

## Including societies in insolvency reforms

April 2020

### Key points

**Co-operative and community benefit societies to be included in the following announced changes to insolvency law:**

- **New moratorium period**
- **New restructuring procedure**
- **Prohibition of supplier termination clauses**
- **Relaxation of wrongful trading legislation**

**There are significant risks in creating further disparities between societies and companies in this crucial area**

**In some cases, we believe it will be appropriate to modify the legislation planned for companies to reflect the distinct form and function of societies**

## 1 Introduction

- 1.1 This paper sets out why and how co-operative and community benefit societies ('societies') should be included in the reforms of UK insolvency law announced by government on 28 March 2020, in response to COVID-19.<sup>1</sup>
- 1.2 Our starting point is that insolvency (and pre-insolvency) legislation should give societies the same opportunities for rescue and survival as it gives to companies, unless the distinct form and function of societies demands otherwise. The extreme risk to business survival created by COVID-19 exists for societies as much as for companies, so the need for appropriate alignment in this area is currently huge.
- 1.3 This paper is structured as follows:
  - In **part 2** we set out why the new **moratorium** provision should be adapted for societies and suggest some modifications to the BEIS proposals.
  - In **part 3** we set out why the legislation to introduce a new **restructuring procedure** should be adapted for societies.
  - In **part 4** we set out why government needs to ensure the planned legislation prohibiting certain **termination clauses** in contracts to supply, will apply to societies.
  - In **part 5** we confirm that the planned relaxation of **wrongful trading rules** should be applied to societies

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<sup>1</sup> <https://www.gov.uk/government/news/regulations-temporarily-suspended-to-fast-track-supplies-of-ppe-to-nhs-staff-and-protect-companies-hit-by-covid-19>

## 2 A moratorium for societies

- 2.1 The law should provide financially distressed societies with the option of entering a 'moratorium period', during which time Boards remain in control and creditors cannot take action against them. A moratorium would allow societies them to fully engage their members and stakeholder communities, make preparations to restructure or seek new investment. This would build on existing adaptations of insolvency law for societies, introduced in 2014.
- 2.2 In our view the rationale for providing a moratorium period is as strong for societies as it is for companies. Conversely, not doing so would further reduce the utility of the society corporate forms, would place existing societies at an unfair disadvantage and increase the risk of their failure relative to companies.

### Existing adaptations: the members' meeting

- 2.3 In 2014 government introduced secondary legislation ('ARA 2014') to adapt key aspects of UK insolvency law for use by societies.<sup>2</sup> This provided distressed societies with the options of entering into CVAs and the process of administration. Taking up recommendations from the sector at the time, government modified certain aspects of insolvency law to reflect the distinct form and function of societies. Most importantly, administration law for societies requires that a 'members' meeting' be held as part of the formal process, with parity with a creditor's meeting in terms of approving, varying or rejecting the administrator's proposals.<sup>3</sup>
- 2.4 While this adaptation is very welcome, it appears not to have operated effectively in recent cases of insolvent societies. The influential Protecting Community Assets inquiry's interim report includes careful analysis of a number of post-2014 high-profile society insolvencies, wherein community ownership of significant assets was lost. The inquiry reports that in these cases 'the community', including crucially the general membership of the societies, was "frozen out" of the process. The inquiry reports that a lack of consistent understanding of society insolvency law across insolvency practitioners, investors, funders and local communities contributed to failure. It is widely suspected that in these cases the required members' meetings were not held, in part because insolvency practitioners were unfamiliar with the law for societies and in part because of the additional administrative challenges involved in organising the required members' meeting.<sup>4</sup>
- 2.5 We agree with the interim findings of the Protecting Community Assets inquiry, that in many cases the general membership and the wider community have the potential to be instrumental in turning around or rescuing a society, so long as they are properly engaged in the process.<sup>5</sup> Co-operatives UK will be taking action to improve understanding of society insolvency law among societies, those who advise them and insolvency practitioners. We believe that with the right best practice and practical support in place, more could be done

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<sup>2</sup> <http://www.legislation.gov.uk/uksi/2014/229/contents/made>

<sup>3</sup> Ibid

<sup>4</sup> [http://www.protecting-community-assets.org.uk/Full\\_Interim\\_Report.pdf](http://www.protecting-community-assets.org.uk/Full_Interim_Report.pdf)

<sup>5</sup> Ibid

to make the most of the existing legal provisions. But there is a limit to what can be achieved within the current law. A moratorium period would significantly enhance the prospects of turning round societies in distress and preserving economic and social value.

*What a moratorium would add: time well spent*

- 2.6 In its consultation response announcing government's intention to introduce a moratorium for UK companies, BEIS says that the key benefit of this measure is the time it will afford businesses to consider options for addressing financial and economic problems, preserve value and safeguard jobs.<sup>6</sup> This applies as least as much to societies as to companies. Indeed in our view, the potential role that members, communities and other mission-aligned stakeholders could play in supporting a society to turn around, means that additional time outside administration could be especially valuable for societies.
- 2.7 In the first instance we believe the additional time will allow society directors to get advice and support from co-operative and community business specialists, which could help them turn things around.
- 2.8 Most importantly, additional time will enable society directors to involve their fellow members and the wider community at an earlier stage, in a more constructive way. This could introduce valuable insights and ideas to help the society get better at meeting its co-operative or community purpose through profitable commercial activity.
- 2.9 The moratorium could also afford societies the time to raise vital funds from their members and the wider community. Crowdfunding and community investment activities can be extremely effective, especially when an asset or enterprise the community values is at risk, but they take time and require focus. A moratorium could afford societies and their supporters the time and space to raise funds this way.
- 2.10 The moratorium could also give societies time to secure financial and non-financial support from other stakeholders. Many of these businesses have social purposes which mean institutions such as grant makers, financial intermediaries and sector associations are very willing to help contribute to a viable rescue plan. Many societies could also use the extra time to call on wider networks for collective assistance, such as SolidFund (for worker co-operatives). As a result of the findings of the Protecting Community Assets inquiry, a working group of leading funders and sector associations is developing plans for assistance and intervention services that could help rescue societies with community assets<sup>7</sup>. A moratorium period would give these initiatives more time and space to be effective.
- 2.11 Societies can leverage social capital and by extension further economic capital to support a turnaround in ways most businesses cannot, but this takes time. Altogether, the moratorium would afford more time and space for societies to fully engage their members and other potentially very helpful stakeholders, so that a viable rescue plan can be developed, through which co-operative or community purpose and member control are retained.

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<sup>6</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/736163/ICG - Government response doc - 24 Aug clean version with Minister s photo and signature AC.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/736163/ICG_-_Government_response_doc_-_24_Aug_clean_version_with_Minister_s_photo_and_signature_AC.pdf)

<sup>7</sup> [http://www.protecting-community-assets.org.uk/Full Interim Report.pdf](http://www.protecting-community-assets.org.uk/Full_Interim_Report.pdf)

### *The impact of 'do nothing'*

- 2.12 We believe the impacts of not adapting the moratorium for societies (the 'do nothing' scenario) would be unacceptably negative for societies, for the vibrancy of the UK's social economy and for the creation of social value.
- 2.13 Societies would be put at a higher risk of business failure relative to companies, because they would have less time and space to turn things around if they got into difficulties. While the real world impact of this risk is likely to be varied, government should not take this lightly. For example, it could negatively impact the credit scoring of societies and their risk rating in the Pension Protection Fund. The potential business costs in both these scenarios could run into the millions of pounds a year.<sup>8</sup> This will put a drag on societies' ability to create social value.
- 2.14 While efforts are underway to improve outcomes for societies that get into financial difficulty within existing insolvency law to, most notably in the community ownership space, the lack of a moratorium and the time and space it provides would reduce the potential efficacy of these initiatives. Ultimately, we believe more societies would fail as a result of not having access to a moratorium period, costing livelihoods and in many cases destroying enormous social value.
- 2.15 The lack of a moratorium would further add to the long list of disparities between the company and society corporate forms. This would further hamper the choices of new and existing businesses in the social economy, discourage diversity in approaches to business and thus stifle innovation. We believe making the society corporate forms more disadvantageous impairs the UK's transition to a more inclusive and sustainable economy.

### *Modification: suspension of share withdrawals and protection of creditors*

- 2.16 The suspension of share withdrawals by society directors during times of financial stress is a key tool for protecting creditors. The registrar of societies (the Financial Conduct Authority) has issued guidance saying that in order to comply with registration under the Co-operative and Community Benefit Societies Act, societies suspend share withdrawals if it appears likely that they will not have sufficient trading surplus to provide the adequate liquidity.<sup>9</sup> Thus registry policy strongly encourages societies to adopt a policy of only allowing share withdrawals when they are solvent with sufficient trading surplus.
- 2.17 During a consultation we ran with our members in 2018, a number of respondents suggested that legislation could be beneficial to make this an explicit legal requirement for societies.<sup>10</sup>
- 2.18 In adapting the company moratorium for societies, we suggest government should consider whether the legislation should explicitly prevent share withdrawals during the moratorium.

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<sup>8</sup> For example, back in 2016 changes in the risk rating of societies, as a result of how credit reference agencies collected data on their registered charges/mortgages, led to additional PPF levies in excess of £2 million for just six co-operatives. See here: <https://www.uk.coop/pension-protection-fund>

<sup>9</sup> <https://www.fca.org.uk/publication/finalised-guidance/fq15-12.pdf>

<sup>10</sup> <https://www.uk.coop/consultation-outcome-getting-better-deal-societies>

### Modification: duties of moratorium monitor

- 2.19 BEIS is proposing a powerful role for an external moratorium monitor in assessing whether a society is eligible to enter and extend a moratorium, as well as assessing compliance with moratorium rules throughout.<sup>11</sup>
- 2.20 When government adapted insolvency law for societies in 2014, it included provisions so that the decisions of administrators and the content of CVAs do not breach compliance with conditions of registration under the Co-operative and Community Benefit Societies Act.<sup>12</sup> While in the proposed moratorium period members and not the monitor are in control of the society, we believe government should consider whether some legislative modifications would be appropriate to guide monitors in the critical assessments they make during the process.
- 2.21 For example, we suggest that the legislation could place a duty on the monitor to have regard for the society's obligations under the Co-operative and Community Benefit Societies Act. Experts in this area agree that this would be a very important modification.
- 2.22 Government may also consider whether the monitor should have a duty to consider the preservation of corporate purpose in societies. In a co-operative society the corporate purpose is to meet the common needs and aspirations of members, usually while also benefiting the community. In a community benefit society, the corporate purpose is to carry on a business, industry or trade for the benefit of the community.<sup>13</sup> While the position of creditors must always be protected, it will be essential for the monitor to appreciate why societies make certain choices in attempting a turnaround, not just to preserve the business in any form, but to preserve the business in a form that continues to fulfil its mutual and/or social corporate purpose.
- 2.23 We believe such legislation would help guide the assessments and decisions monitors make, in a way that is appropriate for the distinct corporate forms they would be dealing with. As recent examples of society insolvencies demonstrate, insolvency practitioners need additional guidance in this area.

## **3 New Restructuring Procedure**

- 3.1 BIES is planning to introduce a new Restructuring Procedure that would allow a company to bind all classes of creditors and all classes of shareholders, even if these classes vote against the plan, through the use of a 'cross-class cram down provision.'<sup>14</sup> This is being described, broadly, as the existing Schemes of Arrangement, with the addition of the cross-cram down mechanism.

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<sup>11</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/736163/ICG - Government response doc - 24 Aug clean version with Minister s photo and signature AC.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/736163/ICG_-_Government_response_doc_-_24_Aug_clean_version_with_Minister_s_photo_and_signature_AC.pdf)

<sup>12</sup> <http://www.legislation.gov.uk/ukxi/2014/229/contents/made>

<sup>13</sup> See CCBSA and FCA Guidance

<sup>14</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/736163/ICG - Government response doc - 24 Aug clean version with Minister s photo and signature AC.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/736163/ICG_-_Government_response_doc_-_24_Aug_clean_version_with_Minister_s_photo_and_signature_AC.pdf)

3.2 If the new Restructuring Procedure for companies increases their opportunities for rescue and survival, then this creates a strong rationale for applying it to societies. As with the moratorium, we believe that the negative consequences of creating further disparity that increases the risk of societies failing relative to companies should be avoided. Our comments in 2.12 to 2.15 are broadly applicable here.

Existing adaptations: Schemes to Arrangement

3.3 The ARA 2014 adapted the companies Schemes of Arrangement legislation to societies with very minor modification. Schemes of Arrangement in societies require FCA certification that they are not contrary to a society's rules or the provisions of Co-operative and Community benefit Societies Act.<sup>15</sup>

Cross-cram down and member democratic control: why there is no significant issue

3.4 HM Treasury has asked us to consider whether the proposed cross cram down mechanism is compatible with the principle of democratic member control in societies. We have considered whether a restructuring procedure for societies would need to include a requirement for members of a society to approve a plan before it could be confirmed.

3.5 Having considered this in detail with the advice of legal experts, we **do not** believe the cross cram down is incompatible with democratic member control. In adapting the Restructuring Procedure legislation for societies, members of societies should be given the same voting rights as are proposed for shareholders in companies. We explain why below.

3.6 If in this context 'restructuring plan' refers narrowly to a plan to restructure debts (which is the view of experts we have consulted), any plan will be a matter between the society and its creditors. Thus there is no reason why members in a society, as equity shareholders, should have any special power to veto these plans.

3.7 The principle of democratic member control in a society does not override the principle that creditors come before equity shareholders in order of preference. Members of a society, as equity shareholders, will always be behind all creditors in order of preference, so a restructuring plan cannot put them in any worse situation than they are in already, as far as their financial interest in the society is concerned.

3.8 The principle of democratic member control could only become material concern if a 'restructuring plan' went beyond the narrow restructuring of debts, to make fundamental changes to the society, in terms of purpose, governance, ownership and so on.

3.9 We believe sensitivities around restructuring debts and society purpose would be most practicably dealt with through the same FCA certification process used in society Schemes of Arrangement - FCA certification that a plan does not breach the rules of the society or the Co-operative and Community Benefit Societies Act should be required, before a plan can be approved. This will limit the extent to which restructuring plans can fundamentally change the society without converting it into a company. Plans that included debt-equity swaps that gave away too much member ownership and control, for example,

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<sup>15</sup> <http://www.legislation.gov.uk/ukSI/2014/229/contents/made>

could not be certified by the FCA.

3.10 Furthermore, Co-operative and Community Benefit Societies Act already contains protections which limit what a restructuring plan can do without member approval:

- **Mergers / amalgamations / transfer of engagements** - If a plan included something as drastic as a merger/ amalgamation/ transfer of engagements between the distressed society and another stronger society, sections 109 to 111 of the Act already requires that these actions be approved by a super-majority of members via a special resolution.<sup>16</sup>
- **Demutualisation via conversion into a company** - Big debt-equity swaps that resulted in a change in control or threatened co-operative/community purpose, or any mergers with non-societies, or anything else that could only be achieved via demutualisation, could only be achieved following conversion into a company. The section 113 of the Act already states that conversion into a company can only proceed if members pass a special resolution by 75 per cent in a vote in which over 50 per cent of members vote.<sup>17</sup>

3.11 These are strong existing protections in the Co-operative and Community Benefit Societies Act. As long as the restructuring legislation does not override them, they ensure that even if a restructuring plan contained things that altered, or had the potential to alter, the fundamentals of the society, members will have their say at the crucial point, even if cross cram down means that the plan has been 'approved' over their objections.

3.12 In practice it would be both foolish and fruitless for a board to use cross-class cram down to push through a plan which included such actions over the objections of members, because in order to actually implement their plan, they would still need member approval under the Co-operative and Community Benefit Societies Act for these parts of their plan.

3.13 **We suggest the key here would be for the restructuring procedure legislation to reinforce rather than override s109 -111 and s113 of the Co-operative and Community Benefit Societies Act**, with the FCA given a certification role as it has for Schemes of Arrangement.

*Modification: FCA certification*

3.14 We suggest that, as with Schemes of Arrangement for societies, Restructuring Plans for societies should require FCA certification that they are not contrary to a society's rules or the provisions of Co-operative and Community benefit Societies Act, before they can be confirmed.<sup>18</sup>

*Modification: vote counting in the member class*

3.15 BEIS proposes that the threshold for shareholder classes approving a plan in companies

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<sup>16</sup> [CCBSA s109 to 111](#)

<sup>17</sup> [CCBSA s113](#)

<sup>18</sup> <http://www.legislation.gov.uk/ukxi/2014/229/contents/made>

should be 75 per cent of shareholder value. Weighting votes by value of shareholding is not compatible with the principle of democratic member control in societies. We suggest that the legislation for societies be modified so that the 75 per cent threshold in the member class is based on how a societies' rules state votes are counted. For example, as the vast majority of society rules stipulate one-member-one-vote, the threshold for these would be 75 per cent of votes by members. Where the rules of a society stipulate some other vote weighting, the threshold for approving a plan should be 75 percent of that weighting.

#### **4 Termination clauses**

- 4.1 BIES is planning to prohibit the 'termination clauses' in business supply contracts, whereby suppliers terminate supply contracts on the grounds that their customer has entered a formal insolvency procedure. This prohibition is intended as a means of enabling businesses in distress to trade out of their difficulties.
- 4.2 Government's policy should be for this to apply to contracts involving all corporate forms, including societies. We ask that care is taken to ensure this legislation does not exclude societies.

#### **5 Wrongful trading relaxation**

- 5.1 Wrongful trading legislation applies to societies in the same way that it applies to companies. We have been advised that there are no reasons why the temporary relaxation of these rules should not be applied to societies as well.

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#### **About Co-operatives UK**

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