Small Business, Enterprise and Employment Bill: R3 written evidence

Summary of R3's views (Part 9 and Part 10 of the Bill)

30 out of 149 clauses in the Bill will reform parts of the UK's insolvency regime. There are also a number of clauses that will have a direct impact on the insolvency process, for example measures on financial redress and the transparency of company ownership.

R3 represents the UK's insolvency practitioners – the people appointed to resolve financially distressed situations. It is insolvency practitioners' role to recover and return money to creditors (small and large businesses, individuals and government), help restore indebted individuals to financial health, and, where possible, rescue businesses and save jobs. By its very nature, insolvency is a technical and complicated subject: legislative change must be handled very carefully to avoid unintended consequences. As with any profession, there is always room for improvement and R3 is very active in proposing reforms and supporting government proposals that would get a better deal for creditors and debtors.

R3 is pleased to have worked with government to introduce measures that will help overcome public concerns around transparency and costs within the insolvency process, and many of the measures in the Bill are welcome, for example modernisation of the director disqualification process.

R3 is very concerned, however, that a number of measures in the Bill will undermine confidence and transparency in the UK's world class insolvency regime (currently ranked 7th best in the world by the World Bank). The objectives of many of the proposals are welcome, however R3 believes that the unintended consequences have not been properly thought-through and will run contrary to the Bill's aims.

R3's main concerns relate to four key themes:

- **Financial redress** – clause 98 will have an adverse impact on the existing means of redress and will reduce the number of director disqualifications. It would be more prudent for the government to use this Bill as an opportunity to discuss concerns around the impact of 2012 legislation that is threatening to undermine the existing financial redress regime.
- **Creditor engagement** – clauses 110 and 111 will lead to a major erosion of creditor power/engagement and are not welcomed by the profession or creditor representative groups.
- **Unintended consequences of wide drafting** – clauses 117 and 132 could lead to adverse consequences for the UK's business rescue culture and insolvency regime.
- **Missed opportunities** – this Bill is a missed opportunity to boost the insolvency regime as a means of preventing and tackling fraud, and resolving the issue of collective redundancies at insolvent companies.

R3 would like to see detailed scrutiny of its concerns, and in some cases see clauses dropped from the Bill altogether, such as clauses 110 and 111. R3 would also like to see the Committee give further consideration to its proposals to strengthen the UK's insolvency regime.

About the UK's insolvency regime

A few facts about the UK insolvency regime

- The UK's regime is the 7th best in the world, according to the World Bank. This means it has one of the highest rates of returns to creditors, is one of the quickest, and one of the cheapest regimes.
- UK Insolvency Practitioners (IPs) return more than £4bn a year to creditors (including HMRC and businesses).
- There are approximately 1,700 IPs in the UK and around 10,000 professionals who work in insolvency.
- Most IPs are accountants or lawyers. They are all qualified and regulated (by one of eight regulatory bodies) and have a statutory objective to maximise returns to creditors.
- In 2012 UK IPs:
    - Saved more than 750,000 jobs.
    - Advised more than 95,000 businesses, with just under 50% (45,000) continuing in some form.

About R3

R3 is the trade body for the UK insolvency profession. From senior partners at the 'Big Four' accountancy firms to practitioners who run their own small and micro-businesses, our members have extensive experience of both corporate and personal insolvency. For more information, please contact Georgina Dowling (Public Affairs and Policy Manager) on georgina.dowling@r3.org.uk or on 020 7566 4214.

Financial redress: clauses 98, 105, 106, 107 and changes by the Ministry of Justice that will undermine financial redress

Clause 98: Compensation orders and undertakings

Summary of R3's views

R3 supports the policy objective of the clause. However, as currently drafted, we believe clause 98 will have an adverse impact on existing means of redress and could reduce the number of director disqualifications. R3 calls on the government to implement a more efficient and fairer way of administering this policy.

R3's concerns

- R3 is concerned that the number of directors disqualified will fall with the introduction of compensation awards, as directors are more likely to contest the disqualification (around 80% of disqualifications are by 'undertakings', where the director agrees to a disqualification for a specified amount of time). This would invariably stretch the Insolvency Service's already limited resources and may well see disqualification rates decrease. By way of background, over the last decade (2003-4 to 2012-13) the number of directors reported to the Insolvency Service by insolvency practitioners has risen by 57%. The number of directors disqualified fell by 25% over the same period. A reduction in the number of disqualified directors would be a significant blow to the UK business community: the government puts the 'value' of this work at £100,000 per disqualified director[1], in terms of the economic harm they would otherwise cause.

- Any monies identified in an insolvency would ordinarily go 'back in the pot' to be distributed to creditors. There is concern that should a compensation award be targeted to a specific creditor(s), then this will reduce the money for other creditors, and those creditors 'with the loudest voice' will benefit from the compensation order. It is likely that small businesses with limited resources to engage in the insolvency process will 'lose out' to larger businesses.

- Insolvency practitioners have a statutory duty to pursue funds for the benefit of the creditors who have lost out as a result of the failed business, and they are very successful in this regard. Research by the OFT[2] indicates that insolvency practitioners in the UK return £4bn a year. The main reason that creditors may not receive any or some of the money owed to them is not a result of the lack of 'tools' available to recoup monies, but that in the majority of cases there is simply no money available in the insolvent business or in the possession of the director or directors. A number of cases may also not progress due to lack of evidence against a director.

- R3 would like the government to clarify whether the policy complies with the European Convention on Human Rights (ECHR), specifically Article 1, Protocol 1 (rights to property). It could be argued that creditors who have a right to 'property' (the proceeds of the compensation order) through the order of priority would be denied this property should the proceeds of the compensation order be directed to a specific creditor. The government has recently attempted

[1] https://www.gov.uk/government/news/cable-takes-aim-at-dodgy-directors
[2] Office of Fair Trading (2010) *The market for corporate insolvency practitioners: a market study.*

to progress a policy for the non-payment of small dividends in the Small Business, Enterprise and Employment Bill, but dropped the proposal due to ECHR concerns.

Recommendation

- Compensation awards should not be targeted to specific creditors, but instead be returned to the 'pot', for the benefit of all creditors.
- Compensation awards should be administered by insolvency practitioners who will be in possession of the relevant information, not by the Secretary of State or Court.

Clause 105, new section 246ZB: Power for administrator to bring claim for wrongful trading

R3 believes that the proposal for administrators to bring a claim for wrongful trading is a positive idea in theory, but it will have little or no impact in practice: Administration is a short-term procedure whereas it usually takes over two years to bring a wrongful trading claim. Should the government wish to see any claims for wrongful trading brought by an administrator, then consideration should be made to abolish the time limit of administration.

Clause 106: Power for liquidator or administrator to assign causes of 'Office Holder' action

R3 welcomes moves to boost returns to creditors but anticipates that the new powers may be little used given the difference in assigning 'company actions' and 'Office Holder actions'. Therefore, the government should either give further thought to how the process will work or drop the proposal.

Clause 107: Proceeds of office-holder claims not part of general assets of company

This provision has been included in the Bill without prior consultation. This new clause is technical in nature – it is determining which 'class' of creditors are the beneficiaries of which type of 'claim'. R3 believes that this proposal should be subject to consultation as it has an impact on returns to creditors.

Ministry of Justice reforms will undermine financial redress

At the same time as the Department for Business, Innovation and Skills is seeking to improve financial redress and tackle director misconduct, the Ministry of Justice is undermining the ability of insolvency practitioners to return more than £160m a year to creditors (including HMRC and small businesses) from directors and third parties who have negligently, wrongfully or fraudulently taken money out of an insolvent business. Changes from April 2015 will result in directors who have committed misconduct getting away with their actions and creditors out of pocket.

R3 calls on the government to grant insolvency litigation a permanent exemption from the 2012 Legal Aid, Sentencing and Punishment of Offenders Act (LASPO) to ensure this does not happen.

Creditor engagement: clauses 110, 111, 112, 113, 121

Creditor engagement is integral to ensuring trust and confidence in the UK's insolvency regime. Greater creditor engagement – particularly with small businesses and individuals – is a key objective for the profession and government, and both have been exploring ways to achieve that goal. However, we are concerned that these clauses will actually reduce creditor engagement.

Clauses 110 and 111: Abolishing the power of an Office Holder to hold a physical creditor meeting in an insolvency (110: corporate insolvency and 111: personal insolvency)

Summary of R3's views

R3 believes that this proposal is a charter for creditor disengagement. Were insolvency practitioners to be prevented from holding physical creditor meetings (other than where 10% of creditors agreed to one), small businesses in particular could be permanently excluded from engaging with insolvencies, returns to creditors could be less, and the cost of some insolvencies could increase.

R3's concerns

R3 and a number of business groups, such as the Federation of Small Businesses and the British Property Federation, are concerned that rather than increasing creditor engagement, the clauses will actually reduce it.

R3 understands the government's concern that creditor meetings are sometimes poorly attended. Professor Kempson's 2013 report showed that 4% of creditors attend creditor meetings – however, when that figure is broken down into specific creditor groups, it shows that 86% of unsecured creditors (small businesses etc) either attend or vote by proxy at initial meetings. It is these creditors who will suffer should the proposal go through.

Even where they are poorly attended, they still remain a vital tool for both the insolvency practitioner and creditors. R3 encourages insolvency practitioners to use new forms of media to hold meetings, but all options should be available.

Specific concerns:

- The first creditor meeting allows useful information about the financial affairs to emerge, for example, who and how many creditors there are, any hidden assets, or any possible wrong-doing by a director or an individual. This knowledge gives the insolvency practitioner the opportunity to increase returns to creditors and ensure that any wrong-doing is dealt with by the justice system.

- The first meeting is the one useful opportunity for creditors to participate in the process, agree the basis of the insolvency practitioner's fees and to establish a creditors' committee (a committee which will scrutinise the process of that insolvency and fix the office holder's fees) – given the recent government focus on Insolvency Practitioner fees it seems strange to propose removing an important check.

- 10% of creditors required to call a physical meeting does not sound onerous but this could build in delays to the insolvency process and also increase costs. In a recent insolvency of a wedding gift website, 10% of the value of creditors was equivalent to hundreds of individuals. In the case of small businesses, where debts are typically low in value, it would take a large number of creditors to constitute the 10% threshold required to hold a physical meeting. Individual creditors with a small but important 'stake' could struggle get a meeting called.

- According to a recent report from the Federation of Small Businesses, 45,000 small businesses do not have broadband and thousands of others have very slow broadband speeds. Holding meetings over web-based video conferencing facilities is therefore not practical for tens of thousands of small businesses.

Recommendation

R3 recommends these clauses are dropped from the Bill.

Clauses 112 and 113: Creditors' ability to opt-out of receiving certain notices

R3 believes that creditors should not 'opt-out' of receiving information in an insolvency as this runs contrary to the goal of achieving greater creditor engagement and transparency. Creditors can already choose what they wish to read on insolvency practitioner websites and by choosing to read information sent to them via the post. Moreover, this clause would lead to increased costs in the insolvency process.

R3 recommends this clause is dropped from the Bill.

Clause 121 and Schedule 9: Trustees in bankruptcy

Schedule 9 would remove the requirement for the Official Receiver to decide whether to hold a meeting and to notify creditors of the decision, and would abolish the right of creditors to request a meeting. This erosion of creditor power is likely to result in reduced returns to creditors.

R3 calls for the changes as set out in Schedule 9 to be dropped from the Bill.

Unintended consequences of wide drafting (pre-packs and Insolvency Practitioner Regulation)

R3 is supportive of reform of pre-packs and insolvency practitioner regulation. However, we are concerned that the clauses as currently drafted are too broad, and suggest that amendments are made in order to avoid the danger of 'unintended consequences'.

Clause 117: Administrations: Sales to connected persons – a reserve power to prohibit or restrict administration sales to connected parties

Summary of R3's views

This clause has been introduced to give the government the power to ban or regulate business sales through pre-pack administrations to connected parties. However, the current drafting of this clause captures connected party sales in all types of administrations. R3 is concerned that businesses not involved in a 'pre-pack' at all could end up going into liquidation instead of an administration as a result of the clause – this would lead to job losses and undermine the UK's business rescue culture.

R3 welcomed the findings of the most recent (June 2014) government-commissioned report on pre-packs (led by Teresa Graham CBE) and is working closely with the government to implement the reforms. In her review Teresa Graham was supportive of pre-packs; however this clause provides the government with a reserve power to ban connected party pre-packs. R3 would like to see the wording amended to ban specific actions that lead to 'bad' pre-packs and further scrutiny of this clause to establish how the government will assess the 'success' (or otherwise) of the Graham reforms to connected party pre-packs, which might lead to the reserve power being used.

Recommendations

- Delete *4) 60A (1) a) prohibiting or*
- *Consider amended wording to address actions that lead to 'bad' pre-packs.*
- Clarity from government on how assessment of pre-pack reform will be judged.

Clauses 125 - 132: Insolvency Practitioner regulation

Summary of R3's views

R3 is fully supportive of the government's aims for an effective and robust regulatory regime and we support proposals that improve the standard of regulation, improve the reputation of the insolvency profession, and are beneficial to creditors.

R3 has a number of concerns with some of the wide drafting of a number of clauses and the potential unintended consequences. For example, R3 is concerned that there is a lack of clarity in the definitions of the proposed new regulatory objectives outlined in Clause 126: references to terms such as 'public interest' without explicit definition, is vague, subjective and open to multiple interpretations.

R3 is supportive of an oversight regulator (the Insolvency Service) being given greater powers over the Recognised Professional Bodies (RPBs - the regulators); the proposal for the Secretary of State to publically reprimand an RPB appears appropriate. However, it is important that the circumstances in which, and for what purpose, these new powers may be used are set out properly. In particular, R3 believes that more detail and clarification needs to be provided to RPBs and insolvency practitioners by the Insolvency Service that would specify the circumstances in which it would issue a direction to RPBs and apply to court to sanction an insolvency practitioner. Failure to clarify these issues could lead to duplication of effort and increase the costs of the regulatory process.

R3 understands concerns from stakeholders and politicians that such a small profession of just 1,700 is regulated by eight different regulatory bodies. R3 agrees that further homogenisation of regulation in the insolvency profession is desirable.

Recommendations

Clause 126:

- Insert amendments: At the end of each section add ‘so far as is reasonably practical’.
- Greater clarification should be provided on key terms, particularly the term ‘public interest’.
- Delete 3 b) iii) *that considers the interests of all creditors in any particular case*.

Clauses 127 – 131: The government must publish guidance on how it will make use of its powers and how it will interact with the regulators’ regulatory actions.

Clause 132: R3 would like the government to clarify the circumstances that would lead them to implement the reserve power to introduce a single regulator.

Missed opportunities (Fraud and collective redundancy)

Tackling fraud and increasing financial redress (Part 7 Companies Transparency; Part 8 Company Filing; Part 9 Director Disqualification)

R3 believes the government has missed an opportunity in this Bill to introduce greater reforms that will be more effective in disrupting directors who commit fraudulent activities and make it more efficient to recover funds for creditors. R3 has a number of recommendations that will achieve the government's objectives for part 7 and part 8 of the Bill that it would like the committee to consider. This includes a recommendation for companies to confirm that all directors 'howsoever be described' have been notified to Companies House.

Collective Redundancies and Protective Awards: a case for clarity and cost-saving

The recent judicial decision on the consultation period for redundancies at Comet highlights the need for the conflict between insolvency and employment law to be resolved.

The conflict between insolvency law and employment law is costing the government, and consequently the taxpayer, millions of pounds each year. Increasingly, it risks inhibiting the UK's business rescue culture, which could result in fewer businesses rescued and jobs saved. This would have a serious negative impact on UK plc.

R3 is working with the government to produce guidance and a protocol for this process to work better. However, there is also merit in considering a change in the law and altering the status of 'Protective Awards' from being treated as wages to a fine. This could potentially save the Treasury a considerable amount of money each year by removing protective awards from the ambit of the Government's guarantee and help better support the UK's business rescue culture. An amendment to the law as part of the Bill could therefore help resolve this issue.