

# **The market for corporate insolvency practitioners**

**A market study**

**June 2010**

OFT1245

Supporting documents and annexes, can be found on our website at:

[www.offt.gov.uk/OFTwork/markets-work/](http://www.offt.gov.uk/OFTwork/markets-work/)

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# 1 EXECUTIVE SUMMARY

- 1.1 Our study focuses on the appointment, actions and fees of corporate Insolvency Practitioners (IPs), especially for two of the main corporate insolvency processes, administration and Creditors' Voluntary Liquidations (CVLs). Together, these account for 75 per cent of IPs' fee income from corporate insolvency.
- 1.2 We analyse whether the market and regulatory framework provide IPs with appropriate incentives to operate in the long-term interests of creditors, what harm may be caused if they do not and what changes to the operation of the market might increase its efficiency.
- 1.3 It is important that the market works well, not only for those directly affected by insolvency but for the economy as a whole. Smooth entry and exit of firms is an important feature of a competitive economy and has an impact on productivity. Fear of non-recovery of debts has the potential to diminish the amount of credit extended, which is especially important in times of reduced bank lending.
- 1.4 IPs are licensed individuals, the vast majority from accounting or legal backgrounds, who administer all personal and corporate insolvencies. The aim of the corporate insolvency process may be to rescue a business and, if sustainable, this is likely to be the best outcome. When this is not possible, the IP is responsible for selling debtors' assets, agreeing creditors' claims and distributing money collected to creditors, after paying for the costs of the insolvency.
- 1.5 Each year IPs earn approximately £1bn in fees from corporate insolvency processes, in doing so realising about £5bn worth of assets, and distributing some £4bn to creditors. IPs can also advise on business restructuring and continuity prior to insolvency and are part of the wider business restructuring market.

## Market failure and harm

- 1.6 We find that most IPs compete by building and maintaining strong relationships with secured creditors, such as banks. So long as banks do not recover their assets in full, the market works reasonably well.

- 1.7 However, when the secured creditor is paid in full, the remaining unsecured creditors find it hard to control or influence the process, and are harmed as a result.
- 1.8 The extensive system of regulation does not stop this harm, and is considered inconsistent or ineffective by a significant number of IPs.

### Strong relationship with banks

- 1.9 Formally, the IP in the case of an administration is usually appointed by the directors of a company. However, secured creditors, such as banks, can veto this choice and we find that in most cases where there are secured creditors they in effect choose the IP and agree the fee scale. There is a close relationship between secured creditors and IPs, and IPs compete primarily by building and maintaining these relationships.
- 1.10 Most banks operate 'panels' to select IP firms for insolvency cases where indebtedness to the bank exceeds £200,000. While panels may pose a barrier to smaller firms trying to expand to handle larger insolvencies, our data suggests this it is not insurmountable. Approximately 25 different firms are on one or more bank panels, representing 40 per cent of IPs. Additionally, 30 per cent of insolvencies where the bank is owed more than £200,000 are dealt with by a non-panel firm. We do not believe that bank panels, at present, cause a significant competition concern in this market.
- 1.11 The dependence of IPs on secured creditors for appointments makes them responsive to the secured creditors' wishes. In addition, secured creditors have a good knowledge of the complex insolvency procedures and hence how to exert influence over the process. As a result, competition and competitive incentives on IPs may be weakened.
- 1.12 Where there are secured creditors, they are paid before unsecured creditors. In effect, the IP's fees are incurred by the last creditor group to be paid. Where there are insufficient funds for secured creditors to recover their debt in full, secured creditors are interested in every extra pound that the IP recovers from asset sales and every extra pound that the IP charges. They therefore have a strong incentive to control the fees and actions of IPs. Combined with the influence that they have over

IPs, since they effectively appoint them, we find that in the 63 per cent of administrations where secured creditors are not paid in full, the market appears to work reasonably well.

### Limited control by unsecured creditors

- 1.13 In the remaining 37 per cent of cases, the secured debt has been extinguished and secured creditors have limited incentives to influence IPs' actions or fees. In these cases it is unsecured creditors who would benefit from further realisations of assets, out of which the IPs' fees are paid. Unsecured creditors range from larger, repeat unsecured creditors such as HM Revenue and Customs (HMRC) and large landlords (in England and Wales), to customers, trade creditors and employees.
- 1.14 Unlike secured creditors, unsecured creditors do not appoint IPs in the administration process, so are unable to reward and punish behaviour and, with the exception of a few larger ones, they typically have little experience of the insolvency process.
- 1.15 While there are formal mechanisms for unsecured creditors to influence the process, their limited use indicates that they are impractical. In the majority of situations the costs of getting involved are perceived to outweigh the benefits.
- 1.16 In addition, the information sent to unsecured creditors are sent by the IPs does not greatly help their understanding of the process. It varies in terms of completeness and clarity, often providing information on insolvency procedures but little which is case specific.
- 1.17 This lack of control by unsecured creditors means that they must necessarily trust IPs to look after their interests. In these circumstances, IPs have little incentive other than regulation and ethics not to charge higher fees or to act independently of unsecured creditors' wishes.
- 1.18 We find that, in a typical administration, like-for-like fees paid to the IP are approximately nine per cent higher when secured creditors recover their debt in full and unsecured creditors pay the IP fee out of their own claims. This is evidence of the weak position of unsecured creditors and the failure of the regulatory regime to correct for this. It also provides

the basis for an estimate of £15m per year higher payment to IPs in this specific instance where market forces are reduced when secured creditor interest ceases.

## Harm

- 1.19 The weak position of unsecured creditors may cause further problems, such as lengthy duration of liquidation proceedings and inappropriate use of pre-packaged administrations. While the OFT has received numerous complaints about these, hard data is not available to be able to quantify how widespread or damaging such practices are. Nonetheless, the total impact of the low ability of unsecured creditors to control the fees and actions of IPs may be a reduction in proceeds of asset recovery many times greater than £15m.
- 1.20 Some unsecured creditors say that if their recovery rate from insolvency increased, they would extend more credit. While this effect is likely to be slight, even a small increase in the £80bn of unsecured credit extended by SME's will amount to many millions of pounds.

## Regulation

- 1.21 IPs make important decisions which can have adverse financial consequences on unsecured creditors. A great deal of trust is placed in IPs. It is for this reason that the industry is regulated to limit the scope for abuse.
- 1.22 We have found that, despite this regulation, unsecured creditors remain unable, in many situations, to constrain IPs' fees and actions.
- 1.23 In addition, a survey of IPs finds that 41 per cent believe the current regulatory system does not deal effectively with rogue IPs, 45 per cent believe that it deals with poor behaviour inconsistently and 75 per cent do not believe that regulations are effective in engaging creditors.

## Remedy

- 1.24 Our remedies increase the efficiency and effectiveness of the regulatory system, and the regulations it enforces. In particular, we propose:

- A. establishing an independent complaints body to increase the efficacy and consistency of after-the-event complaint and review, restore creditor trust in the regulatory regime, and allow a cost-effective route of fee assessment
- B. setting clear objectives for the regulatory regime, and changing some of the regulatory processes and responsibilities, to increase its ability to meet those objectives, and
- C. amending some of the detailed regulations to better align the interests of the IP with the interests of the wider creditor group.

1.25 Whether and how these are taken forward is a matter for the Department of Business, Innovation and Skills (BIS) which may consult on its plans.

#### A - Independent complaint body with the ability to assess fees

1.26 To help correct the imbalance in power during the process, it is essential that effective complaint and review mechanisms are in place to deter IPs from inappropriate behaviour, ensure they act in the best interests of the body of creditors, and build trust in the market. The current complaint and redress systems do not do so.

1.27 We recommend the creation of an independent complaint handling or appeal body, with the ability to review complaints and assess fees, funded by the IP profession. It should be able to sanction IPs in a way that deters future transgression.

1.28 If this new independent complaint body finds that IPs have overcharged, it should also have the power to order that any overcharge should be returned to creditors.

1.29 A survey of IPs suggests that 72 per cent are in favour, in principle, of a single complaints handling body. Discussions with stakeholders suggest that an independent complaints body would help restore trust in the regulatory process and encourage them to make well argued complaints when they see inappropriate behaviour.

## B - Setting clear objectives for the regulatory regime, and increasing its ability to deliver them

- 1.30 While it is possible to go some way towards correcting the market failure that we identify by simply changing some of the rules that govern the actions of IPs, it is also necessary to ensure that the rules are effectively monitored and enforced.
- 1.31 In order for any improvements to be resilient, the way in which rules are changed and overseen must also be improved to cope with changes in the market place, such as the possibility of increased diversity in sources of secured debt.
- 1.32 The basic structure of the current regulatory system originates from 1986. Professional bodies in the areas of accounting and law were given the mandate to licence IPs in an attempt to stamp out bad practices and improve the reputation of IPs. This move did not foresee the development of insolvency as a distinct profession and as such poorly reflects the way in which the market currently operates. It consists of 10 overlapping organisations that together regulate the approximately 1,800 licensed IPs.
- 1.33 Unlike the regulatory regimes in legal services and financial services, the current regime lacks objectives that determine the appropriate regulatory actions, and against which regulators are held accountable.
- 1.34 As such, our primary recommendation for reform of the regulatory system is adopting a set of regulatory objectives focusing on:
- maximising long-term returns to all creditors,
  - protecting vulnerable market participants, and
  - encouraging a competitive and independent IP profession.
- 1.35 In addition, we believe that the complexity of the current regulatory structure limits its ability to regulate the market in a proportionate, responsive and effective manner. To help correct this, we recommend:

- establishing the Insolvency Service (IS) as a regulator of the Recognised Professional Bodies (RPBs) with a more proportionate set of oversight powers, while decreasing the role of the IS in direct regulation of IPs
- changing the decision making process between RPBs to increase the efficiency and agility of the self regulatory regime, and
- focusing the independent voice body, currently the Insolvency Practices Council (IPC), on assessing how well the objectives are met.

## C - Amending some of the regulations

- 1.36 The lack of clear regulatory focus has led to extensive prescriptive regulation. However, it fails to address the main market problems, in particular unsecured creditors' involvement and the lack of constraint on IPs' actions and fees.
- 1.37 Most unsecured creditors do not have both the incentive and the experience to invest sufficient time in the process to make much difference to IPs' fees and actions. However, there is a larger class of unsecured creditor and changes to the regulations to facilitate their involvement would benefit all unsecured creditors.
- 1.38 While detailed changes to the regulations are best made by the market regulators, we make a number of recommendations that we believe would be likely to mitigate some of the market problems faced by unsecured creditors' being unable to constrain IPs' actions and fees. We would urge the current, or future, regulators to consider making these changes, outlined in the body of the report, as soon as possible.

### Next steps

- 1.39 We have informally consulted on our recommendations. If enacted, we believe they will benefit the wider economy, increase trust and demand for good insolvency practitioner advice, and impose no extra burden on the taxpayer. We suggest that BIS consult on whether to take these recommendations forward and, if so, how.

## 2 INTRODUCTION

### Launch of the study

- 2.1 The market study was motivated by a range of factors, including the strategic significance of the market, the size of the market, public reports on market performance, and concerns raised in the media, government and academia. It was launched in November 2009.<sup>1</sup>
- 2.2 Market studies involve an analysis of a particular market, markets or set of issues, usually with the aim of identifying and addressing all aspects of market failure from competition issues to consumer detriment and the effect of government regulations. Possible results of market studies include:<sup>2</sup>
- enforcement action by the OFT;
  - a reference of the market to the Competition Commission;
  - recommendations for changes in laws and regulations;
  - recommendations to regulators, self-regulatory bodies and others to consider changes to their rules;
  - voluntary action by business;
  - campaigns to promote consumer education and awareness; or
  - a clean bill of health.
- 2.3 We are very grateful for the support and assistance provided to us throughout our study by the industry, academics, regulatory bodies, creditors, creditor groups, and other stakeholders.

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<sup>1</sup> [www.offt.gov.uk/news-and-updates/press/2009/132-09](http://www.offt.gov.uk/news-and-updates/press/2009/132-09)

<sup>2</sup> [www.offt.gov.uk/OFTwork/markets-work/market-studies-further-info](http://www.offt.gov.uk/OFTwork/markets-work/market-studies-further-info)

## **Purpose of study**

- 2.4 The OFT's mission is to make markets work well for consumers.
- 2.5 We adopt a broad interpretation of consumer. It includes both businesses and final consumers. It includes both the person or firm that directly purchases a service, and the effect of that purchase on other people or firms.
- 2.6 The role of an IP, once a firm has gone insolvent, depends on the nature of the insolvency procedure that has been initiated. However, broadly speaking, it will be either to rescue a firm or business from bankruptcy if it is possible, or to distribute the maximum amount of assets to creditors as efficiently as possible if it is not.
- 2.7 It is important to note that our study is on the operation of the market for corporate IPs not on the insolvency process itself. We will comment on the process only insofar as it affects the market for corporate IPs.

## **Scope of the study**

- 2.8 The study has considered, to some extent, the market for corporate IPs in the whole of the UK. However some of our primary research has been limited to England and Wales, and for this reason our findings and recommendations focus on this jurisdiction. However we believe the same issues and potential solutions are relevant to a large extent in Scotland and Northern Ireland, and have commented on this throughout the report.
- 2.9 The study has been limited to the market for corporate IPs. Personal and corporate insolvency procedures are different, and involve different key stakeholders and market dynamics. As this was a relatively short study we have chosen to focus on corporate insolvency to avoid duplication with other regulatory initiatives in the personal insolvency market currently underway. In particular we noted at the launch of the market study that:
- The Ministry of Justice (MoJ) was considering, via public consultation, making legislative changes to introduce statutory debt

management schemes. This is likely to involve many of the same entities that provide non-corporate Independent Voluntary Arrangements (IVAs). The MoJ have not currently reported back on this consultation.

- The OFT's compliance review of debt management guidance was launched on 3 November and is likely to report in Summer 2010. The debt management guidance applies to IVA providers, so this review will cover non-corporate insolvency issues.

2.10 However, some of our recommendations for reform to the regulatory system will affect personal insolvency as licensed IPs are able (and do) carry out both types of work. While the focus of our study is not personal insolvency, we have discussed our findings and recommendations with some of the key stakeholders in the personal insolvency market to ensure they are unlikely to have negative unintended consequences in the personal insolvency market.

## **Research undertaken**

2.11 The analysis of this market is based on six main pieces of work, carried out over the course of the study:

- **Stakeholder information** – We collected stakeholder evidence through meetings, phone calls, conference attendance and written submissions. We spoke with 36 stakeholders (in person and by telephone), attended and presented at five industry events and received written submissions from 66 stakeholders. Stakeholders included insolvency regulatory bodies, IP firms (large and small, and from throughout the UK), creditor interest groups, banks, receivable finance companies, academics, former directors and creditors with experience of corporate insolvency, Scottish court reporters and the World Bank. Stakeholders that we met with and received written submissions from are listed in Annexe A.
- **Online survey of creditors** – We conducted an online survey of small businesses in industries likely to have been affected by insolvency. The survey was conducted by the OFT in-house. A total of 1,232 people completed the online survey with a response rate of

approximately ten per cent. The results of the survey are available on our website and further information and results can be found in Annexe B.

- **Companies House data collection** – We gathered and analysed data from Companies House relating to 500 administrations starting in the year 2006. Where the administration was followed by another process, e.g. Creditors' Voluntary Liquidation (CVL), then data was also collected from the subsequent process. This unique and detailed dataset enabled us to analyse how much was owed to creditors, how much they received, the fees charged by IPs, and the competitiveness of the IP market. This data is more fully explained in Annexe C.<sup>3</sup>
- **Survey of IPs** – In May 2010, R3, the professional association for IPs, conducted a survey of its members asking about their views of insolvency regulation. R3 provided us with the anonymous responses to this survey which we have analysed and used to help inform our views on the regulatory system. The survey's sample size was 312, and the methodology and results of this survey are explained in Annexe D.
- **In-depth creditor interviews** – We contracted an external company (Marketing Science) to conduct detailed structured interviews with 33 randomly selected creditors. Questions asked related to creditors' rights and influence, fees charged by IPs, effect on business behaviours and what changes to regulation might affect creditor behaviour. The methodology and results of these interviews are explained in Annexe F.
- **Desk research** – The OFT market study team conducted a review of publically available market reports, government reports, insolvency legislation, regulation and guidance, and other relevant documents.

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<sup>3</sup> [www.offt.gov.uk/OFTwork/markets-work/](http://www.offt.gov.uk/OFTwork/markets-work/)

### 3 MARKET DESCRIPTION

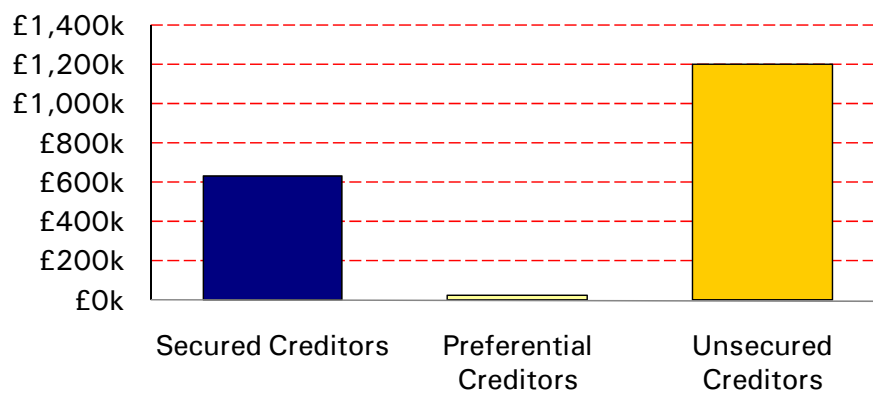
#### Summary

- Corporate insolvency arises where a company is unable to pay its debts. The law relating to corporate insolvency is set out in the Insolvency Act 1986, as amended in particular by the Enterprise Act 2002.
- The aim of a corporate insolvency procedure may be to rescue the business (where this is feasible) and/or realise assets and distribute any money available to creditors.
- There are three main types of creditor. Secured creditors have claims that are either fixed on certain of the firm's assets, 'floating' over various assets, or a combination of both. Preferential creditors, such as certain categories of payments due to employees, have a claim by statute. Unsecured creditors are paid any remaining amounts. Secured creditors are usually banks or large financing firms.
- There are five corporate insolvency procedures: company voluntary arrangement (CVA), administration, administrative receivership, creditors' voluntary liquidation (CVL) and compulsory liquidation.
- The focus of our study is on administration and CVL, which are the most commonly used corporate insolvency procedures in England and Wales by fee income, accounting for about 75 per cent.
- Formally, creditors may influence the insolvency process through a system of creditors' meetings and creditors' committees.
- Insolvency Practitioners (IPs) are licensed individuals, the vast majority from accounting or legal backgrounds, who administer personal and corporate insolvencies.
- Each year IPs realise about £5bn worth of assets in insolvency procedures, distributing approximately £4bn to creditors and earning about £1bn in fees. IPs can also advise on business restructuring and continuity prior to insolvency and are part of the wider £3bn per annum business restructuring market.

## Corporate insolvency and the different types of creditor

- 3.1 A company is generally considered to be insolvent when it is unable to pay its debts ('inability to pay debts' is formally defined in section 123 of the Insolvency Act 1986 (IA1986)). The corporate insolvency process may aim to rescue a business and, when this is feasible, it is likely to be the best outcome for all stakeholders. When it is not possible, the procedure involves selling the debtor company's assets, agreeing creditors' claims and distributing money collected to creditors, after paying for the costs of the insolvency.
- 3.2 There are three main types of creditors – secured creditors, unsecured creditors and preferential creditors.
- 3.3 In insolvency proceedings, unsecured creditors rank behind secured (fixed and floating charge holders) and preferential creditors, and typically recover the least money.<sup>4</sup>

**Figure 1: Average debt owed to different creditor groups**

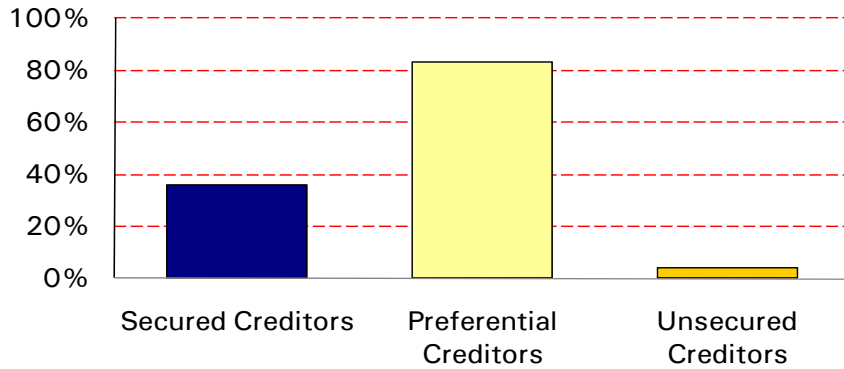


Source: Companies House data, based on 500 records

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<sup>4</sup> In our sample of 500 administrations, preferential creditors had the highest average recovery rate (83 per cent), followed by secured creditors (36 per cent) and unsecured creditors (4 per cent). The recovery rate is the proportion of creditors' claims which the IP is able to realise and distribute to creditors. These figures include any subsequent process following administration (CVL for example).

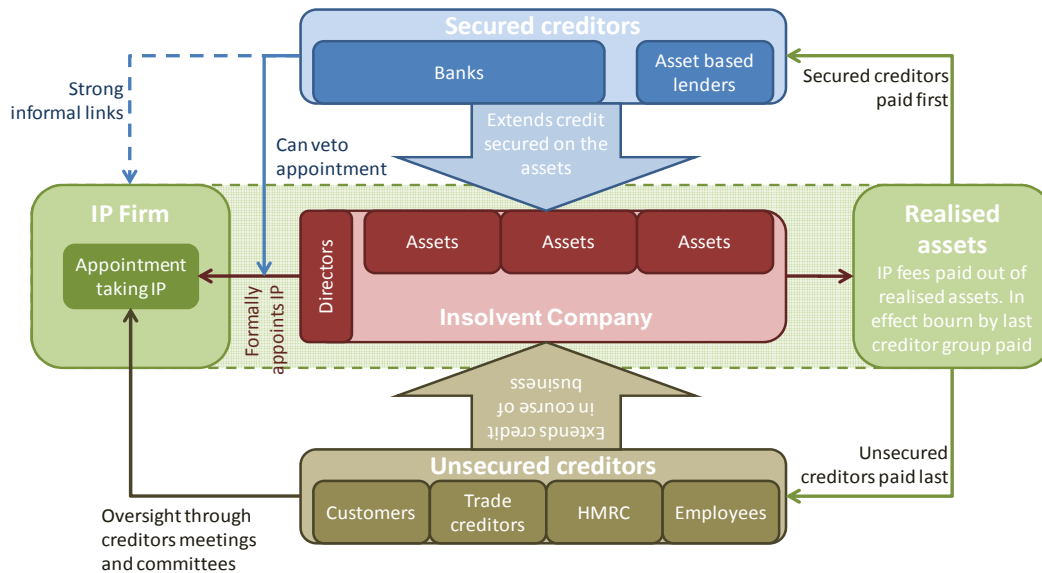
**Figure 2: Average recovery rate for different creditor groups**



Source: Companies House data, based on 500 records

3.4 Figure 3 shows the main participants in the corporate insolvency market, and their relation to each other.

**Figure 3: Diagram showing main relationships within a typical insolvency**



Note: Preferential creditors have been omitted for simplicity

### 3.5 Secured creditor

- A secured creditor has the benefit of a security interest over some or all of the assets of the debtor. Essentially, a secured creditor takes

collateral for the extension of credit to the debtor. If the debtor becomes insolvent, the secured creditor is able to enforce its security. A common example of a secured creditor is a bank that has extended a business loan that is secured by a charge over the assets of the business. If the business fails to keep up with its payments, the bank can step in and enforce its security against the assets through an insolvency process.

- Until recently, secured creditors were predominantly banks. However, in the last few years a number of receivables financiers have established a presence in the market (see paragraphs 4.38 and 4.40). As a result the complexity of secured lending may be expected to increase over the next few years.
- Secured creditors may have either a fixed or floating charge over company assets. A charge over a specific asset (or assets) would usually constitute a fixed charge. Floating charges usually cover general assets such as stock and work in progress. Fixed charges take priority over floating charges in the order in which claims are paid in insolvency proceedings.<sup>5</sup>

### 3.6 Unsecured creditor

- An unsecured creditor is a person or company that is owed money by a company but does not have a security that they can enforce to realise this money in the event that the company defaults on their debt repayment.
- If a company has traded, unsecured creditors may very well include trading partners, such as those involved in the supply of goods or services to the firm. There are frequently a very large number of

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<sup>5</sup> The statutory provision for the order of payments is: preferential debts in a liquidation (and administration) s.175 and s.386 Insolvency Act, expenses of liquidation rule 4.218 Insolvency Rules 1986, expenses of administration rule 2.67 Insolvency Rules 1986 (as amended by the Insolvency Amendment) Rules 2010).

unsecured creditors each owed a small amount of money. HM Revenue and Customs is often the largest unsecured creditor.<sup>6</sup>

### 3.7 Preferential creditor

- A preferential creditor benefits from a statutory priority over floating charge holders and unsecured creditors in the order in which claims are paid. Preferential creditors are predominantly employees of a company although until 15 September 2003 HMRC had preferential status with respect to certain claims.
- We have found that preferential creditors make up a much smaller component of insolvent companies' total debt burden than both secured and unsecured creditors.<sup>7</sup> Therefore much of our analysis in this report focuses on secured and unsecured creditors.

## The insolvency processes

3.8 There are five different corporate insolvency processes: company voluntary arrangement (CVA), administration, administrative receivership, creditors' voluntary liquidation (CVL) and compulsory liquidation. The following table shows the number and total IP fees of each.

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<sup>6</sup> From our analysis of Companies House records we found that on average HMRC debt accounted for 24 per cent of total unsecured debt (based on 384 records for which data was available).

<sup>7</sup> In our Companies House dataset, we found that the average amount owed to unsecured creditors (collectively – this was the average amount owed per administration) was the highest (approximately £1.2 million), followed by secured creditors (approximately £635,000) and lastly preferential creditors (approximately £25,000).

**Table 1: Estimated IP fee income by insolvency type**

	<b>CVA</b>	<b>Administration<sup>8</sup></b>	<b>Administrative Receivership</b>	<b>CVL<sup>9</sup></b>	<b>Compulsory liquidation</b>
Annual number of each <sup>10</sup>	577	3,832	891	10,272	5,434
Per cent by volume	3%	18%	4%	49%	26%
Annual IP fees <sup>11</sup>	£50m	£500m	£100m	£250m	£100m
<b>Per cent by fees</b>	<b>5%</b>	<b>50%</b>	<b>10%</b>	<b>25%</b>	<b>10%</b>

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<sup>8</sup> Where administration is the first insolvency procedure entered into. Note that we find below (paragraph 4.22) that 29 per cent of administrations move to CVL.

<sup>9</sup> Where CVL is the first insolvency procedure entered into. Note that we find below (paragraph 4.22) that 29 per cent of administrations move to CVL.

<sup>10</sup> Annual average 2007-2009 (2009 provisional) Source: Insolvency Service.

<sup>11</sup> Source: Insolvency Service data (2007-2009), Companies House records relating to 500 administrations and submissions from 18 Insolvency Practitioner firms. These annual fees are derived using a rough estimate for industry fees of £1bn. This was computed by two methods. Firstly, the average cost of administrations and liquidations was calculated using Companies House data and this was multiplied by the respective volume of each procedure with a residual amount added to account for administrative receiverships and CVAs. The second method involved calculating the total value of IP fees earned by the 18 firms who responded to us with fee data. Having done this, we used Companies House data to estimate the combined market share of these 18 firms. We then extrapolated to obtain a figure for total IP fees.

Note that our Companies House records are for administrations that started in 2006. Given that the number of corporate insolvencies has increased, current annual fee levels may very well be higher. The split according to process is based on submissions from IP firms.

- 3.9 The diagram in Annexe G sets out the main stages in the administration and CVL procedures, including what happens when an administration moves to CVL.
- 3.10 The main characteristics of the various insolvency procedures are described below.

### **Company Voluntary Arrangements (CVAs)**

- 3.11 A CVA is a process which aims to rescue a company and can be initiated by company directors, an administrator or a liquidator. As the figures show, CVAs are not commonly used. They have their own particular processes that differ in terms of the main market dynamics from CVLs and administrations, and as such we do not comment on them further.

### **Administration**

- 3.12 This is the most commonly used procedure by volume of fees. It enables a company to be reorganised or its assets realised under the protection of a 'statutory moratorium' on other insolvency proceedings and legal processes. This procedure has the potential to give the company an opportunity to recover because it freezes all actions by creditors. The IP appointed as the administrator is responsible for running the company in place of the directors.
- 3.13 The period of administration usually lasts a year.<sup>12</sup> Formally, creditors may oversee the fees and actions of the IP through creditors' meetings and committees.
- 3.14 The purposes of administration are (in order of priority):<sup>13</sup>

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<sup>12</sup> Although this can be extended with the consent of the creditors and/or by the court under the Enterprise Act 2002.

<sup>13</sup> The administrator is required by paragraph 3 of Schedule B1 to the Insolvency Act 1986 to perform their functions with the objective of achieving the three-tier statutory purpose of the administration.

- rescuing the company as a going concern
- achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), and
- realising property in order to make a distribution to one or more secured or preferential creditors.

3.15 A company can enter administration by means of either a petition to court (resulting in a court order) or an out of court appointment. The out of court route into administration has been employed in a large number of administrations since its introduction in 2003 under the Enterprise Act 2002 (EA02).

### Oversight by creditors of IPs' fees and actions in administration

3.16 Creditors meetings and committees are the formal mechanisms by which creditors oversee the actions of the IP.

3.17 The IP must hold a creditors' meeting within ten weeks of the start of the administration.<sup>14</sup> The IP presents his proposals for the conduct of the administration<sup>15</sup> and for the basis for his remuneration at the first creditors' meeting. The remuneration may be set according to either: time spent, assets handled or a fixed fee.<sup>16</sup> Guidance issued to IPs is that

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<sup>14</sup> Having sent out invitations and proposals for achieving the purposes of administration within eight weeks.

<sup>15</sup> These may include such factors as whether the administrator intends to move to CVL and what is proposed with regard to selling assets (sometimes justifying what has already been done – see 'pre-packs' in paragraph 4.110 onwards) and collecting debts.

<sup>16</sup> The remuneration of IPs in administrations and insolvent liquidations may be set (according to SIP 9) either:

- as a specified percentage of the value of either the property the IP has to deal with (administration) or the assets which are realised or distributed or both (insolvent liquidation), or

they should specify hourly rates in their proposals<sup>17</sup> but these rates are indicative and IPs are not bound by them<sup>18</sup>.

- 3.18 The creditors vote on these proposals which can be approved by a majority of creditors (by value of unsecured claims).<sup>19</sup> Thus votes on proposals are taken by those with an unsecured claim only. We note that secured creditors may have an element of unsecured debt (for example an outstanding balance on a bank account), in which case they would be able to vote at these meetings.
- 3.19 The creditors' meeting may also appoint a creditors' committee consisting of at least three and a maximum of five creditors.
- 3.20 If there is a creditors' committee, it will set fees and oversee the IP's actions. If there is no committee, the basis for remuneration can be agreed (along with the IP's other proposals) at a creditors' meeting. Where the creditors' meetings have failed to agree the IP's proposals (including the basis for remuneration) in administration they may be settled by the court on application by the IP.
- 3.21 The administrator may dispense with creditors' meetings if he believes the company has insufficient assets for a payout to be made to

- 
- by reference to the time properly given by the administrator and his staff in attending to matters arising in the administration/liquidation.

In addition, from April 2010, it has also been possible for the remuneration of office-holders to be set as a fixed fee. The IP is able to use any of the three bases or a combination of them for payment to set his remuneration, with different bases capable of being applied to different functions performed by the IP (Amendment to Insolvency Rules 2010).

<sup>17</sup> SIP9 states that hourly rates should be provided even where remuneration is not proposed to be on a time basis.

<sup>18</sup> Guidance provided by SIP9 is that creditors should be notified of any changes.

<sup>19</sup> On proposals relating to remuneration, if the administrator thinks that unsecured creditors will receive no recoveries, only secured creditors vote unless there are also preferential creditors, in which case voting is by both secured creditors and preferential creditors whose debts amount to more than 50 per cent of total preferential debts.

unsecured creditors. If a creditors' meeting is not held for this reason the IP's proposals are deemed to have been approved.<sup>20</sup> Thus, the creditors' meeting is designed to allow unsecured creditors to influence the process of administration if they are likely to receive any money at the end of it, but not if it is unlikely.

- 3.22 However, a creditors' meeting must take place if ten per cent of all creditors (by value) request one within eight business days of the administrator's letter to them.
- 3.23 Creditors and company members are able to challenge the administrator by application to court on the basis that the IP has acted in a way which is not in the interests of the company and its creditors. They can also apply to court on the grounds that the IP is not acting as efficiently or quickly as reasonably possible. For reasons of cost, however, this is rare.

### **Pre-pack administrations**

- 3.24 In pre-pack administrations a company enters administration and its business/assets are immediately sold under an arrangement made prior to the appointment of the administrator. The IP will usually have been working with the firm and/or the secured creditors prior to the administration. We have been made aware of substantial concern among some creditors over the use of pre-packs.
- 3.25 We believe the problems of pre-packaged administrations are symptomatic of the problems we have found in the market as a whole, and our recommendations go some way to resolving these issues. However, we do not discuss them extensively separate from our discussion of administrations generally.

### **Administrative Receivership**

- 3.26 The objective of administrative receivership is to realise the company's assets and then repay the money owed to the floating charge holder (the

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<sup>20</sup> Rule 2.33(5) of Insolvency Rules 1986

secured creditor). This process can be initiated by the holder of a floating charge<sup>21</sup> over a substantial part of the company assets that was created before September 2003.

- 3.27 This use of this procedure has diminished substantially since the introduction of the out of court route into administration and the barring of the right to appoint an administrative receiver for any security created after 15 September 2003 in the EA02. Receiverships account for approximately five per cent of total corporate insolvencies each year by fee income and the number of them is expected to fall further. Given this, we do not focus on administrative receiverships in our study.

### **Liquidation**

- 3.28 Liquidation is a formal procedure in which an IP may be appointed<sup>22</sup> as liquidator to 'wind-up' the affairs of a limited company that cannot continue trading. It involves selling the company's assets and distributing the proceeds to creditors in statutory order. The company is then dissolved, meaning that it ceases to exist.
- 3.29 Once a company enters liquidation, the directors' control of the company ceases – this responsibility passes to the liquidator.
- 3.30 In voluntary liquidation, the liquidation is initiated by the company itself.<sup>23</sup> There are two types of voluntary liquidation:

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<sup>21</sup> A secured creditor whose charge is held over the general assets of a company and 'floats' until converted into a fixed charge. The company can use the assets without his consent until the charge 'crystallises' (becomes fixed), which can occur upon the launch of insolvency proceedings.

<sup>22</sup> Note that an IP is not necessarily appointed in compulsory liquidation.

<sup>23</sup> A compulsory liquidation is initiated by a petition to the High Court (or alternatively county court if the company has £120,000 or less issued share capital). If the court decides that one of the conditions for winding-up is satisfied it will make a winding-up order. There are various circumstances in which a company may be wound up by the court, including inability to pay its debts. Compulsory liquidation is managed by the official receiver at the start but he can be replaced by an IP upon request by creditors. We do not discuss this further.

- **Members' voluntary liquidation:** the company is solvent, i.e. there are enough assets to repay all of the company's debts. Since these only apply to solvent companies we do not consider this type of liquidation in our study.
- **Creditors' Voluntary Liquidation (CVL):** the company is insolvent, i.e. it is unable to repay its debts. CVL may follow administration, usually where the administration has not succeeded in saving the company and there are assets available to distribute to unsecured creditors.

3.31 CVL is commenced by the members passing a special resolution to wind up the company. A creditors' meeting must be held within 14 days of this although it is commonly held on the same day. Both members and creditors nominate a liquidator at their respective meetings, with the creditors' choice taking precedence.

#### Oversight by creditors of IPs' fees and actions in CVL

3.32 As in administration, the creditors' meeting may vote to establish a creditors' committee<sup>24</sup>. The liquidation committee is responsible for approving the liquidator's remuneration and monitoring his conduct. The committee receives reports from the liquidator and in turn may report back to the remaining creditors. The liquidator must call the first meeting of the liquidation committee within six weeks of its establishment and must also report to the committee at least every six months on the progress of the insolvency.

3.33 Where the creditors have failed to agree the remuneration it may be fixed in CVL in accordance with a statutory scale. The IP can still apply to the court if he feels that the statutory scale payment is too low.

3.34 Where CVL follows administration, there is no requirement to hold a creditors' meeting although the liquidator must summon a meeting if

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<sup>24</sup> Votes on proposals are taken only by those with an unsecured claim (which may include creditors with a claim that is partly secured).

requested in writing to do so by ten per cent of creditors (by value)<sup>25</sup>. Any creditors' committee which is in existence at the end of administration shall continue as if it had been approved in the liquidation.<sup>26</sup> We find that the statutory scale is infrequently applied in CVL following administration,<sup>27</sup> suggesting that remuneration in CVL was usually fixed previously.

## Scotland

- 3.35 Certain aspects of the Scottish corporate insolvency regime are dealt with by the Insolvency Service (IS). These are known as reserved elements and include CVAs, administrations, the legal effect of liquidation and the regulation of IPs.
- 3.36 However, some processes are devolved to the Scottish Parliament. The Accountant in Bankruptcy (AiB) operates on behalf of the Scottish Government and is responsible for these devolved elements. Its responsibilities include developing the policies on receivership and specific to administrative duties for liquidation.
- 3.37 Additionally, the AiB is responsible for receiving and recording information on liquidations and receiverships of Scottish businesses. These are held in the Register of Insolvencies (RoI).

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<sup>25</sup> IA86 s168(2)

<sup>26</sup> IA86 paragraph 83(8)(f) of Schedule B1

<sup>27</sup> Our analysis of 140 liquidations (preceded by administration) shows that IPs are paid more than the default scale in at least 83 per cent of cases.

3.38 A notable difference is that compulsory liquidation is more common in Scotland than in England and Wales.<sup>28</sup> There is no official receiver in Scotland so all compulsory liquidations are dealt with by IPs.

## **Northern Ireland**

3.39 There is different legislation for administration, liquidation and CVAs in Northern Ireland. Additionally, there are separate provisions for administrative receiverships.<sup>29</sup>

3.40 The Department of Enterprise, Trade and Investment in Northern Ireland is responsible for overseeing and regulating the insolvency profession. Additionally, it is responsible for formulating specific insolvency legislation and policy for Northern Ireland, and handling the disqualification of directors in all corporate insolvencies.

3.41 Despite the differences in corporate insolvency legislation between Northern Ireland and England & Wales, there are many similarities between the jurisdictions, notably in relation to the regulation of IPs.

## **IPs**

3.42 Each of the formal corporate insolvency procedures described above requires the appointment of an office holder who must be a qualified IP.<sup>30</sup> Anyone who acts as an IP in relation to a company or an individual

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<sup>28</sup> Compulsory liquidation accounts for approximately 60 per cent of all Scottish corporate insolvencies, compared with 15 per cent of corporate insolvencies in England and Wales.

<sup>29</sup> The legislation under which most formal insolvency procedures are administered is The Insolvency (Northern Ireland) Order 1989 and The Company Directors Disqualification (Northern Ireland) Order 2002.

<sup>30</sup> Section 388 of IA1986 defines to 'act as insolvency practitioner' in relation to a company as acting as a liquidator, provisional liquidator, administrator or administrative receiver, or where a voluntary arrangement in relation to the company is proposed or approved as nominee or supervisor. Section 230 of IA1986 requires holders of office (administrators, administrative receivers and liquidators) to be qualified insolvency practitioners.

when not qualified to do so commits a criminal offence punishable by imprisonment, a fine or both.

- 3.43 A person can only practice as an IP where they have been granted an authorisation to act as IP by either the Secretary of State (SoS) or a Recognised Professional Body (RPB).<sup>31</sup>
- 3.44 There were 1746 authorised IPs in Great Britain at 1 January 2010. Only about three quarters of these actually take formal appointments (1331 as of 1 January 2010).
- 3.45 The vast majority of IPs come from an accounting or legal background. While there are both accountants and lawyers that are authorised to take appointments, in practice office holders are predominantly accountants, with lawyers acting largely as advisers.
- 3.46 Each year IPs earn approximately £1bn<sup>32</sup> in fees from corporate insolvency procedures, in the process realising about £5bn worth of assets and distributing £4bn<sup>33</sup> to creditors.
- 3.47 As well as carrying out formal work as a result of formal insolvency procedures, many IPs also take part in the wider £3bn<sup>34</sup> business restructuring market, but this is not the focus of our study.
- 3.48 Our study does not consider the wider market for Law of Property Act receivers (LPA Receivers). LPA receivers are not required to be IPs; they are appointed under the Law of Property Act 1925 by a lender holding a fixed charge over property to enforce the lender's security. An LPA receiver is usually appointed with a view to selling the charged property or collecting rental income from it for the lender.

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<sup>31</sup> IA1986 s390

<sup>32</sup> See footnote 10.

<sup>33</sup> Extrapolated from Companies House data.

<sup>34</sup> Keynote 'Market Report 2009: Accountancy' page 15.

## The role of IPs

3.49 As each insolvent business will be different and face a different set of circumstances, the strategy, aims and decisions of an IP will vary.

3.50 The IP may make a number of important decisions regarding the company in insolvency and its assets, including:

- whether to enter an insolvency procedure
- which insolvency procedure is appropriate
- whether to consider refinancing of the business by a third party lender
- whether the procedure will aim to save the company outright, save some element of the company or wind up the company and distribute its assets
- how to secure and recover the assets
- whether to pursue any possible claims against the directors or any debtors of the insolvent company, and
- how to protect and balance the interests of competing creditors.

3.51 These decisions may have a significant effect on the outcome of the insolvency. In this study we have tried to consider the incentives that drive these decisions by IPs and whether these incentives encourage IPs to provide efficient services that benefit creditors.

## 4 MARKET ASSESSMENT

### Summary

- Secured creditors effectively determine the appointment of IPs in administrations.
- IPs' dependence on secured creditors for appointments makes them responsive to the secured creditors' wishes. Most mid-tier and large IP firms compete primarily by building strong relationships with repeat secured creditors.
- We find that banks' use of panels to select IP firms for insolvency cases does not cause a significant competition concern.
- The market appears to work reasonably well where the secured creditor is not re-paid in full. This is approximately two thirds of the time.
- Unsecured creditors find it harder to influence the process, despite formal mechanisms for doing so. This is because they find it hard to coordinate, can have limited understanding of the process, are provided with poor information and are not aided by the procedures. The costs of engaging are perceived to outweigh the benefit.
- We find that, in a typical administration, like-for-like IP fees are approximately 9 per cent higher when secured creditors recover their debt in full and unsecured creditors pay the IP fee out of their own claims. This is evidence of less control by unsecured creditors, which may also contribute to other outcomes such as insolvency cases taking a longer time to complete or recovery of assets at below their market rate.
- Our assessment focuses on administration and on CVL where this follows administration. However similar concerns are likely to arise where a CVL is the first insolvency process initiated since the formal processes are similar.
- Rectifying problems in the market should increase the amount of money unsecured creditors receive from insolvencies and, at the margin, might be expected to improve the amount of credit extended.

- 4.1 In this chapter we assess how well the market for IPs works, with a particular focus on administration and CVL.
- 4.2 The chapter has three sections:
- an assessment of how IPs are chosen, with a particular focus on the role of bank panels
  - an assessment of how the fees and actions of IPs are constrained by the market, with a particular focus on the differential abilities of secured and unsecured creditors to exert control over them, and
  - an assessment of the harm caused by the market failures we identify.

### **An assessment of how IPs are chosen**

- 4.3 In this section we
- review the appointment of IPs in administration
  - review the effect of bank panels on competition between IPs
  - assess whether there may be any competition concerns in the appointment of secondary advisors, such as lawyers, and
  - review the appointment of IPs in CVLs following administration.
- 4.4 We find that the market for appointment of IPs is competitive. However, the strength of secured creditor control over appointment raises concerns which will be addressed in the next section.

## **Appointment of IP in administration**

- 4.5 While directors formally appoint IPs in the majority of administrations,<sup>35</sup> evidence from academics, banks, IPs and regulators suggests that secured creditors effectively control the appointment of IPs.<sup>36</sup> This is principally because secured creditors can formally veto the directors' choice of IP (see diagram in Annexe G).
- 4.6 Secured creditors, notably banks, are often repeat players in the insolvency process. As such, they tend to develop and maintain relationships with insolvency firms. Most mid-tier and large IP firms compete primarily by building strong relationships with repeat secured creditors.

## **Bank panels and their effect on competition between IPs**

- 4.7 All the banks we spoke to told us that they operate some sort of panel, or list, of IP firms considered suitable for appointment when the secured creditor's exposure exceeds a particular amount, usually around £200,000.<sup>37</sup>

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<sup>35</sup> 75 per cent of the 500 administration records considered in our analysis of Companies House records (13 per cent were directly appointed by secured creditors with the remainder made by court order and company shareholders).

<sup>36</sup> 'The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK', Armour, J., Hsu, A., Walters, A., University of Cambridge Centre for Business Research Working Paper No. 332 (March 2009). In addition, corroborated in conversation with and submissions from seven large IP firms, three large banks and a number of other stakeholders.

<sup>37</sup> Some of the banks we spoke to have formal panels of approved firms. The remaining banks we talked to have lists of 'preferred IP firms' which they use in insolvency proceedings, essentially operating as a panel. The use of bank panels appears to be confined to administration, as a number of banks have told us that they do not seek to influence IP appointments in liquidation (based on responses of three banks to OFT questionnaire). We believe this to be the case because there is a much lower prospect of recovering money when a company goes straight into liquidation, and so banks are not as concerned about which IP is appointed to do the job.

- 4.8 Banks employ panels as they are able to build a relationship with the IP that creates trust and enables the bank to negotiate lower fees in return for a promise of repeat work. IP firms and banks have confirmed the existence of 'panel rate' discounts.
- 4.9 While panels can thus have beneficial competitive effects, they also have the potential to restrict competition in the market by restricting appointments to a select number of firms.
- 4.10 Very few panel firms are regional and panels may make it harder for smaller firms to compete and grow. In the longer term, bank panels could create a barrier to growth that effectively prevents smaller IP firms achieving sufficient size to join panels, leading to barriers to entry to the mid-tier of the market. Indeed seven IP firms<sup>38</sup> told us that the fact that they were not on a bank panel restricted their ability to get appointments in certain cases.
- 4.11 Despite this, it seems to us that bank panels of IPs do not pose insurmountable obstacles to competition for two reasons:
- there are a large number of firms on the bank panels, and
  - analysis of Companies House records suggests fluid competition in the market.<sup>39</sup>
- 4.12 Responses from five banks show that 25 firms are on one or more large panels. On average, each bank has a panel comprising approximately 12-15 firms. Moreover, the composition of IP firms on these bank panels is

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<sup>38</sup> We received written responses to our questionnaires from 28 IP firms, of which seven told us that the fact that they were not on a bank panel restricted their ability to get appointments in certain cases.

<sup>39</sup> Analysis of Companies House records shows that in cases where the bank is owed more than £250k, a non panel firm will be appointed in approximately thirty three percent of cases. This data relates to administrations started in 2006. We use a £250,000 threshold in our analysis as large retail banks have indicated that they will only seek to influence the appointment of an IP when they are owed in excess of about £200k, and we have included a margin £50k excess to account for cases that just went over the bank guideline amount.

varied, ranging from the 'Big Four' firms to smaller 'boutique' insolvency practices. These figures do not suggest any immediate concern relating to market concentration between panel firms.<sup>40</sup>

- 4.13 Table 2 shows the percentage of appointments accounted for by firm type ('Big Four', panel, non-panel) according to the amount of debt owed to secured creditors.

**Table 2: Market shares of different types of IP firm in different types of insolvency**

Total Amount owed to secured creditors (£):	per cent of time each type of firm is appointed		
	BIG 4	Panel	Non - panel
< 250k	3%	40%	57%
250k – 500k	4%	54%	42%
500k-1m	7%	57%	37%
1m-2m	14% *	57% *	29% *
2m +	52% *	48% *	0% *

Source: Companies House data. \* - Small sample size of 28 and 23 respectively.

- 4.14 As the total amount owed to secured creditors increases, it becomes increasingly rare for non-panel IP firms to secure appointments. However, they do not appear to be excluded from the market until the level of debt exceeds £2m. The fact that 29 per cent of appointments go to non-panel firms when secured creditors are owed between £1m and £2m suggests that the operation of bank panels does not deny market access to non-panel firms. Banks will not always insist on a panel

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<sup>40</sup> 'BIG 4' refers to the Big Four accountancy firms – Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers.

IP appointment where the directors' appointed IP is from what it considered to be a reputable firm.<sup>41</sup>

- 4.15 The fact that non-panel firms appear unable to obtain appointments when a secured creditor is owed more than £2m may be due to lack of resources and expertise to deal with such big cases.<sup>42</sup> It cannot be assumed that it implies a restriction of competition.
- 4.16 Additionally, the table shows us that bank panels do not give rise to particularly high concentration of the 'Big Four' accountancy firms.
- 4.17 We note that there is no clear market definition or segmentation: almost all types of firms are able to compete for work across almost all of the insolvency market.<sup>43</sup>
- 4.18 While we do not believe that bank panels pose a threat to competition, it is nevertheless important to identify areas where improvement might be possible in order to ensure they do not do so in future. In particular, it is necessary for banks to continue to be flexible in appointing non-panel firms where appropriate. We would urge all secured creditors who operate a panel to do so openly, affording IP firms clear and regular opportunities to tender against transparent selection criteria to be on their panel.

### **Concerns in the appointment of secondary advisors**

- 4.19 Nearly all of the IP firms we spoke to told us that they appoint legal advisers in most of the corporate insolvencies they deal with.<sup>44</sup>

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<sup>41</sup> This is based on responses from a number of banks and IP firms.

<sup>42</sup> This is based from responses from a number of banks and IP firms.

<sup>43</sup> This finding is supported by the written responses we have received from a number of IP firms, both large and small, to our questionnaires.

<sup>44</sup> Several of the banks we spoke to told us that they are involved in the appointment of legal advisor appointments. These firms have legal panels which comprise a number of firms. Other banks told us they will not seek to influence the appointment of legal advisors.

- 4.20 Despite the existence of legal panels in some circumstances, firms told us that they have appointed an average of 20 – 30 different legal advisers over the past two years. In addition, of the 150 Companies House records we saw, where this data was provided, more than 60 different law firms were appointed as legal advisers.
- 4.21 Some stakeholders have expressed concern about how particular legal advisers get chosen and paid and we believe these are related to general concerns about oversight of IP fees and actions discussed later. However, in terms of competition between legal advisers, we do not believe that panels raise any substantial issues due to the range of firms that are appointed.

### **Appointment of IPs in CVLs following administration**

- 4.22 Our analysis of Companies House records found that 29 per cent of companies placed in administration subsequently moved into CVL.
- 4.23 Where a company moves from administration to CVL, it is very likely that the IP who was the administrator will also be the liquidator.<sup>45</sup> This will be the case unless creditors had nominated a liquidator before the creditors' meeting in administration (see Figure 4) or creditors exercise their right to requisition a meeting once administration converts to CVL in order to replace the liquidator (see paragraph 3.34).
- 4.24 When an administration moves into CVL<sup>46</sup> the secured creditor has no further interest in the process. The divergence between the interests of the creditors that appointed the IP and the creditors that are affected by the IP's fees and actions has the potential to be problematic.
- 4.25 There are differing views as to whether there might be benefits from the same IP continuing in office. Some point out that it may be more cost

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<sup>45</sup> The administrator became the liquidator in 96 per cent of the administrations that moved to CVL for which we collected data (we have data on 145 such cases).

<sup>46</sup> An administration can only go into liquidation when the secured creditor has received all that they can expect from the insolvency process or the IP has set these funds aside.

effective given the IP's understanding of the company and its business that would have been gained in preceding stages. Others believe that there is a potential conflict of interest for the IP to continue in office and that a new appointee could in effect provide a check on the previous IP's fees and actions.<sup>47</sup>

## **How the fees and actions of IPs are constrained by the market**

4.26 Once an IP is appointed, he must make decisions about the operation and/or sale of assets of the company. In this section we assess how the market constrains IP actions and fees during this process.

4.27 Our assessment is in three parts:

- A - the ability of secured creditors to control IP actions and fees during the process
- B - the ability of unsecured creditors to control IP actions and fees during the process
- C - the ability of creditors to influence IP actions through threat of after-the-event challenge in the courts.

4.28 We find that secured creditors are able to provide effective oversight of an IP's fees and actions and, where they have the incentive to do so, they effectively constrain the IP. However, we find that unsecured creditors rarely have both the ability and incentive to provide effective oversight and, where it falls to them to do this, the market is less likely to work well.

### **A - Ability of secured creditors to control IP actions and fees**

4.29 Where there are insufficient funds for secured creditors to be re-paid in full, they are interested in every pound that the IP recovers from asset sales and every pound that the IP charges. Therefore in these

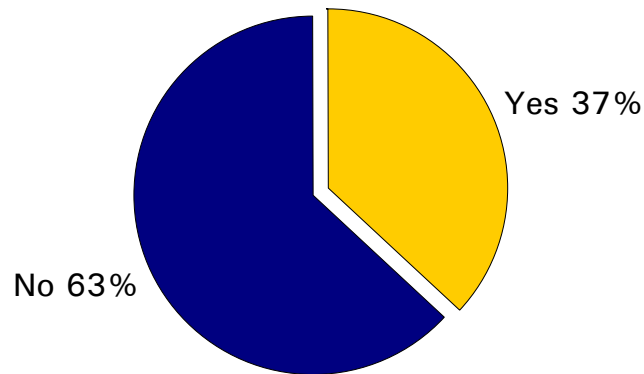
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<sup>47</sup> Based on responses from a number of IPs and banks.

circumstances they have a strong incentive to control the actions and fees of IPs.

4.30 We estimate that secured creditors are not paid in full in 63 per cent of administration cases (weighted by value).<sup>48</sup>

**Figure 4: Per cent of time, by IP fee income, secured creditor recovers its debt in full**



Source: Companies House data, based on 500 records.

4.31 Our discussions with secured creditors and IPs and our analysis of Companies House records indicate that secured creditors are able to constrain IP fees. IPs' dependence on secured creditors for appointments makes them responsive to the secured creditors' wishes. In particular,

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<sup>48</sup> Based on Companies House data. Recovery rates were calculated for secured creditors. We looked at IP fees in two situations: 1) where the secured creditor recovered all of their money, i.e. their recovery rate was 100 per cent (or alternatively when they made no claim on the insolvency assets), 2) where the secured creditor did not recover all of their money, i.e. their recovery rate was less than 100 per cent. We find that IP fees in cases where the secured creditor's recovery rate was 100 per cent accounted for 37 per cent of total IP fees. Additionally, we find that when the secured creditor's recovery rate is less than 100 per cent, IP fees accounted for 63 per cent of the total.

the banks' operation of panels for the selection of IPs allows them to negotiate lower 'panel' fees with the firms on their panels in return for repeat work for these firms. One bank told us it believed panel rates were 33 per cent lower than normal hourly rates charged by IP firms.

- 4.32 In addition to negotiating reduced per hour rates through panels, the strong informal control that secured creditors have over IPs allows them effectively to influence IP fees and actions throughout their involvement in the insolvency process. One bank told us that it required an estimate of total fees in advance and that it would not pay any fees above this figure without very good reason. We have seen explicit references in Companies House records to caps on total fees being agreed between secured creditors and IPs. Almost all of our discussions with company directors and larger unsecured creditors also emphasised the strong relationship between secured creditors and the IP so long as the secured creditors had not recovered all their debt.
- 4.33 All the banks we talked to were broadly happy with the service that IPs deliver for them, the amount of control and oversight they have over the IP and the amount of competition in the IP market.
- 4.34 Our evidence shows that secured creditors have both the incentive and ability to influence IP fees and actions, and we have not identified any substantial lack of market incentives for IPs when secured creditors are not paid in full.

#### Impact of secured creditor control on other creditors

- 4.35 As discussed, so long as secured creditors anticipate some debt outstanding at the end of the process, they have an incentive to ensure the IP recovers the most assets at the best price and charges the lowest fee. In the vast majority of circumstances, this will be in the interests of all creditors and of the wider economy.
- 4.36 There may be some situations where the interests of the secured creditor are in short-term recovery of a reduced amount of debt, at the potential expense of the longer-term interests of other creditors and the economy as a whole. While some unsecured creditors have suggested this, it appears that banks may be more concerned with business

recovery than in the past.<sup>49</sup> We have no evidence that this problem is widespread at this time.

- 4.37 Nonetheless, the regulatory regime should be sensitive to changes in the financing of firms and the incentives of those providing the finance, in case this situation changes.
- 4.38 Academic research<sup>50</sup> has found that a significant majority of companies that went into administration or administrative receivership had secured debt held by at least two parties. A loan or overdraft facility would be serviced by a bank with an independent receivables financier providing further capital through a factoring or invoice discounting facility.
- 4.39 The research outlined various ways in which this could make insolvency procedures more likely as well as more complicated (entailing greater IP costs both pre- and post- insolvency).<sup>51</sup>
- 4.40 The increasing complexity of secured financing has also arisen in a number of stakeholder conversations with both banks and IPs. For example, it has been suggested to us that the interests of receivables finance secured lenders may not always lie in the long term viability of a business. Receivables finance firms have contested this, noting that

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<sup>49</sup> Based on time series analysis of the instigation of administrations and administrative receiverships and discussions with banks, IPs and industry observers.

<sup>50</sup> Sandra Frisby 'Report on Insolvency Outcomes' Presented to the Insolvency service 26 June 2006 pp. 32-44.

<sup>51</sup> The research included interviews with IPs and bankers and Dr Frisby quoted one interviewee: 'Now you have situations where the bank is out-manoeuvred, if you like, by other stakeholders who don't have the company's interest as much at heart. We found this with a case last year, quite a big case, where there was a clearing bank who are probably at the forefront of restructuring and trying to work things through, even to the point of putting more money in to sort the problem out. That bank was basically blown out by an asset based lender who said, 'No, we just want the money out now', and who wasn't interested in a restructure at all. You have situations now where those competing stakeholders, there may be an asset-based lender, a clearing bank, some other stakeholder, an equity house for example, don't all have the same interest in supporting the business. In the old days you would be dealing with the bank's relationship manager and the owner of the business trying to sort it out, but not now.' (p.40)

when a firm goes into insolvency the recovery rate on any outstanding invoices can sharply decrease.

## **B - The ability of unsecured creditors to control IP actions and fees during the process**

- 4.41 When secured creditors have been paid in full, oversight of IPs falls to unsecured creditors as the secured creditors have no remaining interest in the outcome of the process. The same applies when there are no secured creditors.
- 4.42 Unsecured creditors do not usually appoint IPs and so are less able to reward and punish behaviour by offering or withholding repeat business. This means they are reliant upon the formal mechanisms available to them for exercising oversight and control.
- 4.43 We analyse below:
- 1 - how often the formal methods of control are used and how effective they are when used
  - 2 - why smaller unsecured creditors do not use formal mechanisms
  - 3 - difficulties for larger unsecured creditors, and
  - 4 - why trade credit insurance does not appear capable of correcting the problems we find.
- 1 - How often the formal methods of control are used
- 4.44 The formal mechanisms for setting the basis for remuneration of IPs and overseeing IPs' actions are set out in Chapter Three, with the key mechanisms being the creditors meeting and committee.
- 4.45 IPs may dispense with creditors' meetings in administrations on the grounds that they do not believe the company has sufficient assets for a distribution to be made to unsecured creditors. In this case and if the IP's remuneration was not among proposals deemed to have been approved (see paragraph 3.21), it may be fixed by secured creditors and

(if the IP intends to make a distribution to preferential creditors) by preferential creditors without necessarily requiring a meeting.<sup>52</sup>

- 4.46 Our analysis of Companies House records shows that a creditors' meeting was held in 61 per cent of the administrations for which we collected data. This is substantially in excess of the percentage of administrations where the unsecured creditors receive any return, and is not a cause for concern.<sup>53</sup>
- 4.47 However, our in-depth creditor interviews suggest that where a creditors meeting is held, it is poorly attended by unsecured creditors.<sup>54</sup> In stakeholder conversations IPs have estimated that no unsecured creditors attend in 19 out of 20 creditors meetings.<sup>55</sup>
- 4.48 Furthermore very few IPs' proposals at creditors' meetings get modified or rejected. Analysis of Companies House records shows that 80 per cent of creditors' meetings in administrations agree all the IPs' proposals (including those for remuneration) without change or rejection. Moreover just three per cent of modifications and rejections relate to IP fees.<sup>56</sup> This

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<sup>52</sup> Rule 2.106(5a) of Insolvency Rules 1986

<sup>53</sup> Our analysis of Companies House data shows that unsecured creditors receive a return in approximately 20 per cent of administrations (based on 500 records).

<sup>54</sup> Just four of the 33 creditors interviewed had ever attended one and only one of these was an unsecured creditor other than HMRC.

<sup>55</sup> Amendments to the Insolvency Rules 1986 that came in to force in April 2010 potentially go some way towards addressing our concerns about the scope for creditor involvement in meetings and in other aspects of the process. However greater flexibility in communication and virtual attendance of meetings still requires initial contact by conventional methods in most cases and easier access to court review still suffers from the problems of using a court outlined later in this section. As such, while these changes clearly mark a step in the right direction, we believe they are unlikely to correct the substantially fundamental imbalance in control resulting from the informal methods of oversight available to secured creditors.

<sup>56</sup> 17 per cent have at least one proposal modified or rejected, leaving approximately 3 per cent which were not stated / information not found. It is notable in particular that just two of the 60 modifications and rejections that we observed in 51 administrations related to post-appointment

suggests, in line with our finding above about the relationship between IPs and banks, that effective oversight and negotiation over IP fees and actions occur independently of creditors' meetings.

- 4.49 In addition hourly rates specified by the IP in his proposals are merely indicative rather than definitive (see paragraph 3.17). This means that ongoing oversight during the insolvency process is important in order to influence the level of total fees. Formally, this may be done by a creditors' committee.
- 4.50 According to our analysis of Companies House records, a creditors' committee was formed in only three per cent of administrations, suggesting that these are also a relatively ineffective method of oversight for unsecured creditors.<sup>57</sup>
- 4.51 Unsecured creditors' interests are therefore rarely represented at the start of administration, and perhaps even less commonly on an ongoing basis during the process.
- 4.52 When CVL follows administration, there is no requirement to hold a creditors' meeting (see paragraph 3.34). Any creditors' committee which is in existence at the end of the administration continues in operation. However, the unsecured creditors may not be paid until CVL and the basis for remuneration and composition of the creditors' committee that were decided on during administration may not necessarily reflect their interests. Moreover the hourly fee rates that applied in administration will not necessarily apply in a subsequent CVL.<sup>58</sup>
- 4.53 We find that unsecured creditors' ability to influence CVL following administration may be even weaker than it was during administration even though they may have more interest in the process.

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fees. Thus post-appointment fees were modified or rejected in just two of the 293 creditors' meetings that were held in 482 administrations for which data was recorded.

<sup>57</sup> Based on 475 records for which data was available.

<sup>58</sup> Guidance on fees provided in Statement of Insolvency Practice 9 does not address this.

4.54 Thus we find that the formal methods of oversight by unsecured creditors are rarely used and are ineffective. The next sections assess why this may be the case.

## 2 - Why smaller unsecured creditors do not use formal mechanisms

4.55 This section discusses the difficulties faced in particular by smaller unsecured creditors in making the system work.

4.56 A large number of unsecured creditors have only relatively small amounts of money at stake and so little individual influence. The costs of getting involved are often perceived to outweigh any benefit. Thus our in-depth creditor interviews suggested that creditors' meetings were poorly attended by unsecured creditors because it was not thought to be justified given the time and travel costs that would be incurred relative to the amount they were owed and their level of influence on the process given the amount owed relative to other creditors.<sup>59</sup>

4.57 Figure 5 (based on our online survey of creditors) shows the distribution of money lent by unsecured creditors.<sup>60</sup> We can see that the median value for average amount owed to unsecured creditors is £3000. This amount is likely to be very small in comparison with the size of the insolvency.<sup>61</sup>

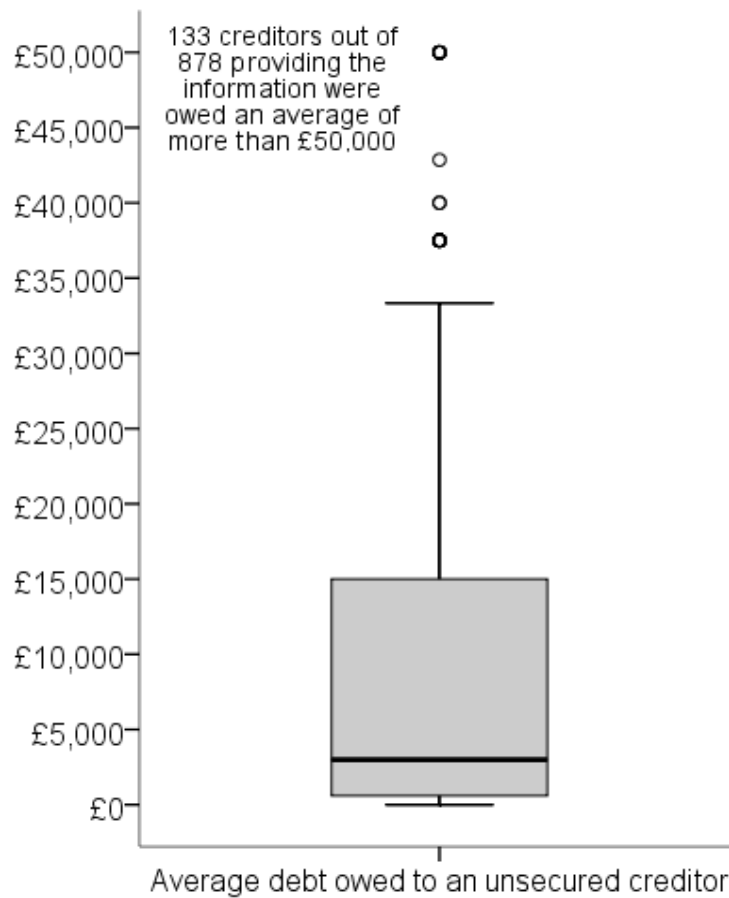
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<sup>59</sup> Paragraphs 2.16, 8.1-8.3 of in-depth creditor interviews report.

<sup>60</sup> This box plot shows us the distribution of the average amount owed to unsecured creditors, i.e. each time an unsecured creditor extends credit, the amount they extend. This has been calculated using the responses to our online survey of creditors, considering the amount of credit extended over the last three years (by unsecured creditors) and the number of firms this credit has been extended to.

<sup>61</sup> Our analysis of 500 Companies House records shows that the average total amount owed to all creditors (secured, preferential and unsecured) at the start of the administration process is approximately £2m.

**Figure 5: Distribution of amounts owed to unsecured creditors**



Source: Online Survey of Creditors, based on 878 respondents.

4.58 Moreover our online survey of creditors found that 55 per cent of unsecured creditors expected to recover nothing in an insolvency process.<sup>62</sup> This actually appears somewhat optimistic considering that Companies House data suggested that they only receive a payout in 20 per cent of cases, with the average return to unsecured creditors being 4 per cent.

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<sup>62</sup> Based on 882 unsecured creditors.

- 4.59 The current procedures mean that unsecured creditors owed small amounts must coordinate their actions with other unsecured creditors in order to influence the process.<sup>63</sup> Coordination is necessary in requesting meetings, attending them, responding to IPs' proposals and voting for creditors' committees. Unsecured creditors would incur time and financial costs in coordinating with one another. When making a decision on whether or not to do so, they will compare these costs with the perceived benefits. As perceived benefits from actively engaging in the insolvency process are low and costs are relatively high, unsecured creditors have little incentive to coordinate with one another in insolvency processes.
- 4.60 Trade Credit Insurance could consolidate the interests of unsecured creditors and thereby resolve problems of coordination. However this is unattractive to most small creditors and take-up is low. This is discussed below at paragraphs 4.77 to 4.79.

### 3 - Difficulties for larger unsecured creditors

- 4.61 There are a number of larger unsecured creditors such as the HMRC, large landlords in England and Wales and national reach services firms. Figure 6 confirms the existence of large unsecured creditors: 133 out of 878 unsecured creditors were owed an average of more than £50,000. Additionally, our analysis of Companies House records shows that HMRC was owed more than £50,000 in 57 per cent of administrations and on average accounted for 24 per cent of the unsecured debt.<sup>64</sup>
- 4.62 Large unsecured creditors are likely to suffer to some extent from the same problems of coordination as smaller unsecured creditors. In addition they often have a lack of understanding and information and are frustrated by procedural difficulties.

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<sup>63</sup> 25 per cent (10 per cent from 6 April 2010) of creditors (by value) are required to challenge IP remuneration in court. 10 per cent of creditors (by value) can collectively demand a creditors meeting if the IP has deemed it unnecessary.

<sup>64</sup> Based on 390 records for which data was available.

## Understanding of the process

- 4.63 Many unsecured creditors have limited knowledge and understanding of the insolvency process.
- 4.64 Focusing on the setting of fees, one of the key elements of the process, evidence from our in-depth interviews and online survey suggests that most unsecured creditors do not have sufficient understanding or knowledge of the creditors' meeting procedures to be able to respond effectively to IPs' proposals on fees.
- 4.65 Our in-depth creditor interviews confirmed that most creditors were vague about the IP's fee, not knowing who was responsible for deciding how it was determined or how it was to be calculated. Only those dealing with insolvency on a regular basis were familiar with the formal methods for agreeing fees.
- 4.66 Our online survey also suggested that unsecured creditors were broadly ill-informed of the process and how it works. It put a number of statements to those creditors who had experienced a business debtor going into insolvency in the last three years. One third of these creditors (33 per cent) responded 'don't know' to the statement 'the way in which the IP was chosen was a good one' and 21 per cent responded 'don't know' to the statement 'the level of fees charged by the IP seemed to be reasonable'. Moreover, about half of the creditors (51 per cent) answered either 'disagree', 'strongly disagree' or 'don't know' to the statement 'It was clear how to complain about the insolvency process' (all based on 731 responses).
- 4.67 The Companies House records show that IPs typically present between eight and 12 proposals at meetings, of which two or three might relate to fees and disbursements. An IP has told us he believed that inexperienced creditors attending meetings might think that their only options were to vote either for or against the entire package of proposals.
- 4.68 We believe that it would certainly require some experience to have any basis for judging whether an IP's pay proposal is reasonable. Inexperienced creditors would not be able to judge what an IP was

required to do on an insolvency case and how many hours work this might involve.

## Provision of information

- 4.69 Creditors are dependent on the IP for information they receive about the process. Guidance to IPs is that they should bring creditors' rights in relation to setting fees to their attention and that explanatory notes<sup>65</sup> on how remuneration is fixed are made available to them before any resolution is passed to set remuneration. However this does not ensure that they will be made available sufficiently in advance of the creditors' meeting and before creditors decide whether or not to attend.<sup>66</sup>
- 4.70 Moreover the information unsecured creditors are sent by the IP may often not aid their understanding of the process. It varies greatly in terms of completeness and clarity, in many cases including voluminous information on insolvency procedures but very little information that is relevant and specific to the particular case.<sup>67</sup> Similarly, information available on the Companies House website frequently has important case information missing, including the Statement of Affairs which details the company's financial position at the start of the process and itemises the company's property and debts, including security, and lists creditors along with their addresses.<sup>68</sup>

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<sup>65</sup> Included in Statement of Insolvency Practice 9 as Appendix C.

<sup>66</sup> One creditor interest group told us that they "often experiences difficulties in getting sufficient information from the IP to enable them to make a decision as to what action they should take"

<sup>67</sup> Creditors interviewed as part of our in-depth survey said the information provided by IPs was sometimes too long and detailed (for example reports of 30 pages) and on other occasions had information missing (see paragraphs 2.12, 6.27 of the in-depth survey report). This was confirmed in a report commissioned by the Insolvency Service ('Study of Administration Cases Report to the Insolvency Service' by Katz, A. and Mumford, M (October 2006)) which found 'great variation in the completeness and clarity' of public records relating to administrations (primarily reports filed at Companies House) (p.27) and documentation that was 'extremely sparse (and non-compliant with the statutory requirements)' (p.46).

<sup>68</sup> Analysis of information filed at Companies House about particular administration cases found:

## Procedural difficulties

- 4.71 IPs themselves do not believe the current system effectively engages creditors in the process. In the survey of IPs, over two thirds of respondents either disagreed or strongly disagreed that 'regulations are effective at engaging creditors in the insolvency process' (72 per cent, based on 299 responses).
- 4.72 HMRC have told us that intervention on their part would be a 'time consuming use of their resources'. Any challenge they made would therefore of necessity be highly selective. They have told us that they would be receptive to procedural or regulatory changes that made doing this more feasible.
- 4.73 We are not best placed to conduct a detailed step-by-step analysis of the process to identify exactly what changes would most assist unsecured creditors and the 2010 changes to the Insolvency Rules may have helped.
- 4.74 Nevertheless, in addition to the difficulties highlighted elsewhere about creditors' meetings and committees, the need for coordination and

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- the Statement of Affairs was missing in approximately 20-25 per cent of cases
  - the identity of key parties was often missing – for example, the person appointing the IP in four per cent of records, legal adviser in 69 per cent of records, identity of surveyor in 52 per cent of cases
  - the final amount owed to the secured creditor and direct collections against this were often unstated, and
  - in the final insolvency report there is great variation in how information is presented (for example, in text or tables) and in the quality of reporting (some reports were logically set out and detailed while others were completely devoid of information beyond the bare statutory information).

When administration moves to CVL a statement of affairs is not required to be provided at all. Moreover we found that information was missing in some of the CVL records we assessed. The main prescribed forms in liquidation (progress reports and final liquidation reports) were restricted to figures and had little explanatory text to accompany the receipts and payments detailed. Furthermore, in approximately 80 per cent of cases there was no breakdown of the IP's time costs and in a further 15-20 per cent of cases there was no clear breakdown of the distribution to different unsecured creditors (trade creditors, HMRC etc.)

information and the use of courts (see paragraphs 4.82 to 4.84 below), we note that the process of transition from administration to CVL may put unsecured creditors at a disadvantage.

- 4.75 Indeed a report commissioned by the IS found evidence of statistically very significant substitution of administration for CVL following the streamlining of the administration procedure introduced by the Enterprise Act 2002.<sup>69</sup> This has raised concerns about potential for abuse and detriment to creditors<sup>70</sup> from unsecured creditors being deprived of the choice of IP<sup>71</sup> and of the opportunity to scrutinise and direct the case.<sup>72</sup>
- 4.76 The report authors found that in 29 per cent of administrations the statutory justification for administration was very weak or non-existent: either no substantive case for administration was made or administration was ostensibly justified under the third priority objective<sup>73</sup> (realisation for distribution to secured or preferential creditors) solely because of the existence of secured or preferential creditors.

#### 4 - Why trade credit insurance does not appear capable of correcting the problems we find

- 4.77 It is possible for trade creditors to purchase trade credit insurance. This has the potential to eliminate the risk involved in extending credit. It also potentially enables the actions of small creditors to be coordinated and

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<sup>69</sup> Katz, A. and Mumford, M 'Study of Administration Cases Report to the Insolvency Service' October 2006 p.26.

<sup>70</sup> Katz, A. and Mumford, M 'Study of Administration Cases Report to the Insolvency Service' October 2006 pp. 23-24.

<sup>71</sup> Indeed the report authors were surprised in informal discussions at the quite widely held view that it was almost naïve to question the reason for the shift from CVL to administration, the suggestion being that the reason is self-evidently to help practitioners to retain cases.

<sup>72</sup> Katz, A. and Mumford, M 'Study of Administration Cases Report to the Insolvency Service' October 2006 pp.44/45.

<sup>73</sup> See paragraph 3.14 above.

their interests represented in aggregate at creditors' meetings. However, as described above, obstacles remain to even large unsecured creditors with good knowledge of the procedures being able to exert influence over the process effectively.

- 4.78 Our online survey of creditors found that 12 per cent of businesses who had extended credit to business customers in the past three years possessed trade credit insurance. However it seems that trade credit insurance might not offer an effective solution for many of those who didn't have it, because the reasons for not purchasing it were significant and are not easily rectified. Of those creditors who did not, just eleven per cent of creditors had 'not heard' of trade credit insurance. 39 per cent stated that a contributing or decisive factor in not having trade credit insurance was that it 'didn't apply to how they do business'. 75 per cent said trade credit insurance was 'too expensive' and 64 per cent said 'the excess was too high'.
- 4.79 Therefore it may be that small companies, to whom insolvency of trade customers might represent a bigger threat, may have most need for trade credit insurance but are least able to afford it. The market for trade credit insurance may also suffer from problems of adverse selection and moral hazard<sup>74</sup> which could make it less likely that it can be offered cost-effectively to smaller businesses. These can arise where creditors have more information about the risk of loss (that is, the risk of its customers going into insolvency) than insurers. Our in-depth creditor interviews found that many had some feeling that the organisation they had extended credit to was facing financial difficulties, prior to the insolvency commencing.<sup>75</sup>

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<sup>74</sup> Adverse selection holds that a customer's riskiness (which may be unobservable by the insurer) affects their demand for insurance. Moral hazard holds that whether a customer is insured may affect the risks they take.

<sup>75</sup> Paragraph 5.1 of in-depth creditor interviews report.

## **C - Ability to seek redress**

- 4.80 The limited ability and incentive for unsecured creditors to seek redress elsewhere may also explain why they are not able to exert significant influence over IPs' fees and actions.
- 4.81 An IP that considers the amount they are paid to be too low can ask the creditors to increase it or apply to court for an order to have it increased, or both.<sup>76</sup> Court officials have told us that it is common for routine, unopposed applications by IPs to fix remuneration result in the IP getting what he applies for or something very close to it.<sup>77</sup>
- 4.82 A creditor that considers the amount paid to the IP to be too high can apply to the court for an order that the IP's fees be reduced if this has the support of 10 per cent by value (changed from 25 per cent by the Insolvency (Amendment) Rules 2010) of unsecured creditors.<sup>78</sup>
- 4.83 However, unless the court orders otherwise, the costs must be paid by the applicant and not as an expense of the administration<sup>79</sup> whereas the costs of an IP that comes to court to have his remuneration assessed are generally allowable out of the assets.<sup>80</sup> Thus taking action through the court after the event, where unsecured creditors believe their interests have been adversely affected, not only suffers from the problems of coordination we described earlier, but is costly.
- 4.84 Indeed, the fact that the costs of IPs who come to court to have their remuneration assessed are allowable out of the assets, even if the costs

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<sup>76</sup> Statement of Insolvency Practice 9 App C paragraph 7.

<sup>77</sup> Based on the response of a Court official to our questionnaire.

<sup>78</sup> A secured or unsecured creditor can make the application to court but the 10 per cent support is calculated by reference to unsecured creditors only.

<sup>79</sup> Statement of Insolvency Practice 9 App C (administrations and compulsory liquidations) paragraph 6.1.

<sup>80</sup> Based on the response of a Court official to our questionnaire

claimed are excessive, appears to pose no deterrent to charging unjustifiably high fees where IPs are in a position to do this. The worst that can happen is they have to return the fees without incurring any of the costs of defending their case in court.

- 4.85 In Scotland where there is no creditors' committee IPs' fees are subject to approval by the court which appoints a court reporter to assess fees. Court reporters are IPs who, in making an assessment of the appropriate level of fees, take into account the relevant factors such as the size and complexity of the insolvency, the use of appropriate staff and the time spent on the case. The court reporter then makes a recommendation and the court decides whether to accept this or not (and we have been told it is very rare that they do not).
- 4.86 The practicability of seeking redress by means of complaints to regulatory bodies is considered in Chapter 5.

## **Harm**

- 4.87 As explained above, we find that secured creditors control the appointment of IPs and that competition between IPs is characterised primarily by building strong relationships with secured creditors such as banks. For the 63 per cent of the time that the secured creditor is not paid in full, the secured creditor has the incentive and ability to constrain IP actions and fees effectively. In the other 37 per cent of the time we find that unsecured creditors' ability to influence the fees and actions of IPs is weak.
- 4.88 This has the potential to cause harm in at least three ways:
- A - reduced competitive pressure on IP fee levels
  - B - reduced pressure and oversight of IP actions, and
  - C - decreased extension of credit as a result of lack of confidence in insolvency procedures.

## **A - Decreased competitive pressure on fee levels**

- 4.89 Our analysis of Companies House records is consistent with our finding that in the 63 percent of administrations (by value) where secured creditors are the last creditor group to receive payment, the secured creditor has strong incentives to oversee IP remuneration effectively.
- 4.90 We have looked at whether secured creditors' ability to negotiate discounts from IPs when IP fees in administration are taken from payments to secured creditors is greater than unsecured creditors' ability when IPs' fees come from unsecured creditors' payments.
- 4.91 In order to do this we conducted a regression analysis of the level of discount provided by IPs.<sup>81</sup> The discount is the percentage discount an IP gives on its billed fees after it has completed the work. In other words, the discount shows how much smaller (in percentage terms) the amount actually paid to IPs in administration is than compared with the amount that they billed (or could have been paid under the fee agreement made at the start of the administration process). As described earlier in paragraph 4.32, the discount is effectively accounted for by IPs not being paid for all the hours that they have worked. We find that where secured creditors are not paid in full, this discount is greater. Table 3 below provides the full regression results.<sup>82</sup>

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<sup>81</sup> Regression analysis is a statistical methodology for determining if there is a statistically significant relationship between variables (in this case the discount and who pays IPs' fees), while accounting for other variables that may affect the relationship (such as the level of assets recovered).

<sup>82</sup> Our preferred regression specification is an ordinary least squares (OLS) regression that analyses the discount by controlling for several factors that are likely to influence it: (1) whether the secured creditor is paid in full, (2) the inverse of the amount of assets realised during the administration, (3) whether the IP was a Big 4 firm, and (4) whether the IP was present on a panel. The results of the regression are very similar when potential outliers are excluded. However, different regression specifications produce results that are not always statistically significant (for example, regressing the difference between fees paid and the cost of the insolvency on other factors). Whilst there is some statistical sensitivity, the fact that our main result is supported by other evidence sources provides us with reasonable confidence in its economic significance.

**Table 3: Result of Ordinary Least Squares (OLS) regression explaining discount provided by the Insolvency Practitioner by whether secured creditor is paid in full**

Variable	Coefficient	St. error	t-stat	Confidence
Secured creditor not paid in full	0.065	0.026	2.48	98%
1 / Assets realised	1616	196	8.25	99%
Big 4	0.068	0.057	1.20	76%
Panel firm	0.013	0.026	0.49	37%
Constant	0.197	0.025	7.85	99%

Notes: Based on 402 observations from Companies House.<sup>83</sup> Adjusted R<sup>2</sup> of 0.15<sup>84</sup>.

4.92 The coefficient of 0.065 shows that the discount on IPs' fees when secured creditors are affected by these fees is 6.5 per cent higher than the discount when secured creditors are not affected. Furthermore, the result that when secured creditors are affected the discount is higher

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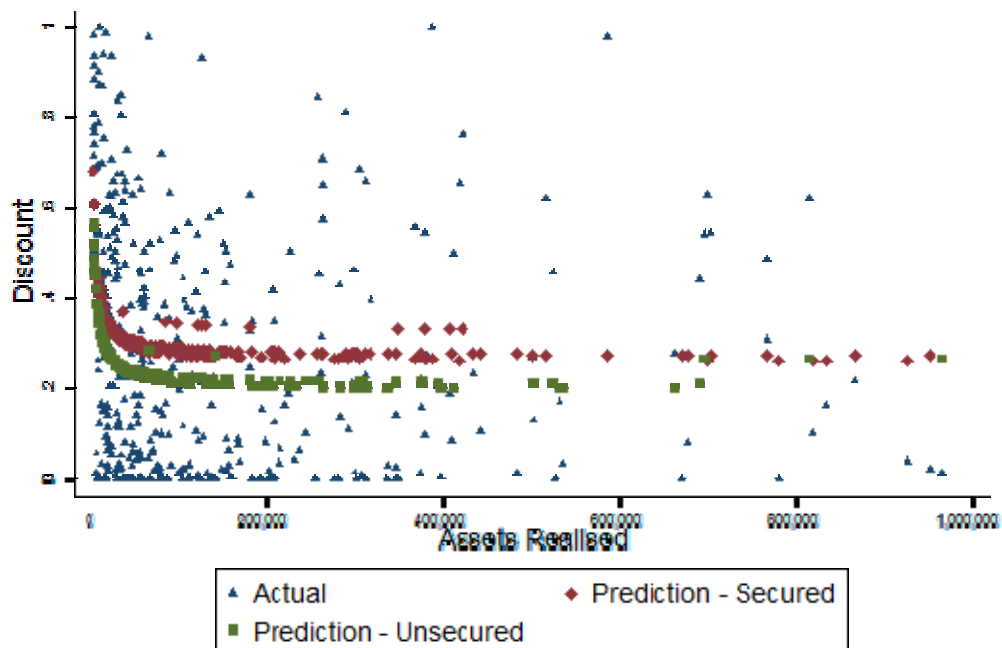
<sup>83</sup> See Annex C for more details on the Companies House dataset. Dataset is available on OFT website. Out of the 500 observations in the Companies House data, the regression includes only observations for which the discount is greater than or equal to 0 and strictly less than 1. We note that including the observations with a discount less than 0 or equal to 1 does not change the results.

<sup>84</sup> R<sup>2</sup> measures the explanatory power of a model. The adjusted R<sup>2</sup> value of 0.15 implies that our model explains 15 per cent of the variation in the discount which IPs give on their fees. The fact that our model explains 15 per cent of the variation in the discount indicates that there may be additional factors that could explain the remaining variation. If these additional factors are not correlated with the factors that are included in our model, then our results will not change when the additional factors are controlled for. Our conversations with stakeholders have not suggested additional explanatory variables that may be correlated with the variables currently in the regression.

than when unsecured creditors are affected, is statistically significant at the 98 per cent confidence level.<sup>85</sup>

4.93 Figure 6 shows a plot of: (i) the actual IPs' discount versus the assets realised (the blue triangles) and (ii) the regression's predictions for IPs' discount broken down into cases in which the secured creditor is affected by the fees charged by the IP (the red diamonds) and cases in which the secured creditor is not affected by the fees charged by the IP (the green squares).<sup>86</sup>

**Figure 6: Predictions of regression**



Source: Companies House data, based on 500 records.

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<sup>85</sup> The magnitude of the coefficient, 6.5 per cent, has a margin of error of five per cent (based on a 95 per cent confidence interval).

<sup>86</sup> In order to facilitate reading, Figure 7 shows the predictions only for observations for which assets realised are between £3,000 and £1,000,000.

4.94 The figure shows graphically that the predicted discount is greater when secured creditors pay IPs' fees than when unsecured creditors pay IPs' fees.<sup>87</sup>

4.95 For a typical insolvency case, this implies an amount paid to the IP that is nine per cent higher when secured creditors are unaffected by the fees charged than when they are affected by the fees charged.<sup>88</sup> This suggests an increase of approximately £15m per annum as a result of unsecured creditors' decreased oversight over fees at the end of the administration process.<sup>89</sup>

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<sup>87</sup> As seen we have used a non-linear specification of  $1/\text{assets}$  rather than  $\text{assets}$  as this provided a substantially better fit with the data. This also corresponds to our discussions with practitioners. When the amount of assets recovered is low, IPs are forced to give high discounts given that in these cases there are likely to be insufficient funds recovered to cover their fees, let alone pay creditors. As the amount of assets realised increases, the discount decreases since more money is available to pay the IP.

<sup>88</sup> We have used the results of the regression to calculate the amount paid to the IP in the typical insolvency case (calculated at the median level of assets realised and at the median cost of the insolvency in our Companies House data). The median of assets realised was £68,208. We obtained the predicted discount at the median of assets realised, when secured creditors are unaffected by the fees charged by the IP and when they are affected (the predicted discount is 22 per cent and 28.5 per cent, respectively). We then obtained the amount paid to the IP as a proportion of the cost of the insolvency, which is equal to one minus the discount (78 per cent and 71.5 per cent, respectively). At the median cost of insolvency (£34,049), when secured creditors are unaffected by the fees charged by the IP, the amount paid to the IP is £26,545, compared to £24,345 when secured creditors are affected by the fees charged by the IP. Thus, the amount paid to the IP is nine per cent higher when secured creditors are unaffected by the fees charged by the IP than when they are affected by the fees charged by the IP.

<sup>89</sup> This £15m figure is calculated as follows:

- i) The size of the administration market is approximately £500m pa. We have found that this market works well approximately two thirds of the time - when secured creditors have an interest in the process. However, we are interested in the third of cases where unsecured creditors effectively pay IP fees. The size of this part of the market is approximately £165m ( $0.33 \times £500\text{m}$ ).
- ii) We have estimated an overcharge of approximately 9 per cent, resulting from lack of unsecured creditor control over the fee setting process. Applying this 9 per cent

- 4.96 We note that the figure of nine per cent determined in paragraph 4.95 above relates only to the effect of the decreased negotiation on fees in administration, once the IP has been chosen, the panel rate has been set, and the actions have been carried out. It does not capture other ways that decreased unsecured creditor bargaining power may lead to decreased downward pressure on fees (affecting hourly rates for example) or oversight of IP actions.
- 4.97 The finding that unsecured creditors pay more has been supported by stakeholder discussions and submissions, including written submissions from two IP firms.
- 4.98 Quantitative data gathered by academics<sup>90</sup> also tended to support the theory that concentrated creditors (that is, repeat playing banks) were better at controlling costs than unsecured creditors. The researchers showed that unsecured creditors are offered a higher rate when fees are put to creditors' meetings for approval, which is accepted because the unsecured creditors are uninterested in the process.<sup>91</sup>
- 4.99 As a separate measure of the effect of unsecured creditors' lack of oversight of fees, we asked six court reporters in Glasgow about the court reporter process (see paragraph 4.85 above). These are asked to assess fees sought by IPs in the absence of a creditors' committee. The average percentage reduction across cases examined (i.e. not just those where a reduction was recommended) by the three court reporters who

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figure to £165m (the size of the relevant part of the market), we find an overcharge of £14.85m pa (0.09 x 165m).

<sup>90</sup> Armour, J., Hsu, A., and Walters, A. 'The Impact of the Enterprise Act on Realisations and Costs in Corporate Rescue Proceedings' publ. The Insolvency Service (December 2006) p.iv.

<sup>91</sup> Armour, J., Hsu, A., and Walters, A. 'The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK' University of Cambridge Centre for Business Research Working Paper No. 332 (March 2009) p.13

provided us with sufficiently complete information to make an assessment was 23 per cent.<sup>92</sup>

## Comparison with guideline hourly rates for solicitors and administrative staff

4.100 In discussions, some IPs have claimed that they provide their services at a price below cost to secured creditors on the basis that they will be able to recover these losses later in the process once secured creditors are no longer involved.

4.101 It is hard to assess the truth of this claim, since it would require an analysis of whether IPs are paid below cost when they sell to secured creditors and above cost once they are no longer involved. Instead, our analysis above is whether they are paid different amounts depending on whether or not creditors are able to hold them to account, and we find that they are.

4.102 However, in an attempt to assess the claim, we analysed 30 random insolvencies from our Companies House data, carried out by a single regional mid-tier firm that we believe is on most bank panels. We find that, during administration, partners are charged out, on average, at about £300 per hour, with administrative staff charged out, on average, at about £70 per hour.<sup>93</sup>

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<sup>92</sup> This sample represented a total of 95 cases although it should be noted that the three reporters had very different average reductions and another court reporter (who did not respond to our request for further information) had estimated a percentage reduction of approximately ten per cent

<sup>93</sup> A random sample of 30 insolvencies from our Companies House dataset where Begbies Traynor were the Insolvency Practitioner and the postcode was outside of London. We looked at more than 30 records and stopped when we obtained 30 for which information on rates by individual grade was available. We also looked at a random sample of 30 insolvencies from throughout England and Wales, including London, covering all size of insolvency firm, which suggested that these numbers were not unusual.

- 4.103 We have compared this with the fee rates of solicitors. We do not suggest that the work of an Insolvency Practitioner partner is equivalent with that of a solicitor, but both are professions with high entry standards, requirements for continued professional education, a regulatory structure, and significant costs of winning business. As a broad comparison it appears that senior IPs in administrations are billed out at rates less than senior solicitors.<sup>94</sup>
- 4.104 It also appears that solicitors are not able to claim the costs of time for administrative staff below the 'trainee solicitors, paralegals and equivalent' level as such costs are subsumed in their hourly rates. Yet it appears that IPs do reclaim the costs of 'junior, support, assistance' and 'cashier' staff.
- 4.105 While this evidence is far from conclusive, it does suggest that it is unlikely that the charge-out rate of IPs, even when subject to secured creditors' bargaining power, is unsustainably low.

## **B - Reduced pressure and oversight of IPs' actions**

- 4.106 We look at how the reduced ability of unsecured creditors to influence the process may also have an impact on three areas of action by the IP:
- 1 - extended duration of insolvency and consequent higher overall IP fees
  - 2 - selling of assets at below market value, and
  - 3 - inappropriate initiation of insolvency.

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<sup>94</sup> Band A solicitors have at least 8 years post-qualification experience, and are paid a Guideline Hourly Rate (GHR) by courts of between £201 and £217 outside of London. See [www.judiciary.gov.uk/publications\\_media/general/guideline-hrly-rate.htm](http://www.judiciary.gov.uk/publications_media/general/guideline-hrly-rate.htm) for details. The regional range covers groups National 1 and National 2. We note that the GHRs may be 'higher than market rates' due to the existence of substantial referral fees paid by solicitors to be able to take on civil cases. [www.judiciary.gov.uk/docs/pub\\_media/guideline-hrly-rate.pdf](http://www.judiciary.gov.uk/docs/pub_media/guideline-hrly-rate.pdf)

## 1 - Extended duration of insolvency

- 4.107 Lack of effective oversight by unsecured creditors may also be likely to be reflected in CVLs taking longer than is necessary.<sup>95</sup> Indeed some unsecured creditors interviewed in our in-depth creditor interviews commented that they thought IPs took a long time to complete cases in order to be able to charge a lot.<sup>96</sup>
- 4.108 The time taken was found by our in-depth creditor interviews to be the main cause of dissatisfaction to creditors,<sup>97</sup> aggravated by a lack of information.<sup>98</sup> Even some of those who were satisfied with the process thought it was too slow. It often appeared that weeks or months could pass without any forward movement.<sup>99</sup>
- 4.109 Creditors in our in-depth creditor interviews gave administrations the lowest satisfaction ratings of any process, partly because of the extension to the process when it went into liquidation.<sup>100</sup>
- 4.110 While we cannot establish whether procedures are often taking longer than they should without a detailed analysis of each case, our Companies House data does suggest that the process appears prolonged, even when there are no payouts to unsecured creditors.

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<sup>95</sup> Our Companies House analysis of 149 liquidations found that only six per cent of liquidations were completed within a year, 48 per cent were completed within two years and 91 per cent were completed within three years. Additionally, none of the 55 liquidations in which unsecured creditors received nothing were completed within a year. 49 per cent of these had been finished within two years.

<sup>96</sup> Paragraphs 2.14, 6.14 of in-depth creditor interviews report.

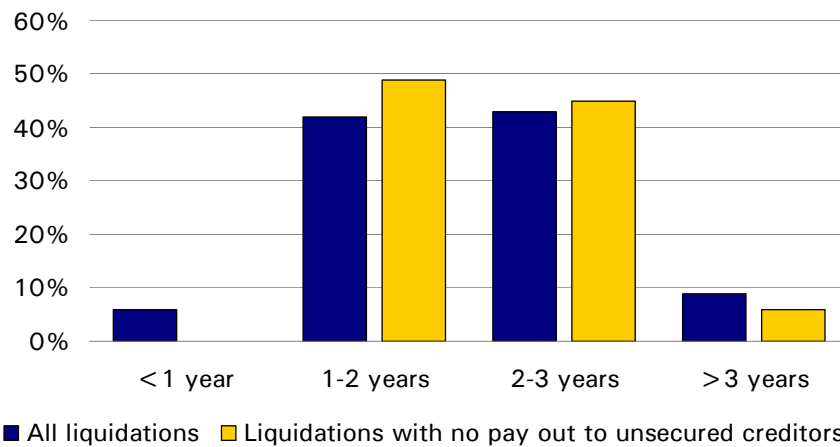
<sup>97</sup> Paragraphs 2.20, 11.4, 11.7, 13.1 of in-depth creditor interviews report.

<sup>98</sup> Paragraphs 11.5, 13.1 of in-depth creditor interviews report.

<sup>99</sup> Paragraphs 2.20, 11.4, 13.1 of in-depth creditor interviews report.

<sup>100</sup> Paragraph 11.4 of in-depth creditor interviews report.

**Figure 7: Graph showing length of liquidations following administration**



Source: Companies House data, based on 147 liquidations following administration

## 2 - Selling of assets at below market value

4.111 The most common allegation of IPs selling assets at a rate below the market value is as pre-packaged administrations (or pre-packs). These are where a company enters administration and its business/assets are sold under an arrangement made prior to the appointment of the administrator, often during an Independent Business Review (IBR) conducted by the IP to determine the solvency of the business for the bank.<sup>101</sup>

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<sup>101</sup> A number of stakeholders have raised concerns about the close relationship between banks and IPs prior to the commencement of insolvency relating primarily to: the bank choosing the firm conducting the IBR while the payment is made by the firm who does not get to see the full report; and the ability of the bank and the IP to decide, in effect, the course of the insolvency prior to formal announcement of the insolvency process and thus the formal involvement of other stakeholders, such as unsecured creditors. If correct, these allegations are symptomatic of the wider problems created by the strong relationship between secured creditors and IPs and the discontinuous nature of the secured creditors interest in the process. It may therefore be necessary for RPBs and other complaints and monitoring bodies to be able consider actions of an IP prior the formal initiation of consultancy as part of an assessment of actions after it has commenced.

- 4.112 The purpose of pre-packs is to ensure the continuation of the business. However, they may set up poor incentives for directors by rewarding failure and make it more likely that a company will enter administration.
- 4.113 Due to the limited ability of unsecured creditors to be involved in the process or to mount a challenge in court after the event, IPs may have little incentive to sell a business as a pre-pack for any more than the total of the amount owed to secured creditors and the level of IPs' fees.
- 4.114 They are a major source of dissatisfaction to creditors: our in-depth creditor interviews found directors immediately re-commencing trading under a different name to be the most prevalent cause of complaints.<sup>102</sup>
- 4.115 However the sale of businesses might raise less money if sale to existing directors or related companies was precluded. The IS has recently launched a consultation on a number of far-reaching options to address concerns with these and we have seen a healthy debate on what changes are needed in the regulations and regulatory system to prevent abuse, and the perception of it.<sup>103</sup>

### Initiation of insolvency

- 4.116 Lack of unsecured creditor oversight could lead to insolvencies being initiated when this is not in the interests of the whole body of creditors. It has been suggested that secured creditors, IPs and company directors may each in particular circumstances initiate insolvencies where this is not in the interests of the wider economy.<sup>104</sup>

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<sup>102</sup> Paragraph 9.2 of in-depth creditor interviews report.

<sup>103</sup> The 'Improving the transparency of, and confidence in, pre-packaged sales in administration' consultation was issued on 31st March 2010. It follows a report issued by the Insolvency Service on 19 March which said that IPs failed to comply with SIP 16 (which effectively regulates how pre packs operate) in approximately a third of cases.

<sup>104</sup> Paragraphs 5.10, 13.3, and 5.11 of in-depth creditor interviews report.

4.117 However, we have no evidence beyond anecdotes that there is widespread harm from incorrect initiation of insolvency. Entering insolvency is, understandably, rarely welcome and we have little reason to believe that it would generally be in the interests of secured creditors to allow debtor firms to go into insolvency unnecessarily (see paragraph 4.35).

4.118 As such, we believe that incorrect initiation of insolvency is unlikely to be a widespread problem at the current time. However, regulators may wish to keep it under review as the funding mix for firms changes over time.

### **C - Decreased extension of credit as a result of lack of confidence in insolvency procedures**

4.119 Our in-depth creditor interviews revealed that for most creditors the debt arose due to their normal practice of extending credit for goods or services supplied. Most said it would not be possible to do business if they tried to charge in advance.<sup>105</sup>

4.120 However, in our on-line survey some creditors said that they could vary their terms of credit, and 12 per cent of creditors said they would be more willing to extend credit if the average recovery rate for all unsecured creditors was increased by 10p in the pound (based on 1,069 responses).

4.121 It is not possible to quantify accurately the exact impact on credit extended of decreased recovery from decreased unsecured creditor control. However, even a small increase in the approximately £80bn of unsecured credit extended by SME's will amount to many millions of pounds.<sup>106</sup>

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<sup>105</sup> Paragraph 4.4 of in-depth creditor interviews report.

<sup>106</sup> Data from the online survey of creditors was used to estimate the proportion of SME turnover which is extended as unsecured credit as 5.2 per cent. This percentage was applied to total SME turnover in the UK of £1500 billion (based on ONS statistics) to estimate the total level of unsecured lending in the economy as £78.4 billion, which we round to the nearest £10bn.

4.122 Quite apart from the effect of the recovery rate on the amount of credit extended, it may be that creditors' experience of the insolvency process also affects their willingness to extend credit and the terms on which they do this. This was reflected in our survey results<sup>107</sup>. However we note that these effects may also stem from unrealistic expectations at the outset of the process.

4.123 Separate from the impact on willingness to lend credit, about half of the creditors interviewed during the in-depth creditor interviews said that being owed money had had some impact on their company, including delaying investment, recruitment and payment to other companies. In one case it was partly responsible for staff being made redundant.<sup>108</sup> Of course, much of this is caused by the trading partner going insolvent rather than any problems with the insolvency process, but any increase

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<sup>107</sup> Many of the creditors we interviewed had tightened the credit they offered as a result of being involved in insolvency (for example chasing invoices as soon as the credit period was up, ceasing trade with companies until their invoices were settled, reducing the number of days allowed for invoice payment or asking for a deposit or payment upfront). (See paragraphs 2.24, 12.5 – 12.6 and 12.8 of the in-depth creditor interviews report.)

In addition our online survey of creditors found that:

- More of those creditors who had experienced the insolvency of a debtor agreed that the experience had made them less willing to extend credit than disagreed (52 per cent agreed and 21 per cent disagreed, based on 731 responses).
- Fear that money would not be paid back because of the risk of insolvency was a factor in not extending more credit for 86 per cent of those companies who had extended credit to business customers in the last three years (based on 779 responses). There was no difference here between secured and unsecured creditors.
- This reason was more likely to be a factor for those unsecured creditors who had experienced debtors entering insolvency in the past three years than for those who had not experienced this.
- More creditors agreed that experience of debtors going insolvent effected the terms on which they extend credit than disagreed (62 per cent agreed and 15 per cent disagreed, based on 731 responses).

<sup>108</sup> Paragraphs 2.24, 12.1 – 12.2, 12.4 of the in-depth creditor interviews report.

in the return to creditors may, at the margin, decrease the effect on their business.

## 5 DESCRIPTION OF THE REGULATORY REGIME

### Summary

- The regulatory regime can play an important role in developing and implementing rules to correct market failures, and ensuring that such rules are monitored and enforced.
- We describe the key roles within a regulatory structure for professionals and outline how these roles are carried out within the current system of regulation of IPs.
- The regulation of IPs stems from 1986, and is a complex system involving 10 different organisations, and a separate purely representative trade body.
- The regulatory system is felt by IPs themselves to be inconsistent in monitoring, complaint handling, and discipline. Discipline is thought to be ineffective at dealing with rogue IPs.
- The regulatory system operating in Northern Ireland is similar to the regulatory system in England, Wales and Scotland.

- 5.1 Competition by itself may not necessarily always deliver the best outcomes. Where the incentives in a market are not correct, and therefore the market (or some aspect of the market) fails and does not produce optimal outcomes for consumers, one solution is to correct this market failure with regulation.<sup>109</sup>
- 5.2 As outlined in Chapter 4, in over a third of administrations and CVLs the market for IPs in corporate insolvencies fails. The current regulatory system for IPs does not appear to correct this failure, which indicates that there are problems with the regulatory system itself.
- 5.3 In many cases the problems in the market are difficult to correct as a large amount of unsecured creditors have only a small interest in the insolvency process and some creditor apathy is inevitable. However it is possible to go some way towards correcting the problem (particularly for

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<sup>109</sup> OFT1113 'Governments in Markets' pages 10 and 12.

large, repeat unsecured creditors) or those with larger sums of money at stake by simply changing some of the rules that govern the actions of IPs. We make recommendations to do this in Chapter 7.

- 5.4 In Chapters 5 and 6 we will examine the regulatory regime for IPs (the regulatory system for corporate and personal IPs is combined). In Chapter 5 we describe the regulatory roles that make up a regulatory system for professionals and describe how each of these operates in relation to IPs. In Chapter 6 we will assess the effectiveness of this system and describe why it is not addressing the market issues described earlier.

## Regulatory roles

- 5.5 In this section we describe the key roles (and purpose of these roles) within a regulatory structure for professionals. These roles are:<sup>110</sup>

- **Authorisation:** Consumers of professional services are not well placed to assess the quality of the service received from a professional (such as an IP). Consequently with many professions it is considered justifiable to have a requirement that the professional demonstrates a certain level of basic competence. Often a professional will be required to demonstrate certain minimum requirements to be authorised (or licensed) to carry out certain roles or use a particular job title.
- **Standards:** In order to protect users of professional services from their position of relative weakness in their ability to detect the quality of the provider of the service, some minimum quality standards for the supply of professional services are justified.
- **Complaints handling:** Where a consumer of a service has an issue with the service delivered or the way it was delivered, they should have the ability to complain and receive a fair hearing of their complaint. Dealing with complaints against the profession is an

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<sup>110</sup> For background see OFT328 'Competition in Professions' 2001.

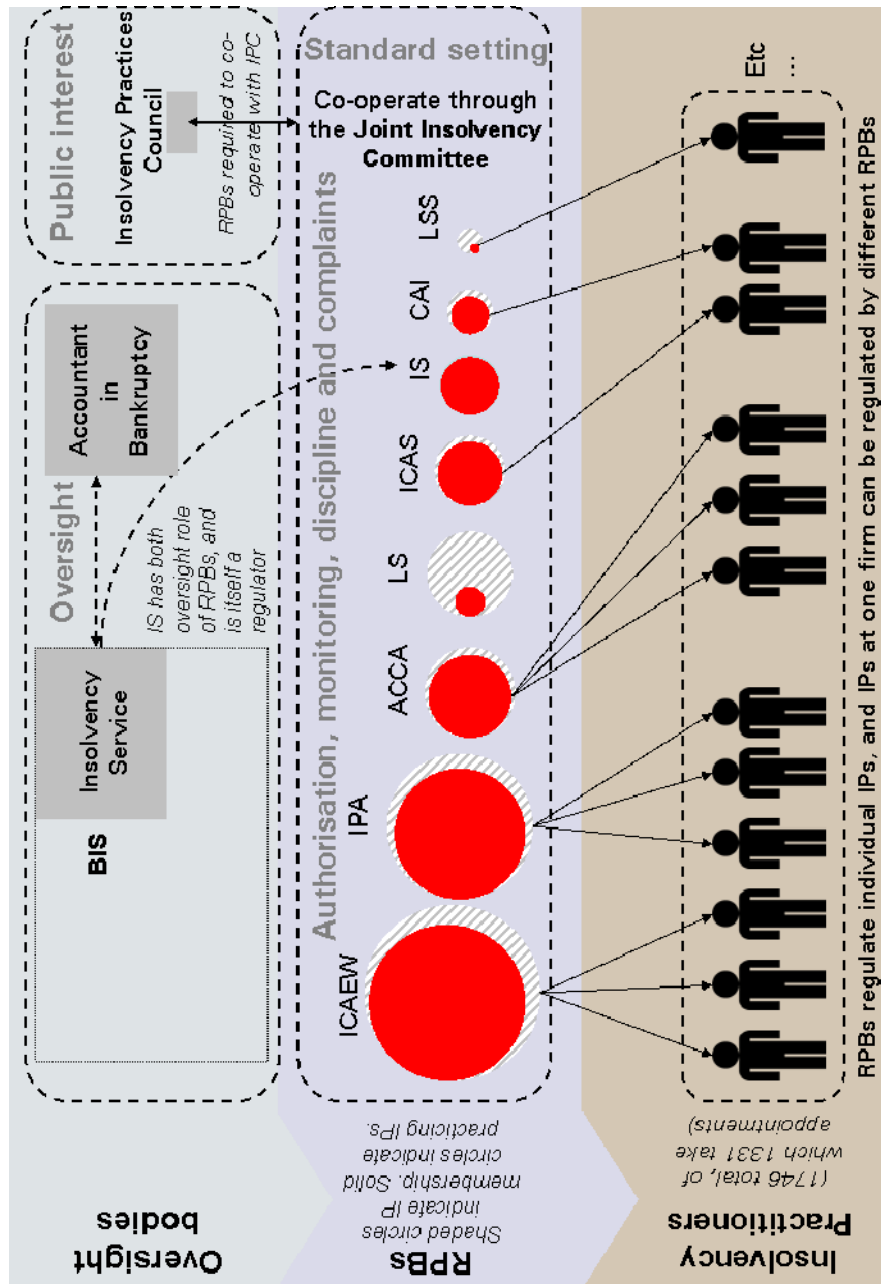
important function for any regulatory system for professionals. It can inform authorisation and standards decisions, and combined with discipline it can provide incentives for the professional to comply with whatever standards are set.

- **Monitoring:** In order to ensure that a professional is complying with the relevant standards and is fit to continue to be licensed, performance needs to be monitored to some extent.
- **Discipline:** As explained, professionals are required to comply with certain ethical and professional standards in order to continue to be authorised. To deter non-compliance, they should be disciplined in a consistent manner when found to be in breach of the rules, and ultimately have their authorisation removed if necessary.
- **Oversight:** Where a self-regulatory system regulates a profession, there often needs to be an independent body (or bodies) to provide oversight and ensure that the profession is properly exercising its regulatory roles.
- **Public interest input:** In a self-regulatory system, there is often a need for the intended beneficiaries of the system to have a clear independent voice in its oversight to ensure it stays focused on delivering its objectives.
- **Representation of the profession:** As well as being regulated, a regulatory system requires a representational body for the profession, to represent the profession to the outside world including government, the media, creditors and the public.

## The regulatory system

- 5.6 In the section below we outline which bodies carry out the regulatory roles in the regulatory structure for IPs.
- 5.7 The current regulatory system for IPs is based on the standard regulatory model for professionals – one of practitioner-led self-regulation within a statutory framework. This system is overseen by the state. This system is summarised in Figure 8, below.

Figure 8: Diagram showing the current regulatory system for IPs<sup>111</sup>



<sup>111</sup> The seven RPBs are The Institute of Chartered Accountants in England and Wales (ICAEW), the Insolvency Practitioners Association (IPA), the Association of Chartered Certified Accountants (ACCA), the Law Society of England and Wales (LS), the Institute of Chartered Accountants in Scotland (ICAS), Chartered Accountants Ireland (CAI), and the Law Society of Scotland (LSS).

## History of the IP regulatory system

- 5.8 The basic structure of the current regulatory system originates from the recommendations of the Cork Committee in 1984 and the implementation of the Insolvency Act in 1986. Professional bodies in the areas of accounting and law were given the mandate to licence IPs in an attempt to stamp out bad practices and improve IPs' reputation.<sup>112</sup>
- 5.9 To a large extent the relative roles and responsibilities of the different regulatory bodies are defined by:
- The Insolvency Act 1986 (IA86)
  - Various Insolvency Regulations and Rules, and
  - A Memorandum of Understanding between the RPBs and the IS (the MoU).<sup>113</sup>

## Authorisation

- 5.10 In the current regulatory system for IPs, individual IPs are authorised to do insolvency work rather than firms. IPs can be authorised by either the Secretary of State (through the IS) or an RPB. The Secretary of State has the power to grant and remove RPB status. There are currently seven RPBs.<sup>114</sup>
- 5.11 As of 1 January 2010 there were 1746 IPs (1331 of which were appointment takers). The two main accountancy bodies, ICAEW and

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<sup>112</sup> See Sir Kenneth Cork, GBE (Chairman) 'Insolvency Law and Practice: Report of the Insolvency Review Committee', 1981.

<sup>113</sup> [www.insolvency.gov.uk/freedomofinformation/Memorandum\\_per\\_cent20of\\_per\\_cent20Understanding.doc](http://www.insolvency.gov.uk/freedomofinformation/Memorandum_per_cent20of_per_cent20Understanding.doc)

<sup>114</sup> The Institute of Chartered Accountants in England and Wales (ICAEW), the Insolvency Practitioners Association (IPA), the Association of Chartered Certified Accountants (ACCA), the Law Society of England and Wales (LS), the Institute of Chartered Accountants in Scotland (ICAS), Chartered Accountants Ireland (CAI), and the Law Society of Scotland (LSS).

ACCA, together with the IPA authorise 76 per cent of the IP market. However smaller regulators (such as LSS) license only a very small number of licence-holders and even fewer appointment takers. The amount of IPs (and percentage of the total) authorised by each RPB is set out in more detail in Annexe E.

- 5.12 All RPBs and the IS receive funding for direct IP regulation through fees charged directly to IPs. Due to the nature of their funding there is potential for an RPB to be financially affected by IPs changing to another regulator, or by an IP challenging a disciplinary decision of their RPB in court (which could potentially be financially crippling for the RPB). We have some limited anecdotal evidence of such behaviour actually occurring.<sup>115</sup>
- 5.13 All IPs must meet certain specified standards in order to be granted a licence (see Annexe E for more information). In practice, when processing an application for a licence to act as an IP, the RPBs appear to have fairly similar processes.
- 5.14 As a result of the number of regulators there is a large amount of duplication of regulatory efforts in that each RPB must have the staff and committees to deal with their licensing role. The same is true of complaints handling, monitoring and disciplinary efforts by regulators.<sup>116</sup>

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<sup>115</sup> We received feedback from one RPB passed on from its members that a number of IPs have switched regulator for commercial reasons (lower fees etc), or for having been given a 'rough ride' by their RPB. Conversely other IPs reported to the RPB that these incidences were 'not high'. In the survey of IPs, a large majority of respondents reported never having changed regulator (83 per cent, based on 311 responses). Of those that reported having changed, none had done so more than twice (15 per cent of respondents reported one change of regulator and two per cent reported two changes, based on 311 responses.)

<sup>116</sup> The five largest RPBs (ICAEW, IPA, ACCA, CAI and ICAS) have between them ten specialist insolvency committees, with combined current membership of at least 76 people (of which, at least 55 are IPs). This does not take into account the number of non-specialist insolvency committees within these organisations that deal with IP issues. The RPBs additionally each employ staff to deal with applications, monitoring, complaints and discipline, and there is the additional cost of the Joint Insolvency Committee.

## Standards

- 5.15 Conduct restrictions have been placed on IPs in the form of legislative, regulatory and other restrictions, including:
- All IPs must comply with insolvency legislation and regulations which are put in place by Government.<sup>117</sup> The legislation and regulations are all fairly prescriptive in nature.
  - The eight regulators also produce common principles and codes (including the Insolvency Code of Ethics<sup>118</sup> and Statements of Insolvency Practice (SIPs))<sup>119</sup> which set out the basic principles and essential procedures that all IPs are expected to comply with. Most SIPs are quite prescriptive in nature; however the Code of Ethics is mainly principles based.
- 5.16 The regulators are required to enforce these restrictions and ensure that they are complied with.
- 5.17 These common standards are designed and agreed by unanimous vote by the Joint Insolvency Committee (JIC) (a committee on which all of the RPBs are represented together with the IS).<sup>120</sup> All RPBs are represented, usually by member IPs who provide their time for free, and a number of non-voting but participating observers often attend.

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<sup>117</sup> Including the Insolvency Act 1986 and the Insolvency Regulations 1986.

<sup>118</sup> [www.insolvency.gov.uk/insolvencyprofessionandlegislation/iparea/ISCodeEthicsBO.doc](http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/iparea/ISCodeEthicsBO.doc)

<sup>119</sup> [www.r3.org.uk/publications/default.asp?page=2&i=402](http://www.r3.org.uk/publications/default.asp?page=2&i=402)

<sup>120</sup> The JIC has no budget and no employees. The costs of providing their own member and secretariat representation are funded by each of the RPBs, with the secretariat for the JIC as a whole currently provided by ICAEW. The JIC occasionally receives external funding on an ad hoc basis.

## Standard setting

5.18 The issue of pre-packaged administrations (see paragraph 4.112 for more details) provides a key example of the regulatory system putting in place standards to address a problem in the market. As a result of the concerns with pre-packaged administrations, SIP 16 was introduced to address the transparency concerns raised by stakeholders. The process of producing SIP 16 was lengthy and involved, with the IPC expressing initial concern regarding pre-packs in its 2006 Annual Report.<sup>121</sup> A final version of SIP 16 was not subsequently agreed and published until October 2008, coming into effect on 1 January 2009.<sup>122</sup> Some of the delay in this process may be due to the particularly slow due to the consensus decision making of the JIC. The IPC has noted that 'it took far too long to produce SIP 16'.<sup>123</sup>

## Compliance with SIPs

- 5.19 As discussed above, IPs are required to comply with SIPs agreed upon by the JIC. Non-compliance with the standards established in SIPs may be taken into account in the event of disciplinary or regulatory action.
- 5.20 When looking at compliance with both SIP 16 and SIP 9, which deals with what information need to be provided on fees, the IS found high levels of non compliance with the standards. However the resulting referrals to RPB disciplinary procedures and resulting disciplinary actions taken by the RPBs were low in comparison.
- 5.21 While non-compliance with SIPs does not automatically result in disciplinary action, the disparity between compliance (high) and penalties

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<sup>121</sup> Insolvency Practices Council '2006 Annual Report'. See [www.insolvencypractices.org.uk/reports/2006/annual\\_report.htm](http://www.insolvencypractices.org.uk/reports/2006/annual_report.htm)

<sup>122</sup> Joint Insolvency Committee 'Annual Report for the year ended 31 December 2008' page 8. See [www.insolvency-practitioners.org.uk/page.aspx?pageID=110](http://www.insolvency-practitioners.org.uk/page.aspx?pageID=110)

<sup>123</sup> Insolvency Practices Council '2000-2009 Tenth Annual Report' page 9. See [www.insolvencypractices.org.uk/reports/2009/annual\\_report.htm](http://www.insolvencypractices.org.uk/reports/2009/annual_report.htm)

(low) is difficult to interpret. Compliance may be being defined incorrectly, non-compliance may be being inadequately punished, or the standards themselves may be inappropriate for the task (that is, identifying numerous procedural issues but not serious non-compliance). Either way this indicates an issue with the regulatory system.<sup>124</sup>

5.22 In Annexe E we have detailed compliance with SIPs 9 and 16.

## **Complaints handling**

5.23 Complaints handling is an important part of the regulatory system as it can often lead to disciplinary actions. It is a valuable tool for a regulator when monitoring its members, and complaints provide a source of 'public interest input' into the profession by highlighting areas of public concern.

5.24 Each of the eight regulators receive complaints regarding the IPs they regulate. The MoU sets out requirements for the RPBs' handling of such complaints. In general each RPB has a similar structure for dealing with complaints.<sup>125</sup> All RPBs have a range of penalties available including warnings, fines, publicity, and finally licence removal or restriction. However the IS has only one sanction available to it over those IPs it directly authorises, which is to remove an IP's licence.

5.25 The regulators will not consider a complaint about the amount of an IP's remuneration or other commercial disputes between the complainant and the IP (providing the actions complained of have been properly approved in accordance with the law and relevant SIP) as that is considered to be a matter for creditors and ultimately the court.

5.26 Our online survey of creditors suggested some lack of understanding and clarity regarding the complaint process. About a third (36 per cent) of

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<sup>124</sup> We additionally note that, in the survey of IPs, almost two thirds of respondents told us the detail of regulations is about right, whilst almost one third stated that regulations are too detailed

<sup>125</sup> See Annexe E for more details.

those creditors who had experienced the insolvency of a debtor disagreed or strongly disagreed that 'it was clear how to complain about the insolvency process' Only 45 respondents (six per cent) complained and of those, 32 respondents disagreed or strongly disagreed that 'the outcome of the complaint process was reasonable' and 28 respondents disagreed or strongly disagreed that 'the way their complaint was considered seemed reasonable'.

- 5.27 Dissatisfaction with the complaints system was also voiced by a large repeat unsecured creditor, who told us that they 'rarely get as far as formally complaining. Partly because it's so uninviting.' Additionally, they told us that there is 'little point making a complaint when you're fairly confident nothing will happen, or where there are so many hurdles.'
- 5.28 Annexe E shows the number of complaints received by the RPBs in 2008 and 2009 (as a yearly average).

## Monitoring

- 5.29 Monitoring is an important tool for the disciplining of IPs as many disciplinary issues will arise as a result of monitoring. All regulators monitor their IPs to some extent through regular monitoring visits and the RPBs have requirements under the MoU.
- 5.30 Each RPB collects information from its licensed IPs each year and uses this information as the basis for their monitoring procedures. While each RPB carries out their own monitoring process, the actual monitoring visits are only carried out by four of the RPBs (ICAEW, IPA, ICAS and ACCA).<sup>126</sup>

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<sup>126</sup> The monitoring visits of the LS are performed by the IPA, and the monitoring visits of the LSS and CAI are carried out by ICAS.

5.31 Monitoring visits are either routine or targeted.<sup>127</sup> Annexe E shows the number of routine and targeted visits carried out by the different regulators (as a percentage of appointment taking IPs). The proportion of IPs receiving a visit (or receiving a targeted visit) varies between regulators.

## **Discipline**

5.32 The disciplinary actions available to the RPBs include those that punish, such as licence withdrawal or restriction and fines. There are also a number of more corrective actions which RPBs impose on members such as 'plans for improvement' or 'undertakings'. Most of the RPBs have indicated that these actions are primarily corrective and are not explicitly linked to restriction or removal of a licence or any escalating disciplinary action.

5.33 Disciplinary issues would usually come to the notice of the regulator as a result of monitoring procedures or a complaint (it has been noted that disciplinary and complaints procedures are very closely linked in the RPBs).<sup>128</sup> The disciplinary procedure often feeds into the complaints procedure, or vice versa. Where punitive discipline restricts or removes a licence it is imposed through the licensing committee, as the committee that originally granted the licence.

5.34 The IS, on the other hand only has the power to remove an IP's licence. The IS does not have the flexibility of the range of sanctions available to the RPBs as a result of their disciplinary codes (such as fines, undertakings etc).

5.35 In Annexe E we have summarised the data regarding disciplinary actions of the IP regulators as a result of monitoring and complaints handling in 2008 and 2009 (averaged). Often full details of the reasons behind the

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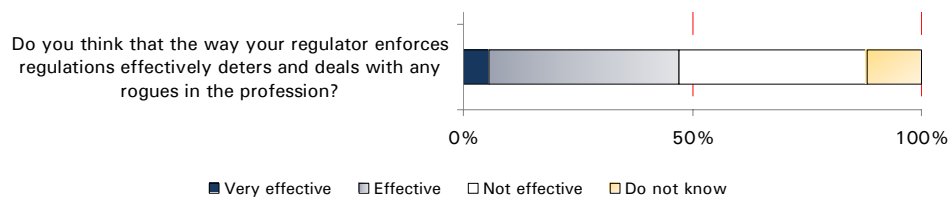
<sup>127</sup> Targeted visits are carried out if the regulator becomes aware of concerns about an IP's activities (such as from previous monitoring visits, desk-top monitoring or complaints).

<sup>128</sup> Walters and Senevirane 'Complaints Handling in the Insolvency Practitioner Profession' 23 January 2008.

disciplinary action are not provided. This makes these statistics difficult to interpret. It has not been possible to split disciplinary actions between corporate and personal insolvency. However there may be an absence of serious punitive sanctions. We consider that greater publishing of disciplinary information and analysis of the different approaches taken by RPBs would be beneficial to stakeholders and the regulators themselves. This would allow comparison of RPBs' approaches to discipline and how sanctions correlate with behaviour, and would improve transparency and deterrence.

5.36 However, in the survey of IPs, a broad dissatisfaction with the way that RPBs discipline can be observed. Many IPs felt that regulation was inconsistent (both as applied by their RPB and between RPBs), and failed to deal with 'rogues' effectively.<sup>129</sup> The lack of consistency adds to problems in discipline. Without consistency of penalties being applied they are not effective at causing deterrence for IPs.

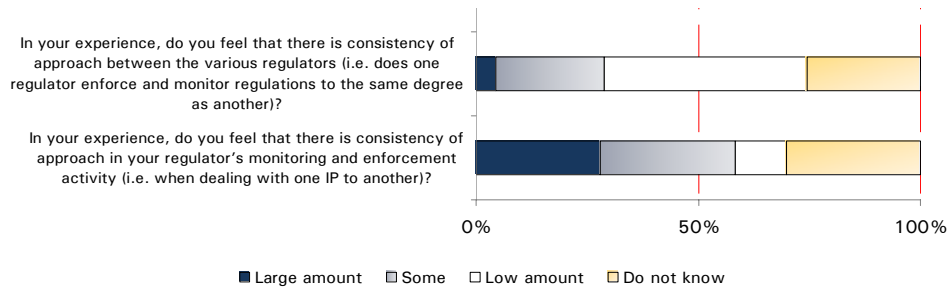
**Figure 9: IP's views on effectiveness of regulator in dealing with rogues**



Source: Survey of IPs, based on 289 respondents who answered

<sup>129</sup> In the survey of IPs, 47 per cent of respondents stated that the regulators are either effective or highly effective in 'deterring and dealing with rogues in the profession' (based on 289 responses). Almost as many respondents stated that regulators are not effective at 'deterring and dealing with rogues' (41 per cent, based on 289 responses). In the survey of IPs, 28 per cent of respondents told us there is a 'large amount' of consistency of approach in their regulator's monitoring and enforcement, 30 per cent stated there is 'some consistency' and 12 per cent stated there was a 'low amount of consistency' (based on 286 responses). In the survey of IPs, almost half of the respondents stated that there was a 'low amount of consistency' of approach between the various regulators (46 per cent), about a quarter told us there is 'some consistency' (24 per cent) and only 5 per cent told us there is a 'large amount of consistency' (based on 287 respondents).

**Figure 10: IP's views on the consistency of approach both between and within RPBs**



Source: Survey of IPs, based on 286 to 287 respondents who answered

5.37 In the survey of IPs, IPs were asked to identify the least lenient and most lenient of the regulators. There was a strong bias observable in the results for firms to identify their own regulator as the least lenient, and not to select their own regulator as the most lenient. The only firm conclusions that can be drawn from the question is that the IS (acting on behalf of the Secretary of State) is considered to be the most lenient, but there is substantial and partisan disagreement by the IPs who responded as to the relative merits of the other RPBs.

## Oversight

5.38 The IS acts as the regulatory oversight body in this system. The IS is an executive agency of the Department of Business, Skills and Innovation (BIS). In the insolvency system, IS carries out the legislative and regulatory roles of the Secretary of State.

5.39 The IS operates under a statutory framework – mainly the Insolvency Acts 1986 and 2000, the Company Directors Disqualifications Act 1986 and the Employment Rights Act 1996 – and has numerous functions (see Annexe F for more details). The IS conducts these multiple roles without any clear regulatory objectives.

5.40 The IS does not possess a range of powers to adequately address varying degrees of poor performance so as to hold the RPBs to account

for their performance,<sup>130</sup> the only sanction the IS has against RPBs is to ask the Secretary of State (BIS) to remove their recognition to act as an RPB. Such a move would require secondary legislation put before parliament.

## **Public interest input**

- 5.41 In the IP regulatory system the public interest input role is mainly carried out by the Insolvency Practices Council (IPC) which is an independent external body, funded by the IP profession. The IPC provides public interest overview and input and was set up in 2000 as a result of recommendations made by the Insolvency Regulation Working Party.<sup>131</sup>
- 5.42 It considers whether standards are being adopted, observed and enforced. The JIC and the RPBs are required to co-operate with the IPC which recommends changes in regulation that it considers are needed in the public interest. The IPC is a small organisation with five independent lay members and three members of the insolvency profession, and a budget of £100,000. Its recommendations are not binding and are not always followed.<sup>132</sup>
- 5.43 Most RPBs also include lay membership to some extent on their licensing and disciplinary committees, but this is not compulsory.

## **Representation of the profession**

- 5.44 R3 is the trade body representing insolvency, business recovery and turnaround specialists in the UK. While R3 is the main representative

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<sup>130</sup> See the Hampton Implementation Review Report of the Insolvency Service, July 2009 [www.bis.gov.uk/files/file52318.pdf](http://www.bis.gov.uk/files/file52318.pdf). In the Survey of IPs, 36 per cent of respondents stated the Insolvency Service is the most lenient regulator (based on 282 responses).

<sup>131</sup> Insolvency Regulation Working Party, A Review of Insolvency Practitioner Regulation, February 1999

<sup>132</sup> In its Tenth Annual Report the IPC outlined its recommendations over the past 10 years and instances where these were not followed by the JIC.

body for the IP profession, the RPBs maintain both representative and regulatory functions.

## **Geographical differences within the UK**

5.45 The details of the regulatory system outlined above relate to England, Wales and Scotland. We discuss the regulatory situation in Northern Ireland below.

### **Scotland**

5.46 Some of the law regarding insolvency is different in Scotland and therefore IPs may be required to comply with this, and the different standards relating to it (issued as SIPs). Most differences in Scottish insolvency law relate to personal insolvency, not to corporate insolvency.

5.47 The Accountant in Bankruptcy (AiB) has an influence in the IP regulatory system in Scotland. The AiB is an agency of the Scottish Government. The AiB is not directly involved in the regulation of IPs but it does:

- develop policy for corporate insolvency and diligence in Scotland;
- maintain a public Register of Insolvencies (ROI) which records company insolvencies in Scotland; and
- maintain responsibility for the registration of company insolvency documents required to be filed by receivers and liquidators in terms of the Insolvency Act 1986.

5.48 The Calman Commission has recommended that the reserved/devolved split for corporate insolvency between Scotland and England and Wales should be ended. It also recommended that the IS be responsible for

laying down the rules to be applied by IPs in England, Wales and Scotland through UK legislation.<sup>133</sup>

- 5.49 From our findings in the market we would support the findings of the Calman Commission and encourage further consistency in insolvency law and regulation between England, Wales and Scotland. However this has not been a main focus for our study.

### **Northern Ireland**

- 5.50 There is separate (but similar) insolvency law and rules in Northern Ireland. The regulatory system for IPs in Northern Ireland operates in a similar way to England and Wales. However regulation of IPs in NI is overseen by the Northern Ireland Insolvency Service (part of the Department for Enterprise, Trade and Investment) which undertakes a comparable role to the IS. The Northern Ireland Insolvency Service also recognises bodies that can regulate IPs – the RPBs are the same as in the rest of the UK, except that the Law Society of Northern Ireland is an RPB instead of the LSS.

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<sup>133</sup> Commission on Scottish Devolution, 'Serving Scotland Better: Scotland and the United Kingdom in the 21st Century' Final Report, June 2009, Recommendation 5.23, and paragraphs 5.274 – 5.275.

## 6 ASSESSMENT OF THE EFFECTIVENESS OF THE REGULATORY REGIME

### Summary

- We suggest three objectives for an effective regulatory regime, against which we assess the current framework in insolvency: whether it promotes growth by maximising long-term returns to the body of creditors, whether it corrects market failure by protecting the interests of vulnerable creditors, and whether it encourages an impartial and competitive IP profession. We also assess how efficiently it operates.
- The regulatory system appears to achieve the goal of maximising long-term returns to creditors to some extent. There appears to be a good focus on recovery, and for the 63 per cent of the time that secured creditors are not paid in full, there is a good focus on maximising returns in an efficient manner.
- The current regulatory system performs poorly at promoting and protecting the interests of creditors. The 37 per cent of the time that secured creditors are paid in full, IP fees increase, unsecured creditors do not get involved in the insolvency process, and they do not trust the complaints system. It is unclear whether IPs are adequately punished. There is no practical ability for unsecured creditors to have fees assessed.
- The system appears to achieve the goal of promoting an impartial IP profession to some extent. There is good competition between IPs and IP firms. However media and political comment about the profession is negative and IPs' close relationship with secured creditors means that they are not always trusted to act in the wider interest of creditors or directors.
- The current regulatory system also appears slow to make decisions or respond to changes in the market.

- 6.1 In Chapter 5, we described the current regulatory system for IPs. In this section we set out what we believe the objectives of the regulatory system should be, we assess whether the regulatory system is effective

at delivering the three objectives and we consider whether it delivers these in an agile, responsive and proportionate manner.

## Regulatory objectives

- 6.2 In can be difficult to clearly assess the effectiveness of a regulatory regime. In order to assess the regime for IPs we have formulated a list of regulatory objectives. We have considered the objectives of regulators in the legal services and financial services sectors and used these to develop specific objectives that an effective regulatory system for IPs should seek to achieve.
- 6.3 In the next Chapter we suggest that the regulatory system explicitly adopt these as its objectives, while in this Chapter we use them as criteria against which we assess the regimes' performance. We also assess how efficiently the regime operates at the end of this Chapter.
- 6.4 As stated in the 'Review of the Regulatory Framework for Legal Services in England and Wales'<sup>134</sup> the first step in defining a regulatory regime should be to make clear what the objectives of the regime should be:
- 'This is critical for those charged with regulatory responsibility, since the objectives represent the criteria against which they must determine the appropriate regulatory action; and against which they will be held accountable. Objectives also need to be clear to those being regulated and other interested parties.'
- 6.5 When looking at the regulation of legal services, David Clementi favoured a short clear list of objectives, much along the lines of those which direct the work of the Financial Services Authority (FSA).
- 6.6 We have adopted a similar approach in considering what objectives the IP regulatory regime should have. For the purpose of this Chapter, we use them as criteria against which to assess the effectiveness of the regulatory regime. As covered in Chapter 7, the IS and other regulators,

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<sup>134</sup> Sir David Clementi 'Review of the Regulatory Framework for Legal Services in England and Wales: Final Report' December 2004.

as industry experts, may wish to develop them further before adopting them as objectives.

- **Promoting growth by maximising long-term returns to the body of creditors:** the primary responsibility of an IP is maximising the returns to the insolvent company from which the whole body of creditors benefit, and this should be the primary responsibility of their regulatory bodies. This usually means sustainably reforming businesses where possible, and efficiently disbanding them where necessary. In the process it should promote confidence and trust in lending, and in the fairness of the insolvency process.<sup>135</sup>
- **Correct market failure by protecting the interests of vulnerable creditors:** Regulation should seek to correct the power imbalances in the market that can lead to market failure. In the market for corporate insolvency, at present this would involve ensuring that unsecured creditors' interests are sufficiently protected.
- **Ensuring an independent and competitive IP industry:** Ensure healthy competition between IPs delivers efficiency and innovation. Ensure IPs act in the wider public interest.

6.7 These objectives are designed with the regulation of corporate IPs in mind. However, we would expect similar objectives to apply to personal insolvency. Although the way in which these objectives would be applied may vary; for example the vulnerable market participant in personal insolvency could well be the debtor rather than the creditor.<sup>136</sup>

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<sup>135</sup> At times there may be a tension between promoting growth and maximising the return to creditors where business rescue would involve the removal of onerous commercial obligations that competitors may still face, leading to insolvency being used as a mechanism to undercut rivals and thus undermine the standard competitive process. Regulatory and policy bodies may wish to keep the possibility of this under observation.

<sup>136</sup> This could be considered a matter of correcting market failure in a wider sense of market forces alone not delivering social policy objectives.

## **Assessment of regulatory system against regulatory objectives**

6.8 In this next section we assess how well the regulatory system meets these objectives, and whether it does so in a manner that is efficient, agile and proportionate.

### **Promoting growth by maximising long-term returns to the body of creditors**

6.9 We find that the objective of promoting growth is achieved by the current regulatory system to some extent.

6.10 As set out in Chapter 4, where the secured creditor has an interest in the outcome of insolvency (in 63 per cent of administrations) it is able to influence and control the actions and fees of IPs. The interests of secured creditors are largely correlated with the interests of the wider economy in terms of business recovery and continuity. As long as this remains the case, the regulatory regime does not need to intervene to ensure that the firms are not unnecessarily liquidated, or that insufficient assets are recovered.

6.11 In the 37 per cent of administrations where the secured creditor is unaffected by the fees charged, there is the potential for IPs to act in a way that is not beneficial to macro economic growth. A regulatory system needs to have an effective disciplinary and complaints monitoring system to identify and discourage such actions. The potential lack of severe disciplinary action (see paragraph 5.35), the view of a large amount of the profession that the regulatory system does not deal with rogues (see paragraph 5.36) and the confusion regarding complaints (see paragraph 5.26) mean that such behaviour may be occurring.

6.12 Additionally as also set out in Chapter 4, expectations of the insolvency process may also have an impact on the amount of credit lent to firms, and the relative failure of the regulatory system to protect unsecured creditors may have an impact on this (see paragraph 4.77 onwards and paragraph 4.119).

## **Correct market failure by protecting the interests of vulnerable creditors**

6.13 The current regulatory system has been ineffective at protecting and promoting the interests of vulnerable market participants such as unsecured creditors. This is demonstrated by the following findings of our study:

- As demonstrated in Chapter 4, where secured creditors are not responsible for paying the IP's fees (37 per cent of administrations) unsecured creditors are adversely affected as a consequence.
- Creditor committees which consider IPs' actions and fees are rarely formed, and there appears to be little regulatory focus on encouraging them.
- Unsecured creditors are unable to affect the incentives of IPs through a credible threat of complaint. They either do not understand how to complain, or if they do, they do not believe that the complaint will be considered fairly (see paragraph 5.26).
- IPs feel that regulation is inconsistent and that it fails to deal with poor performance effectively. In addition, there appears to be a lack of serious punitive sanctions imposed by RPBs (although it is not easy to interpret whether this is merited or not). See paragraphs 5.19 onwards, paragraph 5.35 and Annexe E.
- The regulatory regime in England and Wales is unable to process complaints concerning IP costs.

6.14 The regulatory regime also appears to be ineffective at educating creditors about the rights they do have available to them. In particular:

- Information is provided by IPs to creditors in an inconsistent manner.<sup>137</sup>

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<sup>137</sup> See paragraph 4.70.

- In many cases, too much information is provided with little thought spent on what information is important for informing and empowering creditors.
- Little effort is made by the regulatory bodies to identify and educate creditor groups who do not take sufficient interest in the process regarding how to use their regulatory rights.

6.15 Our online survey of creditors supports this, showing a broad lack of understanding of the insolvency process by unsecured creditors – even relatively large companies who experience a number of trade partners going insolvent each year.<sup>138</sup>

6.16 The fact that, in the 37 per cent of cases where the secured creditor is unaffected by the fees charged by IPs, fees appear to be approximately nine per cent higher, supports the fact that vulnerable unsecured creditors' rights are not being protected and promoted by the current regulatory system, and this is leading to a certain level of market failure.

### **Ensuring an independent and competitive IP industry:**

6.17 We find that the objective of promoting competition and encouraging an impartial IP profession is achieved by the current regulatory system to some extent.

6.18 The market for IPs appears competitive and vibrant, with firms of different sizes competing with each other across the board.

6.19 However, the IP industry is not impartial as it is predominantly serves the interests of secured creditors. In the 67 per cent of administrations where the bank does not get paid in full these interests are largely aligned with the interests of an impartial IP aiming to maximise the

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<sup>138</sup> In our online survey of creditors, we asked those with experience of at least one insolvency whether they agreed or disagreed with each of eight statements about different aspects of corporate insolvency. Of 731 respondents answering the questions, 110 creditors (15 per cent) responded Don't Know to at least half the statements. Indeed, 50 creditors (seven per cent) responded Don't Know to **all** of the statements.

return to all creditors. However, the one third of the time that they are paid in full, it appears that the strength of the relationship between IPs and secured creditors can have a negative effect.

6.20 In addition, as the asset mix of secured lenders may change, the interests of secured creditors may no longer be aligned with those of an impartial IP industry. If this occurs it is important that the regulatory system is focused on achieving an impartial IP industry to counteract and deal with such issues.

### **Regulating in an agile, consistent and proportionate manner**

6.21 It is important for a regulatory regime to deliver on its objectives at any one moment in time. It is also important that it can react to changing circumstances, and do so in a proportionate manner.

6.22 We have indicated the ways in which the current regulatory system is not meeting the objectives we consider it should. The current system has made attempts to deal with the issues raised. For example, we note:

- the changes to insolvency rules to allow more participation by unsecured creditors, including the recent rule changes introduced by the IS (see footnote 56)
- the introduction of SIPs to deal with specific issues, including SIP 9 to provide creditors with more information and SIP 16 to address issues with pre-pack administrations
- the introduction of the IPC in 2000 to provide public interest input
- the publishing of data regarding the performance of IPs and RPBs, including the IS's Annual Report on Insolvency Regulation and its specific reports on SIP 16 compliance.

6.23 However these changes and efforts from the regulatory system have not been successful at addressing the issues raised. We suspect this is because problems with the current regulatory system make it difficult for it to respond in an agile, consistent and proportionate manner. We note that:

- standards are set by consensus of all regulators, which means that the regulatory system is slow to react to problems that are raised (see paragraphs 5.17 and 5.18)
- there is a lack of clarity about the IS's role (see paragraph 5.39)
- IPs can switch between different regulators (see paragraph 5.12)
- there is a lack of consistency between regulators and a perception amongst the profession that some regulators are more lenient than others (see paragraph 5.37)
- there is potentially an overall lack of severe punishment (see paragraph 5.35)
- the IS reports high non-compliance with standards that result in only small levels of discipline, indicating issues with either the standards in place, their interpretation or the discipline imposed (see paragraph 5.19 onwards)
- there is duplication of work by regulators (see paragraph 5.14)
- the IPC's public interest input is limited (see paragraph 5.42).

6.24 IPs are also relatively dissatisfied with their regulatory regime, as show by responses to the survey of IPs (see Annexe D and Figures 8 and 9 at paragraph 5.36).

6.25 There is also a lack of satisfaction amongst creditors and other stakeholders regarding the profession, as demonstrated by our online survey. More creditors who had experienced the insolvency of a debtor disagreed that the amount they recovered seemed fair than agreed (54 per cent disagreed and six per cent agreed, based on 731 responses), more thought the time the insolvency process took was not reasonable than thought it was reasonable (51 per cent thought it was not reasonable and ten per cent thought it was reasonable, based on 731 responses), and more disagreed that it was clear how to complain than agreed (36 per cent disagreed and 18 per cent agreed, based on 731 responses).

## 7 REMEDY

### Summary

- Our recommended remedy is designed to reform the regulatory system, to restore trust and to create more proportionate regulations focused on correcting market failure.
- First, we propose increasing trust and consistency in the market by establishing an independent complaints body. It should also have the ability to review fees, creating an accessible and cost-effective alternative to court.
- Second, we propose ensuring that future changes to regulations are clearly focused on correcting problems in the market by reforming the regulatory regime with clear objectives, and clearer powers and responsibilities. In particular, we suggest refocusing the IS as a dedicated regulator of the Recognised Professional Bodies (RPBs), with a broad suite of proportionate oversight powers.
- Third, we propose a number of more detailed changes to the regulations that would assist unsecured creditor involvement.
- It is for the Department of Business, Innovation and Skills (BIS) in consultation with the industry, to design and implement any changes.

7.1 It may be possible to go some way towards correcting the inability of creditors to influence IPs' fees and actions by simply changing some of the rules that govern the process of insolvency. We make some recommendations of how to do this at the end of this Chapter.

7.2 However, it is also necessary to increase the ability of stakeholders to influence the actions of IPs through the threat of complaints and redress after the event. We believe that creating stakeholder trust in the complaint and discipline regime is the most important remedy.

7.3 In addition, to ensure that the rules are effective, and that they are sensibly updated to reflect future changes in the market, we also recommend changes to the structure and processes of the current regulatory regime to increase its focus and efficiency.

## Trust and consistency in the complaint and discipline regime

- 7.4 We have found that some market participants, unsecured creditors in particular, find it hard to influence the insolvency process as it happens.
- 7.5 In many situations the relatively small amount of money at stake for each unsecured creditor means there is relatively little that can be done about this. They have very little ability or incentive to influence.
- 7.6 Even where larger amounts of money are at stake, concerns with the process can sometimes only come to light after the process has completed. This is especially true in pre-packaged administrations.
- 7.7 It is therefore essential that effective complaint and review mechanisms are in place that deter IPs from inappropriate behaviour, and incentivise them to make the decisions during the process that are in the best interests of the body of creditors.
- 7.8 The current mechanisms fail for three reasons:
- **They are hard to access.** Court reviews are prohibitively expensive, outweighing any perceived benefit and rarely in creditors' interests as the costs of defending the review are charged by the IP to the insolvency process itself. There is very low satisfaction with complaint handling by RPBs, and some confusion as to how the processes work.
  - **They are inconsistent.** IPs indicate a high level of perceived inconsistency between complaint handling both within and across RPBs. This apparent randomness breaks the link between poor behaviour and punishment, decreasing any deterrent effect that the complaint and review processes may have had.
  - **They have a limited remit.** By reserving fee assessment to an expensive court process, one of the major elements of concern is excluded from the main complaint handling systems currently in place.

- 7.9 Together, this leads to stakeholders showing little trust in the system, and IPs feeling that the system is ineffective at dealing with 'rogue' firms.
- 7.10 We recommend the establishment of an independent complaints handling or appeal body, with the ability to review fees in some circumstances. This would increase consistency, and have a broad remit more in keeping with the concerns raised by market participants within the insolvency process.
- 7.11 We are confident an independent element to the complaints handling system will increase the involvement of a number of repeat unsecured creditors who are owed a significant amount of money.<sup>139</sup> They have indicated that it would increase their trust in the process, and encourage them to make well argued complaints when they saw poor performance, in order to deter it from happening again.
- 7.12 While it would be for the IS, in consultation with the industry, to design and implement any changes, we suggest a possible framework below.

### **Details of independent complaints body**

- 7.13 An independent complaints body could operate in two ways. It could either operate as a first tier body, taking complaints directly from creditors who are unsatisfied with an IP. This would be similar to the Financial Ombudsmen Service or the Office for Legal Complaints.
- 7.14 Alternatively, it could operate as an appeal body after RPBs have considered the complaint themselves. This would be similar to the Solicitors Appeal Tribunal, or the Office of the Health Practitioner Adjudicator.
- 7.15 There are costs and benefits of both systems, with first tier bodies usually having some ability to arbitrate and provide redress, and appeal

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<sup>139</sup> See paragraphs 4.80 onwards

bodies usually focusing on discipline and adjudicating on whether actions or behaviour were acceptable.

7.16 While we do not have an opinion on which type of body would be best suited to insolvency, we recommend that whatever structure is put in place should meet the following objectives:

- **Independence.** The body should be wholly independent from the industry and regulators, perhaps with input from IPs limited to a technical advisory capacity. To minimise negative financial incentives, we suggest that the body be funded by the profession for each case referred, regardless of whether the body finds in favour of the IP or not.
- **Consistency.** At present there is a large amount of perceived inconsistency between RPBs and within RPBs. The independent complaints body should ensure that complaints and concerns are treated consistently, promoting trust in the system, and providing IPs with clear incentives to comply with rules and regulations.
- **Deterrence.** In addition to consistency, the complaints body should be able to sanction IPs in a manner that provides a clear deterrent. This may include fines, but may also include removal or suspension of their licence.
- **Efficiency.** The complaints handling or appeal body should enable speed and efficiency in the process. This would suggest a relatively limited ability to appeal decisions of the body, and providing the body with a broad discretion.
- **Oversight.** Complaints information can be a rich source of insight into the operation of the market. We suggest that the complaints handling or appeal body should have a modest budget for analysing the causes of complaints, or the lack of them, for determining patterns within the complaint dataset, and providing advice to the IS and the RPBs on how well the regulatory objectives are being met.

## The ability to review fees

- 7.17 It is also necessary to reduce the costs to creditors of challenging fees. As outlined in paragraphs 4.82 to 4.84, the current court route is prohibitively expensive and impractical for anything but the clearest transgressions.
- 7.18 As such, we recommend that the complaints handling or appeal body also be able to review fees.
- 7.19 Since the review of fees is closer to the arbitration roles of first tier complaint handling bodies, it may be preferable for creditors to be able to refer complaints on fees directly without having to first go through a process of adjudication within an RPB.
- 7.20 In addition to the objectives for non-fee complaints, we recommend that the structure for reviewing IP fees meets the following objectives:
- **Appropriate incentives to refer.** To mitigate the chances of vexatious complaints, we suggest that the system incorporates processes to avoid such complaints. These may involve retaining the current ten per cent floor limit on the number of unsecured creditors agreeing to trigger the complaints system, and apportionment of costs for adjudication following the event.<sup>140</sup>
  - **Redress.** If the IP is found to have overcharged, the creditors should be left in as good a position as if the IP had not overcharged in the first place, and no complaint had been made.

## Improve the effectiveness of the regulatory regime

- 7.21 To ensure that rules are effective, and that they are sensibly updated to reflect future changes in the market, we also recommend changes to the structure and processes of the current regulatory regime to increase its focus and efficiency.

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<sup>140</sup> For example, costs of the adjudication being paid by the IP if they lose, but out of the costs of insolvency if they win.

- 7.22 The current problems of the regime are highlighted in Chapter 6.
- 7.23 We believe that changing the current regulations in the market without reforming the regulatory regime itself may lead to benefits only in the short-term since it will not address the cause of the current regulatory failure.
- 7.24 We suggest four changes to improve the effectiveness of the regulatory regime:
- setting clear regulatory objectives for the IS and RPBs to measure themselves against
  - focusing the IS on overseeing and regulating the RPBs by providing the IS with more powers of sanction and investigation, but decreasing their direct involvement with regulation
  - streamlining decision making between RPBs, and
  - focusing the independent voice body, currently the Insolvency Practices Council, on assessing how well the objectives are met.
- 7.25 Together we believe these will allow the regulatory system to be more effective and proportionate in its interventions.

### **Set clear regulatory objectives**

- 7.26 As set out in Chapter 6, effective regulatory regimes need clear objectives which, unlike legal services and financial services, the current IP regime lacks. These objectives would represent the criteria against which regulators determine the appropriate regulatory action and against which they are held accountable.
- 7.27 The absence of regulatory objectives contributes to the system failing to produce the outcomes which we believe the insolvency regime should strive to deliver. It is very hard for one institution to have a clear direction without objectives on its own, but even more difficult for the ten regulatory bodies together.

7.28 As such, our primary recommendation for reform of the regulatory system is adopting a set of regulatory objectives similar to the criteria used to assess the effectiveness of the regulatory regime set out in chapter 6, focusing on:

- maximising long-term returns to all creditors
- protecting vulnerable market participants, and
- encouraging a competitive and independent IP profession.

### **Focus the IS on overseeing and regulating the RPBs**

7.29 The IS is currently responsible for regulating the RPBs, but is frustrated in its ability to do so by factors that include:

- its dual role as both a regulator of RPBs, and a direct regulator of IPs,
- a lack of proportionate Hampton compliant powers of monitoring and sanction, and<sup>141</sup>
- a lack of clear regulatory objectives against which it can hold RPBs to account.

7.30 Our previous recommendation goes some way to dealing with the third of these.

7.31 In addition, we suggest:

- removing the ability of the IS to directly license IPs, except as a last resort if no RPB exists
- requiring those who are currently regulated by the IS to join an existing RPB, and

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<sup>141</sup> See the Hampton Implementation Review Report of the Insolvency Service, July 2009 [www.bis.gov.uk/files/file52318.pdf](http://www.bis.gov.uk/files/file52318.pdf)

- providing the IS with increased powers of sanction and monitoring over RPBs.

7.32 While the IS would have to consult on any changes, we suggest that an improved regulatory regime would have the following attributes:

- **Self-regulation.** Provision of licences, setting of standards and guidance, monitoring compliance and outcomes, and licence withdrawal and sanction should all reside with the RPBs with the purpose of meeting the regulatory objectives.
- **Oversight by the IS.** The IS should be responsible for ensuring that the RPBs are regulating in a manner that meets the regulatory objectives, and should have whatever investigatory or monitoring powers, resources and sanctions that may be required to do this in a proportionate manner. In any case, we suggest sanctions available to the IS should include fines of a sufficient size to deter future transgression.
- **Strong negative power of oversight.** Where the IS believes a change in standards or professional regulations may have a negative impact on achieving the regulatory objectives, the IS should have a clear and discretionary power of veto to prevent the change taking place. A system similar to that of notification of regulatory rule changes in legal services may be appropriate.<sup>142</sup>
- **Objective based positive power of oversight.** Where the IS believes that current standards or processes mean that the regulatory objectives are not being met, they should have the ability to notify RPBs, and impose sanctions if a sufficient improvement in meeting the objectives is not seen within an appropriate amount of time.
- **Cost-reflective fees to RPBs.** While the IS should retain broad discretion in setting the fees charged to RPBs, we suggest the IS fee scale should be a reasonably accurate reflection of the costs likely to

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<sup>142</sup> See the Legal Services Act 2007 and the Court and Legal Services Act 1990.

be incurred by the IS in oversight of an RPB regardless of the number of IPs authorised by that RPB. This may lead to an element of fixed fee charging

### **Streamlined decision making**

7.33 Even were there to be a set of universal regulatory objectives, and the IS to have a stronger focus on regulating RPBs, we suspect the regulatory regime would still find it hard to function without streamlining the decision making process amongst RPBs.

7.34 At present, as discussed in Chapter 5, the JIC is the decision making body amongst RPBs. All RPBs are represented, usually by member IPs who provide their time for free, and a number of non-voting but participating observers often attend. Decisions are made by consensus.

7.35 This process is time consuming, inefficient, and subject to hold-up by particular interests.

7.36 We recommend it is reformed in two ways:

- Ensuring membership of the JIC is limited to those who have a direct interest in the JIC making the right decision. If the regulatory changes proposed earlier are put in place, this would be the regulatory staff of the RPBs who will be answerable to the IS if decision making is poor or untimely.
- Replacing the current consensus voting system with a proportionate system where RPBs voting power is proportionate to the number of IPs they represent. To avoid one RPB quickly becoming the de-facto decision maker, it may be necessary to set the percentage to pass at a level greater than 50 per cent. With current membership numbers, a level of 75 per cent would allow the three largest RPBs to pass motions. We suggest that the IS be able to review this level from time to time as it sees fit.

## **Focusing the independent voice body**

- 7.37 The independent voice organisation is the IPC. It is broadly well respected, but by its own admission has been slower at securing change than it would have liked.
- 7.38 By comparing the role of the IPC to voice organisations in the legal services sector and the financial services sector, we suspect this reduced impact may be caused in part by its overlap in scope with the policy operations of the IS. We suggest that any independent voice organisation in insolvency should have the objective of commenting on whether the regulatory objectives are being met, and, if not, why not.
- 7.39 In addition, voice organisations usually exist to correct the imbalance in decision making between market participants who can effectively lobby for their interests, and those that can not. Just as regulators need to protect the interests of vulnerable market participants in the market, voice organisations need to ensure their interests are protected in the designing of regulation.
- 7.40 We suggest that the role of the independent voice organisation could be strengthened by a clear responsibility to represent the interests of market participants who would find it hard to have a voice within the regulatory regime, such as unsecured creditors. This might mean focusing the voice organisation on commenting on how well the objective to promote and protect the interests of vulnerable market participants is met, and what could be done to meet it better.
- 7.41 Such changes could be brought about by adjusting the objectives of the current IPC, by replacing the IPC with a new body, or potentially by requiring the independent complaints handling or appeal body to produce an impartial report on what can be inferred from complaints data.
- 7.42 We note, however, that it would be dangerous for the complaints handling or appeal body to take on a partisan role representing just one section of market participants, and care would need to be taken that taking on any reporting role did not prejudice its independence and impartiality when assessing complaints.

## Detailed suggestions for changes to regulations

7.43 We would urge the current, or future, regulators to consider seriously making the changes listed below in order to address the difficulties faced by unsecured creditors in influencing the process. The problems which each proposed remedy seeks to avert are described below:

- Inhibiting the use of administration procedures when CVL would be more appropriate<sup>143</sup> or alternatively seeking ways to improve unsecured creditor oversight in the administration process. This seeks to avert the potential for abuse and detriment from reduced oversight by unsecured creditors that can result from administration being substituted for CVL (see paragraphs 4.75 to 4.76).
- Enhanced opportunity for creditors to review the appointment of the IP at the point at which an administration moves to CVL. This addresses the divergence that arises because the IP is appointed in administration by secured creditors but it is unsecured creditors that are affected by the IP's actions and fees in CVL (see paragraphs 4.51 to 4.53).
- Requiring the IP's proposals for remuneration in a CVL to be voted on by creditors separately from other proposals. This is so that creditors can see that they do not have to accept the entire package of proposals and the IP's other proposals will not fall if his proposals on fees are rejected (see paragraph 4.4867).
- The IP to provide creditors with an estimate of the duration of the process and his fees (with definitive hourly rates) and to publish at the end of the insolvency process the amount by which these estimates were exceeded (if at all). This is intended to overcome creditors' lack of awareness of the level of fees (see paragraphs

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<sup>143</sup> This could be achieved by clarifying law and best practice in respect of whether an administration may properly be made for the objective of realising property in order to make a distribution to one or more secured or preferential creditors if it is not made by or at the behest of a secured creditor, or at the behest of a preferential creditor.

4.64-4.65 and 4.668), motivate creditor involvement in the process by showing what is at stake (in terms of IP fees and the likely duration of the process) and facilitate comparison of IPs when it comes to appointing them (in part by enabling comparison of IPs' past performance in meeting similar estimates they have made in the past).

- The discounted hourly IP fee rates charged in administration to apply when it moves to CVL as well. This would not stop excessive claims for hours worked but would enable unsecured creditors to benefit from secured creditors' greater ability to negotiate hourly rates (see paragraph 4.3152).
- IP court costs from defending challenges to fees or actions not to be included within the costs of the insolvency when the IP loses the case. This would encourage IPs to behave in a way that made such challenges less likely to arise and less likely to be sustained in court, such as not charging excessive fees (see paragraphs 4.82 to 4.84).
- Improving transparency, in particular clearer, more consistent provision of information (both provided to creditors and filed at Companies House). This will assist creditors (particularly inexperienced creditors) in their understanding of the insolvency process. See paragraphs 4.69 and 4.70 .
- Clearer legal sanctions if directors fail to provide a statement of affairs (showing assets, debts, creditors etc) and clearer legal requirements for IPs to ensure this is complied with. This is a key piece of information that should be available at the outset of the insolvency process, but is often missing. It provides basic information that assists the IP in performing his role and informs creditors about the state of the company and hence their likelihood of recovering money. The list of creditors may also assist them in coordinating with each other (see paragraph 4.59).

## **Costs and benefits**

7.44 We believe that making the changes suggested above is likely to increase the efficiency of the market for IPs, bringing direct benefits in

the short term for unsecured creditors and indirectly increasing the flow of trade credit. We also believe that the suggested reforms will ensure that the regulatory regime will be flexible and responsive to changes in the market in the future.

7.45 Failure to correct the problems we have identified, either by the changes suggested above or by other mechanisms, is likely to lead to the market for IPs continuing to fail unsecured creditors. As the funding mix for firms changes, further damage to the efficient operation of the economy could also occur if secured creditors interests become more short-term.

7.46 However, there are costs to the changes suggested, and the IS would have to consult before any changes take place. Table 4 below summarises our suggested changes, the benefits we believe they would bring, and an initial estimate of the scale of both transition costs, and the ongoing cost implications to both the exchequer and the regulatory burden on IPs.

**Table 4: Summary of remedy**

	<b>Benefits</b>	<b>Costs</b>
<b>Independent complaint handling or appeal body</b>	Substantial increase in after-the-event constraint on IPs' actions and fees, correcting large part of market failure.	Some transition and start-up costs. Per-complaint costs unlikely to differ substantially from complaint handling costs currently spread across the seven RPBs.
<b>Ability of out-of-court review of fees</b>	Correcting one of the major imbalances in unsecured creditors' ability to constrain IPs' actions.	Per-complaint costs will be significantly lower than court, though correction of market failure may lead to an increase in complaints.
<b>Introduction of regulatory objectives</b>	Substantial systemic benefits for regulatory regime.	Negligible, if well designed and implemented.

	<b>Benefits</b>	<b>Costs</b>
<b>Reform of IS</b>	More effective oversight of RPBs. Increased trust in self-regulatory structure.	Net regulatory cost may increase to correct current regulatory limitations.
<b>Reform of decision making between RPBs</b>	More effective decision making by RPBs.	Net regulatory cost may decrease due to increased speed of decision making.
<b>Reform of IPC</b>	More effective voice for vulnerable market participants in regulatory process.	May decrease regulatory burden if merged with complaint handling or appeal body.
<b>Changes to the detail of the regulations</b>	Likely to go some way to increasing unsecured creditors ability to influence IPs' fees and actions.	Negligible, if well designed and implemented.

7.47 Our strong preference and recommendation is that the broad package of remedies set out above is adopted.

7.48 While we have made some suggestions as to the detail of how they be adopted, it will be for BIS to decide whether to take these proposals forward and consider how they could be applied.