



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

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By post

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Dear Mr Nicholls

Encouraging Company Rescue

The Institute of Chartered Accountants in England and Wales (the Institute) is pleased to respond to your request for comments on *Encouraging Company Rescue*.

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

Yours sincerely

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ICAEW REPRESENTATION

ICAEW REP 93/09

Encouraging Company Rescue

Memorandum of comment submitted in September 2009 by The Institute of Chartered Accountants in England and Wales, in response to the Insolvency Service consultation paper Encouraging Company Rescue published in June 2009

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the consultation paper *Encouraging Company Rescue* published by the Insolvency Service.

WHO WE ARE

2. The Institute 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, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
3. 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. The Institute ensures these skills are constantly developed, recognised and valued.

GENERAL COMMENTS

4. We can see theoretical merit in the Insolvency Service proposals as they would introduce some elements of the US lending and insolvency regimes that are perceived to have been successful. However, we note that the UK lending market is very different from that in the US, where floating charges are rare and thus unencumbered assets are more common. Also, the governance arrangements for Chapter 11 are different, as control vests with the court. Therefore, we recommend that, before pursuing these proposals further, the Insolvency Service should investigate how the US lending market and insolvency procedures work in practice, including the availability and cost of Debtor in Possession ('DIP') finance, and how the security market operates.
5. Regarding the UK market, some of our IP members in larger firms are currently involved in a large amount of upstream work, as companies are desperately trying to avoid administration and the associated publicity and stigma – whereas schemes of arrangement and CVAs can be portrayed positively, and for court approved scheme there may be no requirement to advertise.
6. This upstream work often comprises contingency planning and options analysis if the client were to enter into a scheme of arrangement or CVA, and can represent up to around 60-80% of the workload of some of our members, as opposed to live administrations. It often involves much negotiation between larger companies/international groups and their existing lenders, often big bank syndicates and investment funds. Lenders also appear keen to avoid definite write-offs and value destruction, although it can be difficult trying to cut a deal across several countries, especially when it involves jurisdictions outside the EU, in particular if they have not signed up to UNCITRAL principles.
7. Where a deal cannot be agreed (eg if the necessary consents can not be obtained from the syndicate members) a CVA or scheme of arrangement is often considered as a mechanism for formalising the deal already struck. Where a syndicate is secured and requires unanimity but one or more consents cannot be obtained, a scheme of arrangement is a useful mechanism. This involves the court and so is relatively expensive but is very flexible, does not require discussion with unaffected parties, and incorporates a fairness test applied by the court in a hearing. Therefore there is no need to wait 28 days to become effective (unlike CVAs). We note that schemes of arrangement and CVAs are usefully complementary alternative mechanisms.

8. Deals with lenders often involve a debt for equity swap. It is usually the existing lender(s) that provide the rescue credit or finance, rather than new third party banks. Therefore the proposal to give super-priority to third party rescue finance will not assist in this regard, and may even exacerbate the current financial crisis as it will distort the market making credit and finance more expensive to obtain (as it would increase risks for lenders).
9. Given the extent of upstream work, the proposals for a moratorium for larger companies would also not assist as it would be applied too late (after the upstream work has been completed – it is the period prior to the CVA that is dangerous as a deal has yet to be agreed) and, if the current lenders are not supportive, the CVA will be unlikely to succeed in any event. In practice, you would only need a court-approved moratorium if the lenders are not supportive (if the lenders support a CVA then other creditors tend to follow their lead).
10. The risk to the IP (as nominee) would be high, given that the IP is in a monitoring capacity (with no powers). A possible solution may be to introduce a statutory exclusion of liability should be provided for IPs, otherwise claims would be likely to be made against the IP (which could also affect the Professional Indemnity insurance market).
11. In respect of a moratorium, the nature and extent of the IP's monitoring duty would need to be agreed in detail, to prevent claims being brought against the IP with the benefit of hindsight. The possibility of having court-sanctioned engagement terms could be investigated, to provide some protection for the IP, although this would have similarities with the old administration procedure and so would probably be a step backwards, involving too many court papers at too high a cost.
12. As with the super-priority proposal, the proposal to extend moratoria to larger companies could also distort the lending market if secured lenders are prevented from making claims, increasing risks (because their security could be dissipated during trading) and thus the cost of finance would also increase.
13. Where a company is insolvent and the value of the group is materially less than the level of secured lending, the economic value in the company is no longer with the shareholders and the directors' duties are to the creditors. The interests of the senior secured lenders therefore become overriding. These proposals should not be used to strengthen directors' hands in negotiations with creditors. It has to be borne in mind that the theoretical underpinning for every restructuring is some form of debt/equity swap or a pre-pack. The proposals to create new secured charges in a CVA or administration could possibly make rescue finance more attractive to other lenders, but Debtor in Possession finance is very expensive (eg in the US, DIP finance is more expensive than pre-Chapter 11 lending). The Corporate Governance arrangements are also totally different (for example, under Chapter 11, control is with the court rather than remaining with the directors). It also should be remembered that (as we mention above) the UK lending market is totally different from that in the US, where floating charges are rare and thus unencumbered assets are more common. For many companies, their greatest assets will be stock and book debts, upon which fixed security cannot be granted, meaning that allowing new (fixed) security will not provide access to the value in the company.
14. 'Adequate protection' for existing fixed charge holders (eg, if negative pledges are to be overridden) could be achieved by requiring a valuation of the company using accepted methodology, which must materially exceed the amount of secured lending. We note that, for many companies, their greatest assets will be stock and book debts (upon which fixed security cannot be granted), and therefore floating charges are very important, and so care should be taken not to impair floating charges as again this will distort the lending market for successful businesses. Floating charges (for which security can include book debts and stock) also make it in the lender's best interests to rescue the business.

15. Other possible reforms could include preventing suppliers from cancelling contracts on insolvency, eg, executory contracts that force suppliers to honour their obligations (as default is often automatic if a company goes into administration).

RESPONSES TO SPECIFIC QUESTIONS

PROPOSAL A: Extension of small company moratorium provisions to larger companies

A1. Do you agree that it would be helpful for medium and large-sized companies to be allowed to benefit from the option of a moratorium from creditor action for up to 28 days?

A2. How useful do you think this would be? Do you think it would encourage medium and large-sized companies to utilise the CVA procedure? (If you can give figures, or comment on those in the initial Impact Assessment, that would be helpful.)

A3. Do you think there are any risks or disadvantages to this proposal? If so, what are they and how would you suggest that they could be addressed? Please provide evidence of the risks or disadvantages, if possible.

16. The ICAEW does not support this proposal, see general comments above.

PROPOSAL B: Court sanctioned moratorium

B1. Do you agree that it would be helpful to have a new Court sanctioned moratorium on creditor action?

B2. Do you agree that the proposed moratorium period of 42 days, extendable to 3 months, is appropriate?

B3. Do you agree with the proposed tests that the Court would need to consider and the suggested role for the Insolvency Practitioner? If not, what do you suggest?

B4. How useful do you think this procedure would be? (Please give figures for numbers of companies or businesses rescued, jobs saved, improved returns to creditors or other benefits, if you can.)

B5. Do you think there are any risks or disadvantages to this proposal? If so, what are they and how would you suggest that they could be addressed?

17. The risk to the IP (as nominee) would be high, given that the IP is in a monitoring capacity (with no powers) and so a statutory exclusion of liability should be provided for IPs, otherwise claims would be likely to be made against the IP (which could also affect the PI insurance market). Also, the nature and extent of the IP's monitoring duty would need to be agreed in detail, to prevent claims being brought against the IP with the benefit of hindsight. The possibility of having court-sanctioned engagement terms could be investigated, to provide some protection for the IP, although this would have similarities with the old administration procedure and so would probably be a step backwards, involving too many court papers.
18. This proposal could also distort the lending market if secured lenders are prevented from making claims, increasing risks (because their security could be dissipated during trading) and thus the cost of finance would also increase. See also our general comments above.

PROPOSAL C: Super-priority of rescue finance in administration Expenses

C1. Do you agree that finance properly incurred in attempting to rescue a company should rank in front of other administration expenses?

C2. How useful do you think this would be? (If you can give figures, that would be helpful.)

C3. Do you think there are any risks or disadvantages to this proposal? If so, what are they and how would you suggest that they could be addressed?

19. The ICAEW does not support this proposal as we believe it would adversely affect the lending market, and thus drive up the cost of finance for all businesses (whether successful or otherwise), for the sake of the relatively small proportion of companies that are insolvent. See also our general comments above.

PROPOSAL D: Greater ability to create new secured charges in an Administration

D1. Do you agree that there should be greater scope to secure post-insolvency financing by an ability to create new fixed charges?

D2. How useful do you think this would be? (If you can give figures, that would be helpful.)

D3. Do you think there are any risks or disadvantages to this proposal? If so, what are they and how would you suggest that they could be addressed?

20. This proposal would be unhelpful in the current economic climate because valuations would be likely to show the secured lender as having a deficit. Going forward, once the credit crunch wanes and the economy recovers, this might become more helpful as there becomes more headroom (with equity in assets increasing). However, we note that, for many companies, (unless the company has eg valuable Intellectual property) their greatest assets will be stock and book debts, upon which fixed security cannot be granted, meaning that allowing new (fixed) security will not provide access to the value in the company. See also general comments above.

PROPOSAL E: Greater ability to create new secured charges in a CVA

E1. Do you agree that access to CVA financing should be facilitated by the ability to offer new security?

E2. How useful do you think this measure would be for companies contemplating a CVA? If you can give figures, that would be helpful.

E3. Do you think that it is appropriate for the Court to have a role in ensuring protection is provided for existing fixed charge holders?

E4. Is it viable to suggest that a company might be able to obtain insurance against the possibility that an existing charge holder is not repaid in full as a consequence of priority being given to a rescue finance provider?

E5. Do you think there are any risks or disadvantages to this proposal? If so, what are they and how would you suggest that they could be addressed?

21. Insurance against the possibility that an existing charge holder is not repaid in full (as a consequence of priority being given to a rescue finance provider) is not viable as it would be too expensive. See also general comments.

PROPOSAL F: Cessation of certain asset based lending (ABL) arrangements on administration or CVA

F1. Do you agree that the effect of an asset-based lending (ABL) agreement or floating charge entered into before an insolvency event should be limited to the assets acquired or book debts arising before the insolvency event takes place (with the express exception of long term contracts where future periodic payments have already been assigned in return for an advance made to the company)?

F2. How useful do you think this would be? If you can give figures, that would be helpful.

F3. Do you think there are any risks or disadvantages to this proposal? If so, what are they and how would you suggest that they could be addressed?

22. The ICAEW does not support this proposal. It would be very complex to introduce, given retention of title arrangements (which would make this very hard to achieve), and it would be complicated in practice, eg how would you deal with pre-insolvency stock that is mixed with post-insolvency items.

We invite views on whether this package is the best way of achieving our aim of making company and business rescue easier and more successful, and welcome any other comments on these proposals.

23. See our General Comments above.

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