Encouraging Company Rescue: Response to the Insolvency Service Consultation

Introduction

The Insolvency Practitioners Association ("IPA") is a membership body for those in insolvency practice; those engaged in insolvency related work; and those with an interest in insolvency. The IPA is the second largest, in terms of the number of insolvency practitioners (IPs), of the professional bodies recognised for the purposes of authorising IPs under the Insolvency Act 1986: we authorise and regulate some 470 IPs of whom nearly 400 take insolvency appointments.

As a membership body and regulator, we welcome the opportunity to comment on these important, and potentially far-reaching, proposals.

Our response is divided into two parts: in part one we make general observations on the proposals and in part two we respond to the questions asked in the consultation document.

Part One: General observations

Practical observations

In principle, we are in favour of any proposals which will enhance the tools available to promote company rescue. However, while widening access to the CVA moratorium and rescue finance may have a part to play in encouraging rescue, we believe that processes alone are not enough. In our view the fundamental requirements for a rescue are a viable underlying business and competent management. If these requirements are met, a means of rescue can usually be found. In our experience, businesses do not fail because of the lack of a process. We would add that there have been recent large CVAs which have been approved without needing a moratorium.

We note that the consultation document makes a number of references to preserving jobs. While this is undoubtedly a worthwhile aim, it does raise the question of priority of purpose. Is the primary aim of the proposals to save businesses in order to preserve jobs, or to create a flourishing business environment in which jobs will be created?

We also believe that there are important questions to be asked about the role of management in a CVA, which are not currently addressed in these proposals. For example, if during a CVA moratorium, a company trades at a loss or cannot repay its rescue finance, should the directors bear any personal liability for the loss? If the claims of loan creditors become subordinated to rescue finance, should there be provisions enabling directors' service contracts to be capped or even set aside?

At present, the Schedule A1 moratorium is rarely used. We believe that the reasons for this should be investigated as they may inform the development of any extended moratorium process. We suggest some possible reasons in our answer to question A1.

As a consequence of the lack of use of the existing moratorium, the provisions of Schedule A1 have not been rigorously tested. If the moratorium process is extended and is used more widely, problems may emerge. If the availability of the CVA moratorium is to be extended, we suggest that its effectiveness should be kept under review.

We believe that the proposed changes would lead to greater involvement of the courts, particularly in dealing with challenges from aggrieved stakeholders (please see our answer to questions A3 and E3). It would be necessary for the courts to be adequately resourced so that they could deal with such cases quickly. At present, unlike the United States, we do not have dedicated insolvency courts.

Our final observation, in this part of our response, is that it is not clear whether any new legislation would be retrospective. As acknowledged in the consultation document, borrowers and lenders will have entered into contracts on the basis of the current order of priorities and lenders will have priced their risk on the basis that they cannot be crammed down. We suggest that if the order of priority is to be changed it should only affect security created on or after the date on which the new legislation comes into force.

Regulatory observations

We note, at paragraph 69 of the consultation document, that the decision to create new charges in administration will be that of the administrator who "will be a licensed IP, qualified and well regulated". We are pleased that the importance of effective regulation is recognised and we look forward to working with the Insolvency Service in this area, as these proposals develop.

If implemented, the proposals will bring new regulatory challenges. For example, if the CVA moratorium becomes more widely used, the nominee's role will become more prominent, particularly if the current requirements to publicise the nominee's appointment (on business documents and on web sites) are retained. We are concerned however that the involvement of a nominee, who is authorised and regulated, may give false comfort to third parties. In the proposals as drafted, the nominee's role is very restricted.

Part Two: Answers to specific questions

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?

We are not necessarily persuaded that extending the availability of the moratorium would lead to greater use of the process. We believe that there are difficulties and uncertainties inherent in the current moratorium procedure and we suggest that they would need to be addressed in order to make the process more attractive. We set out below what we perceive to be some of the drawbacks of the present procedure:

- suppliers and customers are free to cancel contracts
- finance providers may withdraw facilities at short notice
- there is nothing to prevent utility suppliers from seeking ransom payments
- the position of moratorium creditors is unclear, in the event that the company becomes unable to service its moratorium debts

- the onus is on the nominee to request financial information from the directors, rather than the directors to provide regular and full reporting
- the nominee has an ongoing duty to monitor the company's affairs, but has no control over the management of the company

If the moratorium process were to be extended, we believe it would also be helpful to amend the Insolvent Partnerships Order 1994 in order to align the threshold requirements for 'small' unlimited liability partnerships with those for companies, and to allow medium sized and large partnerships to obtain a moratorium.

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.)

We think that these provisions could be useful where the alternative is administration. However, directors of smaller companies are sometimes deterred from proposing a CVA because of onerous modifications proposed by creditors. In such circumstances, there is little incentive to directors to pursue a CVA if they can buy the business back, minus its liabilities, for value in an administration.

Extending the moratorium provisions to medium and large-sized companies would not necessarily result in CVAs becoming more popular with debtors unless the issues we have highlighted were addressed and creditor behaviour changed.

As the Impact Assessment acknowledges, it is difficult to predict how many companies might use the new procedure. We suggest that more research is needed into the reasons why companies do not currently use the CVA moratorium procedure.

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.

We believe that the costs of a moratorium for a medium-sized or large company could be significant. For example, a nominee is likely to have to carry out more extensive monitoring for a large company than for a smaller one. Larger companies often have more complex relationships with a greater number of stakeholders. Given that paragraphs 26 and 40 of Schedule A1 provide for aggrieved parties to be able to apply to court, this could give rise to lengthy and costly litigation.

The existence of a moratorium could lead to suppliers or customers cancelling contracts or withholding payment and making the position even more critical.

It may also be difficult for a company to find sufficient funds to be able to continue its business during a moratorium period, particularly if its assets are already substantially pledged as security.

We are also concerned about the risk of significant trading losses during a moratorium. A company seeking the protection of a moratorium is likely to be insolvent. If the purpose of a moratorium is to stabilise the position rather than carry out any restructuring, it is possible that the company will make losses in the moratorium (even if it has sufficient funds to enable it to carry on business), leading to asset dilution. At worst, a company could run out of funds and be unable to pay its moratorium creditors.

We suggest that legislation should set out how moratorium creditors' claims are to be dealt with, in the event that they are not paid in the moratorium period and the company subsequently enters an insolvency process.

We also believe that there might need to be sanctions if, as a result of losses or asset dilution in the moratorium period, creditors are worse off at the end of the CVA process than if the company had not obtained a moratorium. Sanctions might include penalties or personal liability for directors if trading had been carried on without due regard for the interests of creditors.

PROPOSAL B: Court sanctioned moratorium

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

We are not convinced that a court-sanctioned moratorium would add significantly to the rescue tools already available. The existing Schedule A1 moratorium is rarely used and we believe that this is due in large part to the drawbacks of the moratorium, which we highlight in our answer to A3 above.

Currently, in order to make the statement required under paragraph 7()(e) of Schedule A1 to the Insolvency Act 1986, an insolvency practitioner must have reviewed a reasonably advanced draft of the CVA proposal before the moratorium comes into effect. Consequently, we are not sure why a company would need up to three months after obtaining a moratorium in which to call meetings of the creditors and the company. A company wishing to propose a CVA could enter administration and obtain immediate protection from its creditors.

In some respects, the proposed moratorium is similar to the Chapter 11 stay in bankruptcy proceedings in the United States. In the proposed UK court-sanctioned moratorium, it appears that the insolvency practitioner's role in the moratorium period is restricted to monitoring fulfillment of the three tests. The insolvency practitioner does not appear to be involved in negotiating with stakeholders or in promoting the proposals, and the directors' responsibilities are unclear. We suggest that if the process is to work, there needs to be leadership and we believe that the insolvency practitioner is best placed to provide this.

In Chapter 11, the court is actively involved in making business decisions. In our experience, courts in the UK have been less inclined to intervene in commercial matters in insolvency. As previously stated, we believe that an extension of the moratorium procedure could result in an increase in applications to court. The courts would need to be adequately resourced, in order for judges to be available to make commercial decisions at short notice.

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

We do not think that a company would need longer than 3 months, but as stated in our answer to B1 above, we are not sure that a court-sanctioned moratorium is necessary at all. We believe that administration provides all that is required, together with the necessary leadership. Administration provides for an interim moratorium and we suggest that this might be extended, as an alternative to a court-sanctioned CVA moratorium.

It is also possible for an administrator to delegate the exercise of management powers to directors in appropriate situations and we are aware of several cases where this has been done.

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?

Yes, we agree with the proposed tests and the suggested role for the insolvency practitioner. Given the importance of the insolvency practitioner's statement, particularly in the context of a longer, court-sanctioned, moratorium, we suggest that the insolvency practitioner should be required to include in the statement his reasons why, in his opinion, the tests are satisfied.

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.)

Given the uncertainties, it is difficult to predict how useful this procedure might be.

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?

There is a risk of incurring further losses in the moratorium period. The longer the moratorium, the greater the potential risk. We suggest that legislation would need to provide for how moratorium losses would be dealt with.

As stated in our answer to B1, it appears that the insolvency practitioner's role in the moratorium period is restricted to monitoring the three tests. It does not appear that the insolvency practitioner is involved in promoting the proposals or in seeking agreement from creditors. In our view, a fragile, loss-making, business requires a different type of leadership.

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?

At present, administration expenses are given an order of priority under Rule 2.67 and are payable out of floating charge assets. It is not clear to us whether it is intended that rescue finance would only be repaid out of floating charge assets – in which case we do not see why it requires super-priority because it appears to be covered by Rule

2.67(1)(a) – or whether it is intended that it could be repaid out of fixed charge realisations.

Administrators are mindful of the risks of continuing to trade and the need to avoid worsening the position for creditors. We have no objection in principle to giving rescue finance super-priority, but we believe that an administrator would need to be satisfied that the rescue finance would be repaid and when it would be repaid.

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

We do not believe that granting super-priority to rescue finance would be useful. In our experience, if lenders are presented with a viable proposition they will usually make funds available to finance an administration. They have security in that they usually insist on administrators accepting personal liability. Consequently, it is not clear to us where the difficulty lies in funding viable administrations.

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?

In theory, rescue finance should be the cheapest form of finance because it is the most secure. However, we are concerned that in practice it could be very expensive, particularly if it is short-term finance and not provided as part of a continuing commercial relationship with the company. We believe that the experience in the United States bears out our concerns. Furthermore, there is the risk that granting super-priority over existing lenders might result in unscrupulous lending practices where a new lender advanced funds in the expectation that the company would fail and high fees could be charged.

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?

If it is in the best interests of creditors, then yes.

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

We believe it could be useful in the right circumstances.

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?

In an administration, the business is inherently uncertain and unstable. The company is insolvent (or prospectively so) and customers or creditors may take unpredictable actions. Consequently there is a risk that the administration may not proceed according to plan and that the administrator incurs additional liabilities to the detriment of an existing secured creditor.

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?

Yes, subject to safeguards to ensure that the interests of existing secured creditors are not prejudiced.

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

We think that it could be useful, as part of a range of solutions available to a company seeking to restructure.

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?

Yes. It will however be necessary for the courts to be able to deal with any applications quickly.

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?

We consider that this is a question best answered by the insurance industry.

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?

We think that the risk is adequately defined in paragraph 82 of the consultation document.

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)?

In theory, yes, but in practice it will cause problems. There may be invoices or credit notes which have not been processed at the date of the insolvency event, or subsequent charge-backs. An asset-based lender would normally rely on future invoices to compensate for these issues.

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

We do not think that it would be particularly useful. In our view, it would make asset-based lenders more cautious at a time when they would otherwise might be prepared to lend more than usual in order to help a company through a difficult period.

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?

Yes, we believe that this proposal could precipitate a cash flow problem which might otherwise have been avoided.

CONCLUSION

G1. 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.

Comments on the proposals

We believe that it is the business which really matters, rather than the company. In our view, five key factors contribute to a successful rescue: a viable underlying business, a strong management team, leadership, a good understanding of the value of assets and where value breaks and the availability of finance. In our experience, finance can usually be found if the other factors are present.

We believe that the current legislation provides an adequate framework and has not been a disincentive to company rescue. Neither are we aware of a shortage of funding in CVAs or administrations. We understand the desire to leave management in place where possible, but believe that there is sufficient market experience of allowing management to deal with the day-to-day running of the business – particularly in large administrations - while an administrator concentrates on restructuring the business.

An extended CVA moratorium and super-priority finance may give rise to challenges and complaints in the event that the restructuring does not proceed according to plan and creditors are worse off.   It will be difficult to regulate, after the event, actions which were taken for valid commercial reasons.

Other suggestions

The role of pre-packs in business rescue continues to give rise to debate and concerns. We suggest that pre-packs could be made more rigorous and transparent either by adopting a ‘stalking horse’ process (as used in Chapter 11 in the United States) or a conditional sale agreement in which the business and assets are transferred on condition that if a better offer is received within, say, 28 days the better offer will prevail. There is anecdotal evidence to suggest that a conditional sale process encourages ‘best’ offers at an early stage, as purchasers are not willing to risk losing the assets to a subsequent higher bid.

There could be cases where a ‘stalking horse’ process or conditional sale agreement was not feasible. We suggest that in such cases a pre-pack sale should require the sanction of the court.

We welcome the opportunity to comment on this consultation and would be happy to discuss with you or your colleagues any of the points raised. Please do not hesitate to contact me if we can be of further assistance.

Yours faithfully