24 June 2010

Our ref: ICAEW Rep 57/10

Your ref:

Insolvency Practitioner Policy Section
The Insolvency Service
Zone B, 3rd Floor
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London
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By Email: policy.unit@insolvency.gsi.gov.uk

Dear Sirs

Consultation/Call for evidence on improving the transparency of, and confidence in, pre-packaged sales in administrations

The ICAEW is pleased to respond to your request for comments on *Improving the transparency of, and confidence in, pre-packaged sales in administrations*.

We also believe it would be beneficial if we could have a discussion with Edward Davey MP on insolvency and pre-packaged administrations in order that we could discuss with him in more detail the circumstances that arise and give him an opportunity to question and challenge our views.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

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ICAEW REPRESENTATION

ICAEW REP 5710

CONSULTATION/CALL FOR EVEIDENCE ON IMPROVING THE TRANSPARENCY OF, AND CONFIDENCE IN PRE-PACKAGED SALES IN ADMINSTRATION

Memorandum of comment submitted in June by the ICAEW, in response to the Insolvency Service consultation paper *Improving the transparency of, and confidence in, pre-packaged sales in administrations* published in March 2010

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INTRODUCTION

1. The ICAEW welcomes the opportunity to comment on the consultation paper Improving the transparency of, and confidence in, pre-packaged sales in administrations published by the Insolvency Service.

2. We also believe it would be beneficial if we could have a discussion with Edward Davey MP on insolvency and pre-packaged administrations, as we would like to discuss with him in more detail the circumstances that arise and give him an opportunity to question and challenge our views. There are considerable complexities arising due to the very different ways in which pre-packs are used, for example in non-trading finance vehicles to achieve an agreed restructuring swiftly, with major creditor support, in "people" businesses, or in mid-market trading companies.

WHO WE ARE

3. The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

4. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.

5. The Institute's regulation of its members and affiliates in insolvency is overseen by the Insolvency Service, and the Institute is the largest of the Recognised Professional Bodies under the Insolvency Act, currently licensing nearly 700 practitioners. The Institute's Insolvency Committee is a technical committee made up of Insolvency Practitioners working within large, medium and small practices. The Committee represents the views of Institute licence holders.

RESPONSES TO SPECIFIC QUESTIONS

Question 1: **Do you believe that the current framework governing the operation of pre-pack sales in administration provides a sufficient level of confidence that pre-packs are only being used in appropriate circumstances and with an appropriate degree of transparency?**

6. As a general point, a pre pack is a method of executing an insolvency process. It is a solution to a problem caused within the company, but it is that problem, rather than the solution which is the root cause of the creditors' concern.

7. It is too simplistic to assume that confidence in the pre pack process is entirely dependent on the current framework. The framework alone cannot address negative responses to the pre pack process. Educating creditors as to the requirements of the law and the code of ethics and seeking to correct some of the misconceptions disseminated by the media will play a vital part in increasing confidence in the process.

8. A general dissatisfaction with a corporate failure and suspicion of the transaction does not mean that the pre pack was an inappropriate course of action. Many of the responses received from the insolvency profession to the Joint Insolvency Committee's consultation on the effectiveness of SIP 16 reveal that they have received few if any requests from creditors for further information after having seen the SIP 16 statement. That would suggest that creditors who are directly involved in a pre pack are either disinterested for reasons unconnected with the pre pack process or have all the information they need.

Question 2: **If not, what are your main concerns with the way pre-packs are currently executed?**

9. See above.

Question 3: **Do you believe that pre-packs are presently subject to abuse? If so, how? Please indicate whether you believe it is the actions of directors, insolvency practitioners, secured lenders or any other parties that are contributing to any perceived or actual abuse and to what extent you believe this is a problem.**

10. The Insolvency Service's own reports into the operation of SIP 16 have not identified any evidence that there are different levels of director misconduct in a pre pack than any other corporate failure. None of the complaints made to ICAEW as an RPB by the Insolvency Service have revealed any misconduct on the part of the insolvency practitioner, beyond the perceived failure to comply with SIP 16. Available information suggests that the vast majority of Insolvency Practitioners are complying with SIP 16, while only a tiny minority (3%) are not - see the Appendix with extracts from R3's March 2010 report on Pre-packs and SIP16 - and we note that the 35% of cases that were stated as 'falling short of full compliance' included a range of outcomes, including cases that had simply not yet reached their conclusion.

Question 4: **Some of the following options would require a distinction to be drawn between pre-packs and 'conventional' administrations. What do you think should be included in a statutory definition as to what constitutes a pre-pack transaction?**

11. This question assumes that there should be a statutory solution to pre packs. If there were to be a legislative solution then it would be inevitable that a pre pack would have to be defined. If the statutory route is taken, we would suggest that the definition is based on that included in SIP 16, which in itself comes from case law. The insolvency

profession are already used to that definition and there seems no benefit in re-defining a pre pack.

Question 5: Do you believe that the new pre-appointment cost recovery mechanism will have a significant effect on transparency and confidence?

12. See our response to Q1 – this will provide greater transparency on fees..

Question 6: Do you believe that by giving statutory force to the SIP 16 disclosure requirements creditors would be given better information about the reasons and justification for the pre-pack?

13. It is unlikely that a statutory requirement alone would result in better information being provided. A statutory requirement is unlikely to contain much more detail than the current SIP .The Insolvency Service's own monitoring of SIP 16 statements has and is applying value judgements on the level of information disclosed and whether they meet the test in paragraph 8 of the SIP. It is unlikely that the reasons and justifications disclosed via a statutory requirement would be assessed using different criteria. Any assessment of compliance with a statutory requirement is likely to apply similar value judgements. Any statutory requirement would be in the nature of a checklist and still need to be supported by additional guidance equivalent to Dear IP 42 or perhaps even a revised SIP 16. A statutory route would also make it difficult to amend disclosure requirements over time as circumstances change.

Question 7: **Do you believe that such a requirement will increase costs and reduce the returns available to (a) secured creditors, and (b) unsecured creditors? If possible, please provide an estimate of the impact on each.**

14. As insolvency practitioners already produce SIP 16 statements any requirement is likely to be cost neutral, on the assumption that the level of detail is not increased.

Question 8: **Do you believe that it would be appropriate for details of the pre-pack to be filed at Companies House? If not, why not?**

15. Representatives of the British Property Federation when they met with the JIC were keen for SIP 16 statements to be filed at Companies House. There would seem to be no obvious harm in SIP 16 statements being filed at Companies House given that the administrator's proposals are also filed with the Registrar. This would undoubtedly incur a cost as Companies House would undoubtedly charge for filing the document. Such a step may require legislative change (unless the SIP 16 statement was included with the proposal documentation) as Companies House only file documents where there is a statutory requirement for them to do so and they tend to impose high levels of prescription on the documents capable of being filed which would have a cost impact. Filing as part of the proposals would however take away from the immediacy of the SIP 16 statement and may therefore be counter productive. Therefore the filing would have to be in addition to a SIP 16 notice being sent to creditors.

Question 9: **Do you believe that it would be appropriate for a statutory offence to be created in circumstances where the pre-pack disclosure requirements are not adequately met?**

16. The logical step to a statutory requirement is an offence of non compliance with that requirement. Without the creation of an offence, failure to comply with any new requirement would be a matter for the RPBs to deal with and in essence no different from the current situation. However, the evidence to date from our knowledge of the

Insolvency Service's reviews of SIP 16 statements suggest that there would always be inconclusive evidence on which to bring a prosecution.

Question 10: **Do you believe that confidence in pre-packs would be improved by requiring companies whose business and assets had been sold through a pre-pack to exit administration via compulsory liquidation? What would be the possible costs and benefits?**

17. The choice of exit route in itself does not impact on any dissatisfaction with the pre pack deal, which will still have been completed shortly after the administrator's appointment. Restricting the choice of exit route undermines the flexibility of the administration process and may simply move the "pre pack" to a different insolvency process such as CVL.

18. There are obviously cost implications for creditors in an exit via compulsory liquidation (court fees, ad valorem fees) or for the public purse if there are no assets available. There would also be resource implications for both the Court Service and the Insolvency Service as the number of compulsory liquidations would increase.

19. We consider that a better solution would be to amend existing law to make it possible for a practitioner to call a meeting even if there are no funds for unsecured creditors and for a meeting to be required to be called at the end of administration where exit via a CVL is proposed, in all administrations.

Question 11: **Do you believe that an insolvency practitioner providing advice to a company on the potential for a pre-pack has an inherent conflict of interest when accepting a formal appointment as administrator with a view to subsequently executing a pre-pack sale?**

20. The code of ethics exists to deal with exactly this kind of situation. Such a potential conflict exists in many insolvency situations where the insolvency practitioner has acted in an advisory capacity to the company before appointment and is not unique to pre packs. The appropriate application of safeguards should reduce such threats to an acceptable level, otherwise the insolvency practitioner should not accept with appointment – this is one of the basic principles of the code.

Question 12: If so, do you believe that such a conflict extends to circumstances where the insolvency practitioner has had an ongoing prior relationship with the company in the context of undertaking review work for a secured lender?

21. See our answer above**.** The appropriate application of safeguards should reduce such threats to an acceptable level, otherwise the insolvency practitioner should not accept with appointment – this is one of the basic principles of the code.

Question 13: **Do you believe that a requirement for a different insolvency practitioner to accept appointment as administrator would improve confidence that pre-packs are only used in appropriate circumstances?**

22. If confidence were to be increased by such a step this would reflect the basic misunderstandings by third parties of the purpose of administration and the pre pack process. This question assumes that the advisor insolvency practitioner has not advised the company appropriately, and if that initial advice was flawed it is unlikely another

insolvency practitioner would accept the appointment as administrator given that there is a defined statutory purpose of administration in schedule B1 to the Insolvency Act.

23. Further, if it is the underlying pre pack deal to which creditors object, its execution by another insolvency practitioner shortly after their appointment is unlikely to increase confidence. Another insolvency practitioner will be working within the same legislative and regulatory framework and subject to the same code of ethics as an any advisor insolvency practitioner.

Question 14: **Do you believe the requirement to use two separate insolvency practitioners would increase costs and delay therefore reducing the returns available to (a) secured creditors, and (b) unsecured creditors? If so, please provide an estimate of the impact on each.**

24. Using two people to achieve what could have been done by one would seem to lead to an inevitable increase in costs. We could see this leading to a considerable increase in costs. The amount of this is difficult to estimate as in theory no additional work is required. However, the second IP would need to familiarise him or herself with the case and repeat various tasks already undertaken by the first IP.

Question 15: Do you believe the requirement to use two separate insolvency practitioners would reduce the number of business sales effected through a pre-pack sale? If so, please provide an estimation of the impact.

25. We are unsure quite what this question means. Are you suggesting that an insolvency practitioner would advise that a pre pack is not the appropriate course of action, despite it being the solution most appropriate to a particular insolvency on the basis that he would not be appointed administrator.

Question 16: Is it desirable that unsecured creditors, who may not stand to receive any dividend from the proceedings, be given an opportunity to influence the proposed pre-pack sale where the business is being purchased by a connected party? If so, why?

26. It could be argued that their involvement could increase confidence in the process. But to return again to the purpose of administration, if a pre pack sale (whether to a connected party or not) is the most appropriate course of action to achieve the purpose, it is difficult to see how unsecured creditor involvement could be achieved without defeating the purpose of the administration. We consider it unlikely that unsecured creditors would be supportive of a sale, regardless of the precise arrangements for a sale.

Question 17: Should approval for such a sale initially be sought from unsecured creditors with a recourse to the court, or from the court in the first instance? If you believe unsecured creditors should be given the opportunity to approve in the first instance, what percentage in value of their claims should be required for approval to be obtained?

27. See response above regarding the role of unsecured creditors. There is a more persuasive argument for the involvement of the court as this would be a dispassionate review of the proposals. However, one of the aims of a pre pack is the immediacy of the transaction. An application to the court would delay the process and could lead to a reduced return for creditors. There is also a real chance that the unsecured creditors obstruct the exercise of the legal rights of the secured creditors who are likely to exceed

in value, the claims of unsecured creditors. A different route to consider is some process by which companies declare the value of secured creditors on a more detailed basis than via the annual accounts. Unsecured creditors can then take a more informed view of the risk of trading with a highly borrowed company.

28. It should be noted that the Courts have consistently refused to act as a protection for the commercial judgement of the administrator. This was recently repeated in the Wind Hellas case, where such protection was given but was noted as not being a normal practice.

Question 18: Would the prior approval of the court or creditors for the proposed sale improve confidence that pre-packs are only used in appropriate circumstances?

29. It may, but only because of the misunderstandings referred to in Q1.

Question 19: Do you believe the requirement to obtain court or creditor approval would increase costs and delay therefore reducing the returns available to (a) secured creditors, and (b) unsecured creditors? If so, please provide an estimate of the impact on each.

30. Any additional step is bound to incur costs, whether that be the costs of issuing notices to creditors and analysing the responses or the cost of an application to court. Delay may affect the value of the business, as the business would have to be traded pending the court hearing and the associated publicity would have an impact on the business' value and also the risk of key staff leaving or a customer base losing faith.

Question 20: Do you believe the requirement to obtain court or creditor approval would reduce the number of business sales effected through a pre-pack sale? If so, please provide an estimation of the impact.

31. See response above – delay may make the pre pack sale unviable. We are unable to suggest an estimate of the impact.

Question 21: Do you believe that any provision requiring the prior approval of the court or creditors for business sales to connected parties should be extended to apply to such sales out of all formal insolvency procedures (i.e. not restricted solely to administration)? If so, why?

32. Whilst not supportive of a prior approval process, we feel it would be logical to apply this to all pre packs outside of administration. It is the sale itself, not the administration process which is the issue.

Question 22: Do you believe that a requirement to obtain court or creditor approval for a pre-pack business sale to a connected party should be combined with the attachment of personal liability to directors and connected parties who purchase a business without obtaining the requisite approval?

33. As noted above we are not supportive of a prior approval process. However it would seem logical that there be a consequence for not seeking prior approval. In addition, we believe that a sale to a connected party should in any event have other consequences. If the connected party was involved in the first insolvency; this suggests that the financial skills of that individual may need improving. Building in some sort of educational or training requirement may have some benefit.

Question 23: Do you believe that it would be appropriate for pre-pack business sales to connected parties executed without the requisite approval to be rendered void?

34. It would be impractical to unpick the original deal. It is unlikely that another purchaser could be found or that a break up sale could achieve greater returns than a business sale. Therefore it would appear that such a step would only disadvantage creditors. Also, it is highly unlikely that an IP would act in circumstances where required court approval had not been sought.

Question 24: To what extent do you believe that pre-packs provide a positive contribution to the wider economy by allowing economically viable parts of insolvent companies to continue trading? How would you quantify such a contribution? Please provide any evidence you may have to support your comments.

35. Dr Sandra Frisby's research suggests that pre packs achieve greater returns to creditors than a break up sale. Feedback from R3 members also suggests that pre packs preserve employment. These can only be positive.

Question 25: To what extent do you believe that pre-packs create market distortions by allowing companies to 'dump debts' and continue trading to the detriment of competitors? How would you quantify this? Please provide any evidence you may have to support your comments.

36. We are unaware of any evidence to support assertions such as this. It is not the pre-pack that allows "debt dumping" but the process of insolvency itself. Whoever purchases the business will do so free of the pre-existing debt and therefore gain advantage.

Question 26: **To what extent do you believe that pre-packs create job losses 'upstream' by allowing companies to 'dump debts' and continue trading to the detriment of suppliers who then experience knock-on financial difficulties? How would you quantify this? Please provide any evidence you may have to support your comments.**

37. We are unaware of any evidence to support assertions such as this. See above.

Question 27: To what extent do you believe that any economic value preserved by a pre-pack sale (e.g. employees, customers, suppliers) would otherwise transfer to alternative ventures (e.g. competitors) if a pre-pack sale was not undertaken? Please provide any evidence you may have to support your comments.

38. We are unaware of any evidence to support assertions such as this.

Question 28: **Do you believe that any of the options identified would have a significant impact on the behaviour of secured lenders? If so, what do you think this is likely to be? If possible, please provide an estimation of the impact.**

39. With the exception of making SIP 16 a legislative requirement all of the changes proposed appear to have the potential to reduce returns to creditors either by increasing costs or by undermining the pre pack sale. We suspect, but can offer no evidence that secured creditors would apply even more stringent criteria to lending decisions and impose higher costs to all lending. This would be to the detriment of the UK economy.

Question 29: **Which of the five proposed options would be your preferred solution(s), and why?**

40. Our preference would be to make no change to the current system, although the changes to meeting and exit procedure could improve transparency.

41. We see the measures suggested as attempts to increase confidence in a process which is generally misunderstood. The changes proposed may increase 3rd party confidence but to the detriment of the legal process underlying the pre pack and other insolvency processes. However, it would greatly assist if the Insolvency Service issued a definitive statement on the role of pre packs in promoting a rescue culture and encouraging entrepreneurship.

Question 30: Are there any alternative measures that you believe ought to be considered?

42. Our view is that the Insolvency Service should be much more engaged in promoting pre packs as a solution for companies in financial difficulty. See our response to Q29 above.

43. We believe that it would be useful if research was undertaken into the skills of directors and their ability to avoid insolvency in the first place.

Question 31: Please provide an indication (if not obvious) as to the nature of your involvement in, or exposure to, pre-pack transactions and the approximate incidence of that involvement or exposure if relevant.

44. See above.

Appendix

Extracts from R3's March 2010 report on Pre-packs and SIP16

https://www.r3.org.uk/uploads/documents/Pre%20packs%20and%20SIP%2016_March%202010.pdf

What does R3 think of compliance with SIP 16?

Available information suggests that the vast majority of Insolvency Practitioners are complying with SIP 16, while only a tiny minority are not:

• The Insolvency Service's own figures for the first half of 2009 state that just 3% of cases were referred to practitioners' regulatory bodies in the first six months of SIP 16's operation (and that was before the Insolvency Service issued clarifying guidance to help practitioners understand what the Service requires from SIP 16 report).
• R3's membership survey reviews the first twelve months of SIP 16's operation and finds that just 1.5% of Insolvency Practitioners who carried out a pre-pack in the last twelve months say their report was referred to their regulatory body. Once a report has been referred to the regulatory body (Recognised Professional Bodies or RPBs), the body may - and have in some instances - conclude that there is no case to answer, so the percentage is likely to be even smaller.
• R3's research among three of the seven RPBs finds that only one RPB has received a case from the Insolvency Service since SIP 16's introduction. The three cases that were referred to this RPB resulted in two warnings and one finding of 'no case to answer'.

Overall, it is important to remember that SIP 16 has only been in operation for just over a year, and the clarifying guidance was only issued five months ago. As with any new procedure it will take time before practitioners fully appreciate how the Insolvency Service wishes them to draft their SIP 16 reports.

On the whole, Insolvency Practitioners have demonstrated a real willingness to adhere fully to SIP 16, and we expect compliance to rise over the next few years as understanding of the process grows.

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Are Insolvency Practitioners complying with SIP 16?

The Insolvency Service started to monitor reports to creditors in January 2009, and their report into the first six months' of its operation found that pre-packs give better information for creditors at an early stage and a greater degree of transparency. The report also revealed that just 3% of Insolvency Practitioners did not materially comply with the SIP, demonstrating that there is no systematic abuse to the detriment of creditors.

The six-month report stated that 65% of reports were 'fully compliant' with the SIP, while the remainder were categorised as 'falling short of full compliance'. This categorisation led many press and political commentators to accuse one third of the industry of failing to comply (e.g. Pre-pack bankruptcy accountants 'mocking rules' the Times, 21st July 2009).

In fact, the remaining 35% of cases included a range of outcomes, including cases that had simply not yet reached their conclusion (e.g. cases in which the Service has written to an Insolvency Practitioner asking for some more information). Only 3% of cases were referred to the practitioner's authorising body.

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Membership survey: a focus on SIP 16

In half of the cases in which Insolvency Practitioners have been contacted by the Insolvency Service, the Insolvency Practitioners appreciated that they need to make changes to their report, which they have since done. In 19% of cases, the Insolvency Service had actually made a mistake. These kinds of cases have been categorised by the Insolvency Service as falling 'short of full compliance'.

13% of Insolvency Practitioners who have done a pre-pack in the last twelve months say that the Insolvency Service contacted them about shortcomings in their report. Of these, 12% say their report was referred to their regulatory body.

All in all, just 1.5% of the total number of Insolvency Practitioners who carried out a pre-pack in the last twelve months say their report was referred to their regulatory body.

One practitioner provided more information about contact with the Insolvency Service: "The Insolvency Service made a complaint to my monitoring body on the same day they wrote to me, i.e. they didn't wait for a reply to the points they had raised. In fact they haven't even acknowledged receipt of my reply. My monitoring body have decided there is no case to answer so I am unsure what was achieved other than lost time and money. I also feel I am less likely to do a pre-pack in future with a small company."

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R3's recommendations

The Insolvency Service should use appropriate terminology when reporting on SIP 16 to avoid encouraging misconceptions over compliance levels

The Insolvency Service should be clearer about the terminology they use to describe their SIP 16 findings. Using terms like 'failure to comply' and 'falling short of full compliance' leads the media, politicians and other readers to assume that the cases under this bracket simply do not comply with SIP 16. In fact, the cases under this bracket cover all manner of outcomes including unfinished cases, cases in which the Service has simply asked for more information, and possibly even cases in which the Insolvency Service itself has made a mistake.

The terms 'falling short of full compliance' or 'failing to comply' should only be used to refer to completed cases in which an Insolvency Practitioner's disciplinary body has concluded that they have not complied with SIP 16. Mindful of how terms like these are generally understood, the Insolvency Service should not use them for cases in which more information has been requested or for cases that have not yet reached a conclusion. Until a case is complete, it should be described as 'pending'. Using appropriate terminology is critical to achieving transparency and to ensure that readers are not encouraged to develop a distorted impression of the way SIP 16, and consequently pre-packs, are operating.

We must not lose sight of the fact that SIP 16 was designed to engender better pre-packs and promote confidence in the procedure. By using ambiguous language, the Service's reports are at risk of encouraging misconceptions, and effectively scaremongering - thereby undermining the purpose of the SIP. The lack of finesse in the reporting terminology risks stymieing the development of confidence in pre-packs and should be addressed.