compositions and arrangements in the absence of equivalent publicity.

Question Five – do you agree that the definition of insolvency should include company voluntary arrangements? Please provide reasons for your response.

See our earlier comments. It depends upon policy preferences and whether a wide or narrow approach to insolvency procedures is sought. If it is the former, then the definition should include CVAs, if it is the latter, they should be omitted.

On the basis of the apparently desired policy preference, we slightly favour their inclusion. It can also be noted that they are widely recognised as an insolvency procedure domestically and internationally. Another argument in favour of an expansive approach incorporating procedures such as CVAs and Pt 26A restructuring plans etc is the general objective of encouraging corporate rescue. On this basis, it may be considered worthwhile to sacrifice the interests of potential assignees or secured creditors in the interests of rescue.

An alternative approach would be to exclude CVAs (and Pt 26A plans) and to rely on the relevant voting procedures to determine what effect the procedure has on the claims or other property in question.

Question Six – should only company voluntary arrangements which include the claim/encumbered property fall within the definition? Please provide reasons for your response.

We can see the argument in favour of this. However, given that a CVA is principally focused on debt/liabilities, and may not necessarily relate to particular property, it is perhaps more straightforward and logical to include all CVAs (or to remove them entirely, if that is the policy preference). As noted, there are some limited protections for potential assignees or secured creditors by virtue of the voting requirements for CVAs.

Question Seven – do you agree that the definition of insolvency should include the making of an order sanctioning an agreement under Part 26A of the Companies Act 2006? If so, at what point in the process should the definition be aligned to? Please provide reasons for your views.

The consultation paper mistakenly states that the second set of amendments was reversed, when, in fact, Pt 26A restructuring plans are included in the relevant procedures under the Act (as passed). The inclusion of these plans is justified on the basis of consistency given the inclusion of CVAs. If either Pt 26A restructuring plans or CVAs are to be removed, the other should also be removed.

One of the main reasons why there has been debate regarding which insolvency procedures should be included is that it was not clear why certain procedures had been included in the first place while others were omitted. If CVAs are to be included, then on what basis should Pt 26A restructuring plans be excluded? While the CVAs regime is located in the Insolvency Act 1986, and restructuring plans are in the Companies Act 2006, both are debt-oriented procedures, commenced via voting approval systems, and restructuring plans require financial distress (and this may involve actual insolvency), while CVAs technically do not (albeit that in practice they involve financially distressed and often insolvent companies).

If restructuring plans are to be included, the relevant point should be the granting of a court order under s 901F. It is only at this point that a restructuring plan formally commences and it provides a significant element of publicity to third parties. It also offers more consistency with the trigger point for CVAs. Furthermore, if an earlier point is chosen, the restructuring plan may not actually be approved and the proposed assignee or secured creditor may be considered unfairly disadvantaged.

Also, the suggestion that a company's financial difficulties will have been eliminated or limited at the point at which the restructuring plan is sanctioned will not always be accurate. A company may be on a possible path to recovery but is likely still dealing with financial difficulties, in the same way that a company would be in other procedures.

Question Eight – should only compromises or arrangements which include the claim/encumbered property fall within the definition? Please provide reasons for your views.

See our above comments, including in relation to CVAs. The same reasoning may justify removing the relevant wording for Pt 26A plans, so that all such plans are included. As a primarily debt-oriented procedure, a reference to property in the definition may cause confusion and would also require the checking of the details of the plan in any given instance to determine its effects. In addition, there is currently inconsistency with the provisions for CVAs, for which there are no equivalent references to “over all or part of the property”. It is desirable to adopt a consistent approach on this point.