A REVIEW OF THE CORPORATE INSOLVENCY FRAMEWORK (JULY 2016)
R3 RESPONSE

ABOUT R3

R3 is the trade body for the UK insolvency profession. From senior partners at global accountancy and legal firms to practitioners who run their own small and micro-businesses, our members have extensive experience of helping businesses and individuals in financial distress. Contact details: Victoria Jonson (Director of Communications) victoria.jonson@r3.org.uk 020 7566 4214

EXECUTIVE SUMMARY

- The UK's insolvency regime is one of the best in the world according to the World Bank. It is ranked 13th in terms of overall insolvency performance, but better than other major economies when judged on key outcomes such as speed, cost and returns to creditors.

- R3 welcomes the government's focus on restructuring and business rescue. This mirrors the focus of many of the UK's insolvency practitioners. The UK has a well-established restructuring and turnaround culture: over the last six years there has been a dramatic fall in the number of formal insolvencies[1] and a shift to restructuring and business rescue[2].

- It is suggested that the proposed tools would improve the UK's World Bank ranking, and R3 therefore understands the political motivation to introduce the measures as outlined in the consultation. After careful reflection and much discussion within R3 and with other stakeholders, R3 does not believe all the tools proposed in the consultation would lead to a significant positive improvement to the UK's business rescue landscape, regardless of their impact on the UK's World Bank ranking. However, there are merits in many aspects of the proposals and these ideas should be developed further. R3 looks forward to supporting the Insolvency Service as it does this.

- R3 encourages the government to focus on improving the current business rescue tools, such as Company Voluntary Arrangements (CVAs). R3 members strongly believe that government departments (such as HMRC) engaging more with business rescue within the existing insolvency framework and efforts by the government to encourage struggling companies (particularly SMEs or micro-businesses) to seek early advice would have more of an impact on business rescue than the changes proposed in this consultation.

- Rather than introducing new tools, combining improvements to the existing regime with efforts by government departments and agencies to support business rescue is likely to facilitate not just improvements to the UK business rescue regime but stability too; an important factor given the economic and political uncertainty following the outcome of the EU referendum.

- However, if the proposals are implemented as drafted, R3 would urge the government to introduce a number of safeguards (with input from the insolvency profession and other stakeholders) to ensure there is a balance between the rights of creditors and debtors. R3 is also very concerned that, without the introduction of additional safeguards, there would be potential

[1] Corporate insolvencies in England & Wales peaked in 2009 at 24,011 and have since fallen to 14,647 (2015)
[2] In 2013-2014 the insolvency profession rescued 41% of insolvent businesses and saved 230,000 jobs.

for abuse. R3 fears SMEs and unsophisticated business owners would be the victims of this potential abuse.

- R3 is disappointed with the short six week timeframe given for this consultation. The proposals outlined would involve significant changes to the UK's insolvency regime and six weeks is not enough time for the insolvency profession, creditor community or financial institutions to thoroughly review such far reaching proposals or make detailed recommendations. R3 was also disappointed to see that the Impact Assessment's calculations were based on out-of-date statistics and some of the assumptions made (such as the reasons for CVA failure) are not based on the best available evidence.

Key points on the four proposals

- **Moratorium:** R3 supports the government's plans for a moratorium but has considerable concerns about its proposed three-month length and its supervision. R3 believes that a moratorium should only be introduced on the basis that:

  - It is 21 days in length (extendable to 42);
  - It is supervised by an insolvency practitioner;
  - The responsibilities on the supervisor are not too onerous or vague (as is the case with the existing moratorium in CVAs) to make it workable.

- **Extending 'essential suppliers':** We understand that the proposal would have a restricted application to businesses which have supplier agreements for a 12 month period. The consultation document does not make this distinction but it is extremely important. Having discussed the consultation document proposal further, in particular at an Insolvency Service workshop held on 20 June 2016, R3 has considerable concerns over how the government's proposals could be applied in practice without adversely affecting the suppliers nominated. We believe that there are relatively few situations where the government's proposal could assist business rescue. R3 believes that the extension of essential suppliers beyond utility companies and IT suppliers would also require new legislation.

- **Restructuring tool:** R3 believes that the tool may be a useful addition to the UK insolvency framework but that, as drafted, there is significant potential for abuse, particularly when small companies are involved. Proper safeguards will ensure that the tool is used for legitimate purposes but may limit its use to a very small number of complex restructurings per year: in the short time available for R3 to consult with the profession and others, opinion has been divided on the likely demand for the tool. To prevent abuse, R3 recommends that the tool should only be introduced with the introduction of a specialist insolvency court or that the tool should not be available to the SME market.

- **Options for rescue finance:** R3 does not believe legislation is needed to encourage more rescue finance lending: secured creditors already make funding available for viable businesses, relying on their existing security, and administrators already have the ability to borrow on a 'super priority' basis. Any changes made to the 'order of priority' will also have an impact on the UK's lending environment. There are many alternative lending sources in the UK market such as peer-to-peer lending and private equity. The comments from many of those R3 has consulted, including the financial institutions, are that there is no shortage of rescue funding for viable businesses in distress.

R3's recommendations for business rescue

- **Reform of CVAs:** R3 believes that the Impact Assessment which accompanies the consultation is flawed in its assessment of the reasons why CVAs fail. R3 believes that the most common reasons why CVAs fail is not because there is a problem with secured creditors but because the management is overly-optimistic in its financial assessment of the company, or the environment in which the company operates changes during the CVA. The proposal for the flexible restructuring tool is, in part, made in response to CVAs failing. A better response might be to consider whether a reform of CVAs might assist. R3 would be very happy to work with the government to consider reforms.

- **Government departments (such as HMRC) should engage more on business rescue**. 65% of respondents to an R3 members' survey[3] identified this issue as the top proposal which would have the most significant, positive impact on business rescue in the UK. In a members' survey focused on insolvency practitioner's work with HMRC in February 2016[4], 49% of respondents stated that HMRC is not helpful when it comes to business rescue; only 10% think it is helpful. In addition, 54% of respondents said that HMRC makes it harder to rescue businesses than to wind them up. Anecdotal evidence from R3's members support these survey findings, with comments that HMRC often does not agree to informal agreements or CVAs despite the fact that they are the best 'deal on the table'. Creditor support is very important when businesses face challenges in a CVA and HMRC could play a leading role in this regard.

- **Efforts by the government to encourage struggling companies to seek earlier advice**. 65%[5] of respondents to the June 2016 R3 members' survey stated that this would have the most significant, positive impact on business rescue. By comparison, the government's proposals attracted lower rates of support: 28% supported the moratorium proposals, 15% the 'essential supply' proposals, 13% the restructuring tool, and 10% the new rescue finance proposals.

Macro issues to consider

R3 has identified a number of macro issues in the consultation which the government should take into account when considering whether to take forward any of its proposals:

- Loss of creditor rights:

    - While the proposals impose restrictions on secured and unsecured creditor rights in an effort to encourage business rescue, they do not include sufficient safeguards to offset the loss of these rights. Improved safeguards in the moratorium, for example, would include R3's proposals for a shorter moratorium period and the presence of a licensed insolvency practitioner with a specific role to oversee the moratorium. The loss of creditor rights is at odds with recent government attempts to improve creditor engagement in the insolvency regime and confidence in the regime could be undermined as a result.

- Increased pressure on the courts:

[3] 319 R3 members responded to an online survey on the consultation in June 2016. Respondents were asked to identify the top three proposals which would have the most significant, positive impact on business rescue in the UK.
[4] 347 R3 members responded to the online survey on HMRC in February 2016.
[5] 64.6% of respondents compared to the 65% who supported more engagement from government during business rescues.

- All four proposals are likely to lead to significant amounts of extra work for the UK court system and appear to move our restructuring and insolvency framework towards a court-based system as seen in other jurisdictions, such as the US. The UK insolvency regime has traditionally relied on out-of-court decision-making, which speeds up the insolvency process and reduces costs. The courts may not be ready to take on an expanded role in insolvency, particularly with recent funding cuts. Many of the proposals made by the government would require the creation of a specialised insolvency court.

- Reliance on the World Bank indicators and the US 'Chapter 11' system:

  - A key driver for the proposals is the UK government's ambition to be 5th in the World Bank's 'Doing Business' rankings. The UK ranks 13th in the World Bank insolvency rankings overall but performs better than other major economies when judged only on key outcomes such as speed, cost and returns to creditors. The World Bank's insolvency ranking criteria are based on the US 'Chapter 11' system – a court-based system which operates in a very different economy and legal system than the UK's, with a specialist and active 'bankruptcy court'. It should also be noted that the American Bankruptcy Institute's 2014 review of Chapter 11 highlighted several weaknesses, including its lack of suitability for smaller firms. Despite the acclaimed quality of the judiciary in the Chancery Division and County Courts, the current UK court system does not provide for the courts actively supervising insolvency cases: courts rely on regulated insolvency practitioners to do this instead. There are also budgetary pressures on the judiciary, which is looking to reduce its workload, not increase it. R3 would encourage the government not to make changes unless they are suitable for our economy and legal system, irrespective of how they may improve a statistical ranking.

- 'One size fits all' approach:

  - The government has said its proposals will benefit both large firms and SMEs. R3 believes, however, that, for many of the proposed changes, a 'one size fits all' strategy will not work. The restructuring tool in particular only has a realistic prospect of helping large, complex businesses given the cost and financing implications. The areas addressed by the other proposals are not considered to be significant problems faced in large restructuring situations. The moratorium and essential suppliers proposals could benefit medium and smaller businesses but only with carefully considered safeguards backed up with penalties for abuse. The rescue funding proposals could expose SMEs to abuse by unregulated advisers.

THE INTRODUCTION OF A MORATORIUM

1. Do you agree with the proposal to introduce a preliminary moratorium as a standalone gateway for all businesses?

1. R3 agrees with the proposal to introduce a standalone preliminary moratorium for companies and believes it could become a very useful business rescue tool. Respondents to R3's survey estimate that an average 22% of businesses they worked with in the past year could have used the moratorium (approx. 2,000 businesses).

2. R3 has already called for a moratorium to be introduced (a 'business rescue moratorium') in order to give businesses time to negotiate or implement a rescue, recovery, or restructuring without the uncertainty of possible adverse creditor action. The moratorium will also allow struggling companies to be much more transparent with their creditors than is possible at the moment. This could lead to more comprehensive, and sustainable, rescue plans or restructurings than are currently feasible. Importantly, the fact that company directors remain in control of the company during the proposed moratorium may encourage directors to take earlier action when financial problems arise.

3. By preventing individual creditors from taking (legitimate) self-interested action, it will become easier to generate higher returns to all creditors by increasing the chances of company rescue. However, while a moratorium should give a company a reasonable chance of recovery that it would not otherwise have had, it must not worsen the creditors' position and therefore must strike a careful balance. This makes the aspects of the moratorium that protect creditor rights, such as the length of the moratorium or the role of the supervisor, particularly important.

4. While R3 supports the principle of a moratorium there are concerns around the government's moratorium proposal, including: the length of the moratorium, the lack of detail regarding the purpose of the supervisory role, and the pressure the proposal may put on the UK court system. As drafted, the moratorium proposal would not achieve the correct balance between creditors and the company using the moratorium and could undermine trust and transparency in the UK's insolvency regime. At worst, parts of the proposal could turn the moratorium into a 'rogues' charter', particularly as far as small companies are concerned. Further, as drafted, the moratorium will introduce aspects of overseas insolvency regimes to the UK, without acknowledging the UK system's unique 'out-of-court' nature. These concerns, and R3's alternative proposals, are outlined in more detail below.

2. Does the process of filing at court represent the most efficient means of gaining relief for a business and for creditors to seek to dissolve the moratorium if their interests aren't protected?

5. R3 agrees that a court filing represents the most efficient way of starting the moratorium. While the court system is already stretched in terms of resources, a filing (rather than an application) should only have a small impact on the court. R3 agrees that creditors should be provided with a window to challenge the moratorium in court, although there are practical difficulties in allowing such challenges to take place (see below).

6. R3 believes that the need for creditors to seek to dissolve the moratorium would be minimised if a licensed insolvency practitioner was to supervise the moratorium because the practitioner would fully appreciate the need to balance the interests of the creditors within the moratorium. The practitioner could be expected to bring the moratorium to an end if it is clear that creditors'

interests are not being protected. At present, the proposal simply envisages that the supervisor will make the creditors and court aware if the qualifying conditions are no longer met.

7. The speed at which a hearing could take place where a creditor seeks to dissolve the moratorium would be extremely important because the uncertainty which such an action would create would be damaging to the business and it would be important for any perceived prejudice to be addressed at a very early stage.

3. Do the proposed eligibility tests and qualifying criteria provide the right level of protection for suppliers and creditors?

8. R3 agrees that eligibility tests and qualifying criteria are needed for the moratorium to ensure the rights of creditors are balanced against those of the company in the moratorium.

9. However, the proposed controls are too ambiguous to properly protect creditors from abuse of the moratorium. As drafted, directors of the company filing for moratorium protection would be the initial arbiters of whether their company qualifies or not. This invites litigation and added pressure on an already stretched court system. R3 believes that the proposed supervisor of the moratorium should be involved in the initial application, having reviewed the eligibility and qualifying criteria and being satisfied that the company involved meets these criteria. The proposed supervisor should also consent to act as supervisor.

10. The primary eligibility test that "the company must demonstrate that it is already or imminently will be in financial difficulty, or is insolvent". The definition of 'financial difficulty' is open to interpretation and a more prescriptive list of criteria would be useful to avoid the cost and distraction of the eligibility of a moratorium being challenged in court.

11. R3 agrees that the company must be able to show it will have sufficient funds to carry on its business during the moratorium, although, again, more prescriptive criteria would be useful. This could include a requirement to provide cash flow forecasts for the moratorium period. Although it can be difficult for companies to predict how the announcement of a moratorium will impact on its working capital, this requirement is essential.

12. In the current moratorium within the Insolvency Act, the proposed supervisor is required to provide their opinion on the availability of working capital – in practice, the degree of risk that this requirement exposes the proposed supervisor to is seen as the primary reason why the current moratorium legislation has not been used more widely for small companies. However, it may be feasible for the directors of the company to provide such an opinion provided that the matters they are required to consider before providing such an opinion are clearly stated.

13. R3 recommends that directors be required to make a statutory declaration that their company meets the eligibility tests and qualifying criteria to enter the moratorium as a deterrent to misuse.

Existing or previous insolvency procedures

14. R3 disagrees with the proposal in paragraph 7.20 of the consultation document that companies subject to a winding-up petition should not be able to enter a moratorium. A very common situation which triggers a company to have to seek protection is receipt of a winding up petition from one creditor while other creditors have been content to work with the business and give it breathing space to effect a rescue.

15. Preventing companies subject to a winding-up petition from using the moratorium could see a rise in petitions from creditors hoping to prevent a moratorium from being initiated. This could put struggling companies under pressure at an even earlier point.

16. Moreover, the proposal would allow an individual creditor to 'trump' the creditor body as a whole, whose interests might be best served by the company entering a moratorium.

17. Companies with a winding-up petition against them should be allowed to enter a moratorium (providing they have met the entry criteria) but should be required to give three working days' notice to the petitioner.

18. Companies that have issued a Notice of Intention to Appoint an Administrator in the previous 10 business days however should be barred from entering a moratorium. This would prevent companies from artificially extending a moratorium length.

4. Do you consider the proposed rights and responsibilities for creditors and directors to strike the right balance between safeguarding creditors and deterring abuse while increasing the chance of business rescue?

19. R3 agrees with many of the proposed rights and responsibilities for creditors and directors, although the listed rights and responsibilities alone are not the only factors that contribute to finding a balance between safeguarding creditors and increasing the chances of business rescue. Factors such as the length of the moratorium and the identity and role of the supervisor are also key for achieving the balance between safeguarding creditors and boosting business rescue.

Role of the courts

20. Creditors should be given the opportunity to challenge the moratorium in court once it has begun, but consideration needs to be given to the most effective way to do this.

21. There are practical concerns: the likelihood of creditors being able to get a court hearing within the 28 day time period is low, and creditors, particularly smaller businesses, will be concerned at the cost of submitting an application. It appears the onus will be on creditors to challenge the moratorium filing, which could lead to several different creditors launching their own applications to challenge, creating multiple sets of application costs. Without action to improve the court's ability to process such cases quickly, the right to challenge may be perceived by those wishing to abuse the system as just a notional right rather than a practical right. There is little evidence in the Impact Assessment that the impact of these proposals on the court system has been fully considered.

22. From the moratorium company's perspective, there is a danger that court applications from different creditor groups would distract it (in terms of attention and funding) from progressing a rescue plan. A more prescriptive set of eligibility criteria (as opposed to the subjective opinion of a company that it was in financial distress) and a clearly defined role for a licensed insolvency practitioner as supervisor could reduce the number of cases where a challenge might be necessary.

23. Court challenges to the moratorium should be a last resort. The UK's insolvency regime has developed to operate outside the court system as much as possible and a number of recent

reforms such as the Red Tape Challenge have been designed to move insolvency work out of the courts; as such, the government should avoid creating a burdensome role for the courts in the functioning of the moratorium. Moreover, given funding cuts, the court system may not have the capacity to deal with a significant amount of extra insolvency-related work.

24. The length of the moratorium provides a key safeguard for creditors and a short moratorium could reduce the need for court challenges. The moratorium should be much shorter than proposed to reduce the risk to creditors and any extension of the moratorium should be clearly justified and the reasons for doing so communicated clearly to creditors.

Essential supply

25. R3 has campaigned for improved protections for the terms of supply between an insolvent company and its essential suppliers since at least 2011. As such, R3 welcomes the government's focus on exploring further ways that essential supplies can be protected.

26. However, R3 is concerned about how the proposals for essential supplies have been drafted. A significant extension of the essential supplier category could do more harm than good to the UK's insolvency regime and creditor community.

27. Our detailed concerns and recommendations are outlined in questions 9 and 10 on pg. 14-17.

5. Do you agree with the proposals regarding the duration, extension and cessation of the moratorium?

28. R3 disagrees with the proposed length of the moratorium: three months without creditor approval followed by an open-ended extension is far too long and outweighs any creditor protections included in the proposal. R3 proposes a 21 day moratorium extendable to 42 days.

29. Additionally, there are a number of practical concerns that come with a minimum three month moratorium.

Protection for creditors

30. The longer the moratorium continues, the more likely creditors' interests could be damaged either by directors' actions or external influences.

31. By comparison, a shorter moratorium is much more predictable in terms of planning cash requirements, and there are far fewer things that could go wrong in a shorter space of time. The effect of an early, unplanned end to an unsuccessful moratorium would be relatively smaller, too: fewer moratorium debts will have been able to build up.

32. Although R3 is hopeful that companies would use the moratorium period to engage in an open dialogue with their creditors, the consultation proposal may mean that creditors must wait potentially for an entire financial quarter before decisions are made about what will happen to the debtor company. Again, a much shorter moratorium period would be more palatable to the creditor community.

33. It should also be noted that smaller companies and sole-traders, who are creditors, are likely to be disproportionately affected by a debtor company entering a moratorium. Smaller creditors

would also be less capable of dealing with three months of uncertainty or restrictions on their ability to pursue debts and its effects on their own business.

34. According to R3's survey, 64% of respondents believe that the proposed moratorium is 'too long' (including 22% who said it is 'far too long'); only 31% felt it is the right length; just 6% want a longer moratorium. 59% believe that the length of the moratorium is 'unfair' (45%) or 'very unfair' (14%) to creditors; just 14% thought it is 'fair' or 'very fair' (27% think it was neither fair nor unfair).

Building up a 'war chest'

35. In order to be able to fund a three month moratorium, businesses could decide to stop paying their suppliers for some time ahead of the moratorium. This 'war chest' could then be used for the business during the moratorium period. Creditors could therefore suffer by not receiving payment in the months leading up to the moratorium and then endure a further period during the moratorium where they would not be paid for these arrears. A shorter moratorium would reduce the need for a 'war chest' and therefore acts as a protection for creditors.

Barrier to entry – how do you fund a three month moratorium?

36. R3 agrees with the proposal that companies must show they have enough liquidity available to continue to trade for the period of the moratorium. However, it is difficult for an insolvent or near-insolvent company to arrange funding for three weeks (R3's originally proposed moratorium length), let alone three months or however long an extended moratorium may end up lasting.

37. Requiring companies to arrange three months of funding before entering the moratorium creates such a significant barrier to entry that only a handful of companies will be able to use the moratorium. The moratorium could have much wider, positive use if it was introduced with adequate safeguards, including a shorter, more appropriate time-frame.

What size of business will use the moratorium?

38. While a three-month moratorium could work for large companies who have complex affairs to resolve, designing the moratorium with large companies in mind means that in practice it will not be suitable for smaller companies. In order to make the moratorium work for smaller and medium-sized companies too, the initial moratorium should be much shorter than three months. Larger companies could always apply for an extension if one is needed.

39. According to R3's survey, 40% of respondents believe that the proposed moratorium will only be used by businesses larger than a small business; 31% believe it will be used by all businesses; 9% believe it will be used by no businesses.

Purpose of the moratorium and the danger of 'drift'

40. The consultation paper makes reference to the purpose of the moratorium as being to allow companies to 'explore options' or to 'develop' a plan rather than to actually implement a restructuring or rescue.

41. While there is no need for the moratorium legislation to prescribe the exits from the moratorium, R3 believes the moratorium will be most successful when it is being used with a

particular outcome in mind. As such, it should not be designed to be used as a means of allowing a company simply to take shelter from creditor action while it works out what to do, with no guarantee of any actual remedial action. The focus should instead be on using the moratorium to present plans to creditors or to implement sensitive aspects of a restructuring or rescue while protecting the company from individual, opportunist creditor action.

42. The moratorium may prove particularly useful for those companies considering a CVA: it will provide a breathing space in which CVA proposals can be put forward and discussed openly.

43. A three month moratorium period would in all but the most complex cases be far longer than would be required by a company with a plan ready to implement. Indeed, a long moratorium may encourage companies to apply for it without a clear idea of what they want to achieve by doing so: they may see the three months as ample time to work out what to do. The risk, however, is that providing companies with an entire financial quarter free from creditor pressure could lead to 'drift' rather than action.

44. A short moratorium would require concentrated effort and a clear direction of travel. The moratorium period should be regarded as a company's 'last chance' to avoid an insolvency procedure and must not be treated as a period of 'business as usual'.

An open-ended extension?

45. The prospect of companies staying in the moratorium for months at a time, with no clear end in sight, would seriously harm confidence in the UK insolvency and restructuring regime.

46. While the proposed moratorium may only be extended by consent from all secured creditors and the majority of unsecured creditors, this could still leave large numbers of small business creditors frustrated at being left in limbo for an extended period of time. Alternatively, the lack of clarity over the moratorium's termination date might prevent creditors from ever approving an extension. A moratorium with no clear end date would be completely unsatisfactory from a creditor's perspective.

47. Even if the government opts for a longer moratorium period, it is crucial that the extension is only available for a finite period.

6. Do you agree with the proposals for the powers of and qualification requirements for a supervisor?

48. R3 supports the government's proposals for a moratorium supervisor given the significant restrictions imposed upon creditor rights.

49. R3 does not support the role and qualification requirements of the supervisor as described in the consultation and believes that only licensed insolvency practitioners should be a supervisor.

The identity of the supervisor

50. Aside from the requirement to be a licensed insolvency practitioner, a lawyer, or an accountant, the only requirement for the moratorium supervisor is that they have 'relevant expertise in restructuring'. It is not clear exactly what would qualify as relevant expertise or who would decide whether the supervisor possesses such expertise. While licensed insolvency practitioners

could be assumed to have such expertise, it is not clear how the expertise of others would be determined.

51. Indeed, R3's conversations with other stakeholders have met with universal agreement that the moratorium supervisor should be specifically regulated and a clear preference for licensed insolvency practitioners to undertake this work has been apparent.

52. Legal and accountancy regulatory structures may not be ready for the extra work required by a loose drafting of the supervisor requirements. The Solicitors Regulatory Authority and the Law Society of Scotland have recently ceased regulating insolvency licences; allowing solicitors to become moratorium supervisors would force legal regulators to cover a specialism that they no longer regulate. And while the chartered accountancy bodies do have experience of regulating insolvency practitioners effectively, 'accountant' is not a protected term in the UK. Anybody could claim to be an 'accountant' and offer their services as a moratorium supervisor.

53. It is also very important that the moratorium supervisor is committed to protecting creditors' interests, rather than those of the company in the moratorium. As drafted, however, the proposal would not prevent a struggling company's own in-house lawyer or accountant from fulfilling the role of moratorium supervisor. Their commitment to protecting creditors' positions would be compromised in this situation. Licensed insolvency practitioners, on the other hand, are used to operating with an obligation to work on behalf of the creditor body as a whole.

54. These proposals are particularly disappointing in light of the work R3, the Insolvency Service and other regulatory bodies have carried out together to tackle the problem of so-called 'ambulance chasers' or unregulated 'insolvency advisers' who do not work in the interest of the distressed business or its creditors but only for their own gain.

55. Small companies would be most vulnerable to unscrupulous advisors. R3 is concerned that by taking financial or debt advice from an unregulated adviser (often for a fee), a director may receive misleading or incorrect advice about how to resolve their financial problems and the duties or responsibilities that they owe to their creditors or their company. This could potentially make their financial situation far worse and could even result in company directors not fulfilling their legal obligations and duties.

56. Given the risks posed to creditors and suppliers during the moratorium, their interests must be represented by an individual who can be held accountable should things go wrong. The UK already has a system in place for regulating and assessing individuals' restructuring and insolvency expertise: the insolvency licence. Restricting the moratorium supervisor role to an insolvency licence holder would be a way of guaranteeing that the moratorium supervisor has not just relevant restructuring expertise, but a commitment to protecting creditors' interests, too. This approach would not add additional costs to the moratorium process in terms of additional regulatory structures.

57. An alternative would be to consider introducing a new licence for moratorium supervisors to ensure those taking on the role are effectively regulated, but this would entail additional compliance and regulatory costs, largely duplicating a regime that already exists and works.

The role of the supervisor

58. The role of the supervisor must strike a balance between having enough power to properly protect creditors and not being over-burdensome on the person in the role. One of the main

reasons why the existing Schedule A1 moratorium is not often used is because the requirements of the supervisory role are too burdensome and the government should avoid repeating this problem with this new version of the moratorium.

59. It is also important that any supervisory role is well-defined so that it is clear what rights and responsibilities the supervisor has.

60. While R3 understands the reasoning behind preventing a supervisor from becoming the office holder of the same company at a later date, we would strongly caution against a blanket ban on this. Insolvency practitioners should be able to act as supervisor and then office holder of the same company provided there is majority creditor support for them doing so. The supervisor's work with a company during a moratorium will give them a good understanding of the company, its market, and its creditors, leaving the supervisor well-placed to act as the office holder in a subsequent insolvency. This would also keep the costs of a subsequent insolvency down.

61. Moreover, insolvency practitioners are subject to strict codes of ethics which already deter or sanction unethical behaviour with regards to conflicts of interest. The codes of ethics for other professionals obviously do not address the issue of sequential appointments in such distress situations as they are not required to do so.

62. The supervisor's role is also not a decision-making role: they would only have as much influence over the decision or need to enter an insolvency procedure after the moratorium as any other advisor to the company.

7. Do you agree with the proposals for how to treat the costs of the moratorium?

63. Debts incurred during the moratorium should be given priority during the moratorium itself.

64. However, any unpaid debts from a failed moratorium should not be treated as a first charge in a subsequent insolvency. There is a risk of abuse under such a system: a company in a moratorium could run up debts with connected parties, to whom the company's assets would then go in a follow-on insolvency procedure. Whereas the moratorium is supposed to protect the positions of a struggling company's creditors, allowing moratorium debts to become a first charge would undermine creditors' positions. Therefore, unpaid debts incurred in a failed moratorium should be treated the same as existing debts in a subsequent insolvency.

65. The ability of the moratorium supervisor to resign and bring an end to the moratorium should things go wrong should prevent unpaid moratorium debts from building up to a significant degree.

8. Is there a benefit in allowing creditors to request information and should the provision of that information be subject to any exemptions?

66. There is a benefit in providing information to creditors, although R3 believes it would be much better for the provision of information to be initiated by the company itself in conjunction with the supervisor. A regular update of the purpose of the moratorium and its progress, subject to sensitive commercial information, could be provided to creditors on a dedicated web page.

67. Companies should only be required to provide information which is related to, and necessary for creditors to consider, the rescue proposals. In addition, companies and office holders should

be allowed to withhold information in response to a request if the information is of a commercially sensitive nature (which could affect the rescue of the company or its business) or if the directors of the moratorium company already intend to provide creditors with the information requested at a later date.

68. There is also no reason why, in a moratorium, it should be the supervisor that is expected to provide information: creditors should be able to request the information directly from the company directors themselves. This would save time and cost (information would not have to be provided twice, once from the company and then once from the supervisor) and would reduce the regulatory burden that comes with the supervisor role.

69. It is important that the company be given a reasonable length of time to respond to requests for information. One of the reasons for the moratorium is to give companies time to put together a rescue plan; having to make responding to creditor requests for information a priority could distract from progressing a rescue plan. Thought needs to be given to how vexatious requests for information should be treated.

70. While the above stands for the proposed moratorium, R3 does not believe the proposal should be extended to other insolvency processes without further consultation.

HELPING BUSINESSES KEEP TRADING THROUGH THE RESTRUCTURING PERIOD

9. Do you agree with the criteria under consideration for an essential contract? Is there a better way to define essential contracts? Would the continuation of essential supplies result in a higher number of business rescues?

71. R3 has long called for the reform of the rules on the continuation of essential supplies to ensure the success of business rescues.

72. R3 was therefore very pleased to see the government respond to R3's campaign on the issue and extend the types of supply deemed essential in October 2015. According to R3's June survey, an average of approximately 15% of businesses with whom respondents worked in the last year could not be rescued because they could no longer access an essential supply or service (approx. 1,400 businesses). 53% of survey respondents agree (or strongly agree) that an extension to the types of supplier deemed 'essential' could improve the chances of business rescue (31% disagree or strongly disagree).

73. The government's focus on exploring further ways that supplies can be protected is therefore welcome and R3 looks forward to working with the government to develop some of the ideas from its consultation further.

74. R3 does have some concerns about the specific proposal outlined in the consultation document. As drafted, the government's proposals may not increase business rescue but could increase the cost and litigation involved in insolvency processes instead (see Question 10). R3 also has practical concerns with the proposal and with the amount of risk to which it would expose suppliers. There are also important questions over the scope of what may constitute 'essential supplies'.

Treating suppliers fairly

75. The proposal is risky for suppliers, especially smaller suppliers or those for whom the provision of goods and services comes with high unit costs. An internet, telecoms or energy provider would incur relatively low marginal costs were it to continue to supply a company during a moratorium, and would not be left significantly out of pocket if the company was unable to meet its moratorium debts; on the other hand, a manufacturer supplying a moratorium company with essential parts could potentially be exposed to a significant loss. For example, suppliers of more complex products or services may have to buy in raw materials or employ labour sufficient for a period of supply beyond the capability of the company in distress to maintain the moratorium. The residual raw materials or termination costs for the employees may be a consequential loss which is not recognised or paid for in the moratorium or a subsequent insolvency if the company is unable to be rescued.

76. Requiring a supplier to continue supply on its usual credit terms may create hardship for the supplier itself, particularly where it has utilised trade credit insurance or debt factoring/ discounting. In each case the insurer or finance provider may modify or terminate those arrangements creating liquidity issues for that supplier.

77. Importantly, the extent to which it is intended that this proposal is applied is not clear from the consultation document. At one of the workshops hosted by the Insolvency Service on the consultation in June 2016, the point was raised that the provisions could only apply in a situation where a company has a supply agreement with the supplier over a period, rather than

what is probably a more normal trading relationship of ad hoc purchases. This distinction makes sense and is very important.

78. The question of whether the arrears owed to a nominated supplier would be discharged or suspended is also a key question. R3 understands that in other jurisdictions, the arrears to the supplier would be discharged but that the proposal by the government is that the arrears should be suspended. Commercially, it seems appropriate that an essential supplier would, where it is envisaged that the business would continue to operate, have an opportunity to recover arrears if it is to be expected to supply through a moratorium period but the payment of arrears raises the spectre of preference payments and potential manipulation of the essential supplier regime. Requiring suppliers to continue to supply without discharging the arrears may be seen as unfair and could damage confidence in the insolvency regime.

Practical concerns with continuation of supply

79. In most cases, there is little a company in a moratorium could do to force an 'essential supplier' to continue to supply if it chose not to. A company facing significant up-front costs associated with continuing to supply may decide there is a greater chance of the company being unable to pay its moratorium debts than the moratorium company taking court action to force the supplier to continue to supply (especially since the moratorium company may become insolvent and unable to afford legal action if a supply is withheld).

80. Allowing a company to identify essential suppliers and then allowing those identified to challenge this designation in court will repeat some of the difficulties outlined in earlier sections of this consultation response: further litigation and extra costs.

81. It is also important to remember that essential supplies extend beyond goods or services. It can be the case that businesses may have licences or trade body memberships suspended once they enter an insolvency procedure; this can be just as problematic for a business rescue attempt as the loss of IT supplies or materials. As such, the definition of supplies needs to take into account such licences or trade memberships.

82. It is difficult to see how the proposals would apply and be enforceable in relation to an international supplier. This would result in an uneven playing field between the UK and non-UK suppliers.

Possible solutions

83. The proposal could be simplified to prevent the variation of the terms of a fixed-term contract or its cancellation by the supplier purely on the grounds of the customer's insolvency or the fact that the customer has entered a moratorium.

84. In the moratorium, the requirement for the insolvent or near-insolvent company to show it is capable of trading through the moratorium may encourage suppliers to continue trading.

85. Payment for goods and services (whether contracted or ad hoc supplies) by a company in a moratorium or one of the insolvency procedures listed in the consultation should be made on a pro forma basis.

10. Do you consider that the Court's role in the process and a supplier's ability to challenge the decision, provide suppliers with sufficient safeguards to ensure that they are paid when they are required to continue essential supplies?

86. R3 agrees that those who continue to trade with a business during a rescue procedure require protection to ensure their position is not worsened by continuing to trade and that the insolvency regime remains fair.

87. However, R3 disagrees that the proposed role for the court would be the best way to offer such protections and outlines a number of alternative safeguards below. 49% of respondents to R3's June survey disagree or strongly disagree that allowing suppliers to challenge their designation as 'essential supplier' in court is the best way to protect their interest (32% agree) while 49% disagree or strongly disagree that court challenges are an acceptable 'price to pay' for a company's right to designate its own essential supplies; 33% agree or strongly agree.

88. Under the government's proposals, suppliers will face increased costs using the courts as they launch court applications to challenge their designation as an essential supplier; insolvent companies will see added costs as they defend the position. The added costs and the increased time demands involved in dealing with litigation for insolvent companies will significantly reduce the chances of its business being rescued (in a moratorium, CVA, or administration) and will significantly reduce the amount of money available to be repaid to creditors.

89. The extra costs created by court applications will be proportionately more significant for smaller businesses which may not have the capability or experience of using the courts to defend their interests. Some small businesses, particularly the very smallest, may not be able to afford to challenge an 'essential supply' designation in court, or know how to make such a challenge.

90. The UK's insolvency regime operates on an out-of-court basis. The UK court system, already subject to budget constraints, would not be ready to deal with an increase in insolvency litigation. Insolvency practitioners are already very concerned about delays in court cases being heard: these proposals would inevitably add more cases which will likely mean more delays and more uncertainty in insolvency procedures; 92% of respondents to R3's June survey believe court challenges will add time and cost to insolvency procedures and 82% believe that allowing court challenges by essential suppliers could lead to less money being made available to creditors.

91. 65% of respondents to the June survey agree that suppliers' interests could be protected in other ways, rather than allowing court challenges. R3's recommendations for supplier protection are outlined above in paragraphs 83 - 85.

92. In a moratorium, there should be further protections for suppliers and creditors. There must be objective criteria for companies to meet to show they can trade for the duration of the moratorium. The ability of the moratorium supervisor to bring the moratorium to a close if creditors' positions are threatened is also important. Above all, the moratorium must be for a short period, to minimise suppliers' exposure, while the moratorium must be overseen by a properly regulated, independent supervisor who has a primary commitment to creditors and suppliers whilst assisting the company during the moratorium.

93. R3 also notes that the October 2015 changes to essential supplies required a personal guarantee by the office holder in return for the continuation of supply on the same terms. It is not clear from the consultation proposals whether such a guarantee would still be required in

future, nor, in the case of the moratorium, who would be giving this guarantee. During the moratorium, R3 suggests that suppliers could ask directors for a personal guarantee that supplies will be paid for, provided the length of the moratorium is short. As R3 has argued before, the requirement for insolvency practitioners to offer a personal guarantee in exchange for the continuation of supply when they are an office holder makes business rescue more difficult to achieve.

DEVELOPING A FLEXIBLE RESTRUCTURING PLAN

General comments

94. R3 understands the political motivation to introduce the ability to 'cram down' creditors in a restructuring deal. Adding an extra feature to the UK's insolvency regime in terms of 'cram down' may see the UK rise in the World Bank rankings. R3 members believe that there may be a benefit of this feature in the UK insolvency toolkit and this extra tool might encourage restructuring. However, opinion on demand for the tool is split. Some insolvency practitioners believe that this restructuring tool would only be used in a very limited number of cases per year given that there will be a relatively small number of businesses which have such complex finance structures that the expense of going to court twice is warranted, whereas others believe that it may be used more widely. Importantly, this tool has the ability to be abused, particularly at an SME level. Therefore, R3 believes that this tool should only be introduced with a number of additional safeguards: either the establishment of a specialist insolvency court (as in the US) or that this tool should <u>not</u> be available to SMEs.

95. The consultation document and associated Impact Assessment points to CVAs as a restructuring tool but highlights the lack of successful CVAs. R3 believes that CVAs are a worthwhile tool and with some further development, could be more widely and successfully utilised. R3 encourages a review of the existing insolvency tools – specifically CVAs – to ensure that there is the ability to successfully restructure all businesses. CVAs are useful in terms of financial <u>and</u> operational restructurings ('cram down' in most instances just addresses financial-type restructurings where there are multiple classes of creditor) and their use should be developed further. At a time of huge economic and political uncertainty in light of the EU referendum, a review of the existing tools rather than introducing new ones may also be more appropriate for the UK's insolvency regime.

96. The proposed restructuring tool makes reference to using a 'liquidation basis' when establishing where the value 'breaks'. The realistic alternative to the restructuring tool is an administration rather than liquidation and the valuation should be based on this assumption instead.

How many businesses could use this tool per year?

97. In the short time available for R3 to discuss the proposals with its members and other stakeholders, including creditor groups and financial institutions, opinion on the likely uptake of the tool has been mixed. Some believe it may only be used in a handful of cases per year (especially if anti-abuse safeguards are introduced) and others believe there may be more demand, or that, even if little-used, the option of the restructuring tool may incentivise creditors to accept a consensual restructuring instead. R3 believes that this tool would only be used by large businesses with a degree of sophistication in the company's finances, for example those with multiple secured lenders, leasing and ABL agreements. There also may be a limited number of businesses per year who have a significant number of 'over-rented' properties where this tool could be useful. The costs and complications involved in the two-stage court process are significant and appear to be neither appropriate nor accessible (in terms of cost) for SMEs.

98. It should be noted that despite the fact that 'cram down' exists in the US, it is not often used as the process is very litigious. R3 accepts that simply having the option to use the tool may be a factor in achieving an entirely consensual restructuring.

What might be the impact on business rescue and the courts?

99. According to the findings of R3's June 2016 members' survey, the plurality of members (45%) believe that the new tool would neither hurt nor boost business rescue, with 29% of members stating that it would hurt business rescue in the UK but an almost equal proportion of members (26%) believe that it would boost business rescue in the UK. The possible introduction of this tool into the UK insolvency toolbox is clearly not met with universal enthusiasm from the insolvency profession in terms of the difference it could make to business rescue.

100. R3 believes that the proposed two-stage court hearings is appropriate for those large businesses which are seeking to restructure given the impact on creditors whose rights are being compromised, although this will be an added burden on an already over-burdened court system in the UK.

11. Would a restructuring plan including these provisions work better as a standalone procedure or as an extension of an existing procedure such as a CVA?

101. R3 believes that the proposed restructuring plan should be introduced as a standalone procedure.

12. Do you agree with the proposed requirements for making a restructuring plan universally binding in the face of dissention from creditors?

102. R3 appreciates the desire to introduce this type of restructuring plan in the UK and agrees that in a limited number of cases, the ability to make the plan universally binding in the face of dissension from creditors may be useful.

103. However, the introduction of a restructuring plan as proposed in the consultation document has consequences on creditor rights and returns to creditors.

104. In many respects, the proposal for a flexible restructuring tool is similar to a Scheme of Arrangement in terms of the identification of the classes of creditors and voting thresholds. However, a Scheme of Arrangement falls outside of the insolvency process whereas the proposed restructuring tool would become part of the insolvency tool-kit.

105. R3 asked members to comment on what impact the new tool could have on creditor rights. R3 members are clear that the proposed restructuring tool would be a very unreasonable or unreasonable interference with creditor rights, with 49% of members stating this view – as compared with 23% who believe that it is neither reasonable nor unreasonable and 28% who state that it is a very reasonable or reasonable interference with creditor rights.

106. We also asked R3 members to share their views on the potential impact on returns to creditors as a result of the introduction of the new restructuring tool. R3 members state that this tool would deliver worse or much worse returns to creditors (44% of members) as compared to 23% of members who believe that it would deliver better or much better returns. 33% felt that there would be no change.

107. The ability to 'cram down' has the most significant impact on secured lenders. This could have a potentially negative impact on the general business lending environment. Again, the potential drawbacks of introducing this tool should be carefully considered in the context of the potential benefits for a small number of businesses per year.

13. Do you consider the proposed safeguards, including the role of the court, to be sufficient protection for creditors?

108. R3 believes that the safeguards as proposed in the consultation are not sufficient protection for creditors.

109. R3 has worked with the Insolvency Service over a number of years to highlight the problem of 'ambulance chasing' firms who promise that they will act in the interests of the directors, rather than the creditors (and unlike qualified and regulated insolvency practitioners who are obliged to act in the interest of creditors). Such firms typically leave the creditors in a worse position, with the advisers themselves paid a hefty fee by the business. With the introduction of this new tool (with the safeguards as currently proposed), R3 can see the potential for a significant number of small and medium-sized businesses targeted by those firms, with the potential for increased business failure and creditors losing out.

110. The proposal as currently outlined would see the courts sanction the classes of creditors and the courts also taking a role to ensure that cram-down only takes place when 'it is fair and equitable and leaves impaired creditors no worse off than they would be in the case in liquidation'. R3 can anticipate a number of scenarios where the courts, especially at county court level, grants approval because a case meets the 'criteria' as stated above, wholly unaware that the use of the restructuring tool is wildly inappropriate for the size of business. This is where the benefit of a specialist insolvency court as per in the US comes in: these courts have the knowledge and expertise to ensure that the abuse as outlined would not be sanctioned. The UK courts currently do not have the knowledge or expertise to ensure that this 'rogues' charter' could not take place.

111. Therefore, R3 believes that either a specialist insolvency court should be introduced or this tool should not be available to small and medium-sized businesses.

14. Do you agree that there should be a minimum liquidation valuation basis included in the test for determining the fairness of a plan which is being crammed down onto dissenting classes?

112. Establishing the 'value' of a business in order to restructure is necessary but plagued with problems. Looking to the US where this tool is already in existence, there is a huge amount of litigation regarding value and the fairness of choosing to use current value or future value as the appropriate benchmark. As above, an 'administration' value may be the most appropriate benchmark as it is the likely alternative to the restructuring tool, although the administration outcome may be economically similar to what may be achieved in a liquidation. However, R3 does warn that should a 'minimum valuation' basis be introduced, there will be a significant amount of litigation on both the fairness of this measure and also on the valuation itself.

RESCUE FINANCE

General comments

113. R3 does not believe reforms to rescue finance are needed, particularly at a time of huge economic and political uncertainty and turmoil in light of the EU referendum outcome.

114. The government rightly points out in its consultation that the issue of rescue finance is complicated and any reforms will have risks, advantages, and disadvantages. Reforms to financing will always have an impact on the lending environment and wider economy and so the views of the financial institutions on the proposals should be carefully considered by the government. The government should work closely with the financial institutions to understand in detail the potential impact of the proposed options, not only to understand the impact on business rescue but also the wider impact on 'normal' business lending.

115. Unlike the US, the UK has not developed a sophisticated specialist rescue finance sector, primarily because rescue finance has typically been provided by the large existing lenders or sponsors. R3 believes that there is no shortage of rescue funding (if a business is viable there will always be rescue finance available) and that the current consensual approach between the lender(s) and existing secured creditor and/or sponsor providing rescue finance to ensure 'super-priority' works well.

116. Administrators also have the ability to borrow on a 'super-priority' basis if they negotiate with current lenders/stakeholders. Negotiation in both these areas helps to ensure a rescue deal maintains momentum and can progress. Any proposal that alters the ability to negotiate could stall a rescue deal and lead to litigation.

117. The government should also carefully consider the impact of changing the 'order of priority' on existing creditors, whose rights may be diluted under these proposals. If the rescue proposal is unsuccessful and rescue finance has 'super priority', unsecured creditors in particular are likely to receive even less than they currently do and so therefore see their rights eroded. This must be an even higher risk in SME situations where the abilities of general managers to effect change is inevitably less than specialist financial experts employed in larger businesses. The cost of lending to SMEs in such circumstances could be even higher than normal.

118. At the smaller end of the market, new sources of finance such as crowd funding and private equity could also provide rescue funding.

119. Any new rescue finance proposals introduced must also include safeguards for existing creditors to prevent any potential abuse, for example, preventing the charging of high exit fees.

15. Do you think in principle that rescue finance providers should, in certain circumstances, be granted security in priority existing charge holders, including those with the benefit of negative pledge clauses? Would this encourage business rescue?

120. Negative pledges are a key protection for lenders, and whilst trying to facilitate rescue finance it is important not to impair the availability of traditional finance.

16. How should charged property be valued to ensure protection for existing charge holders?

121. It is for professionally qualified and regulated valuers to comment on how this would be achieved.

122. An important point to note, however, is that unlike in the US, there is no court protection in the UK of valuations and so no safeguard for the lender.

123. The proposal could therefore lead to a significant amount of litigation which would in turn harm any prospect of business rescue.

124. R3 is also concerned that the proposals as currently drafted do not set out clearly the responsibilities of the insolvency practitioner who is expected to persuade the court that the requirements to obtain rescue finance through the above proposal have been met should it be challenged in court.

125. The insolvency practitioner is also expected to deal with any court applications in the event that disputes arise. R3 encourages the government to provide more detail on the role of the insolvency practitioner and to ensure that if they are given these new responsibilities that it comes with appropriate protections for the practitioner.

17. Which categories of payment should qualify for super-priority as ‘rescue finance’?

126. R3 does not believe the current system needs reform.

IMPACT ON SMEs

18. Are there any other specific measures for promoting SME recovery that should be considered?

127. R3 does not believe the government's proposals outlined in the consultation will significantly benefit SME recovery and as currently drafted actually have the potential to harm SMEs, both those in financial distress and their creditors.

128. As outlined throughout the consultation, R3 would like to see significantly more safeguards put in place around the proposals to prevent abuse of the proposals by unregulated advisers. The reliance on the court to protect creditors' rights is also not practical for SMEs who will simply not have the time or the money to be able to go to court.

129. The most effective way to rescue a business is to encourage it to seek advice as soon as it runs into financial distress. R3's January 2014 member survey found that 22% of R3 members who work on corporate insolvency say that it typically took businesses more than a year to contact them from the point at which they first showed signs of financial distress. The government should work with the insolvency profession, financial institutions and creditor community to seek ways to encourage directors to deal with financial issues at an early stage.

130. R3 would also encourage a review of the existing insolvency tools (specifically CVAs) rather than introduce new ones for SMEs, particularly at this time of huge economic certainty following the referendum. As a 'debtor in possession' tool that aims to rescue a business, a review of CVAs would sit within the government's objectives for the corporate insolvency framework.

131. In its Impact Assessment, the government says that CVAs are underused and limited in their functioning as they do not bind secured creditors. R3 does not believe the lack of binding secured creditors is the reason CVAs fail. As the government goes on to point out, a CVA can fail for a number of reasons such as unforeseen changes in the business environment and changes of opinion by directors/shareholders. R3 encourages the government to work with the insolvency profession and creditor community to find ways to improve CVAs so that they can become a much more effective business rescue tool for SMEs.