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Editor
Chris Laughton, Mercer & Hole

Editorial board
Will Black, R3
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Graham Rumney, R3
Michael Rutstein, Jones Day
Paul Williams, MCR Corporate Restructuring

Publishing manager Sarah Houghton
Tel: 01491 828939, sarah.houghton@groupgti.com

Advertising Brendan McGrath
Tel: 01491 826262, Fax: 01491 833146
brendan.mcgrath@groupgti.com

Art editor Thomas Gray

Administration Eva Faberova

Printed by Stephens & George

Forthcoming themes & advertising
www.r3.org.uk/recovery

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Tel: 020 7566 4200, association@r3.org.uk, www.r3.org.uk

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Editorial

Mr Justice Henderson recently gave two of the profession's regulators the opportunity to demonstrate that the current regulatory system is effective and fit for purpose. After appropriate investigation the regulators may or may not endorse his finding that there is a *prima facie* case of misconduct on the part of the administrators in the *Miss Sixty* case (while accepting that he had not had the opportunity to hear the administrators in reply). However, the regulators should, for the good of the profession as a whole, both respond and be seen to do so quickly, clearly and fairly. The alternative would risk insolvency regulation finding itself changing more radically than was suggested by the OFT.

The *Miss Sixty* case is said by some to be not only a victory for landlords but also curtailment of the alleged excesses of CVAs. It is nothing of the sort. CVAs are a valid and constructive restructuring and insolvency tool. Even the somewhat restricted technique of compromising guarantees, as long as it is not unfairly prejudicial, is judicially approved – as was acknowledged by Mr Justice Henderson. However, central to the proper and full use of the CVA process is the promotion by IPs who are experienced in acting as officers of the court of proposals that are fair.

Interestingly, Mr Justice Lewison's remarks in *Re Agrimarche Ltd* [2010] EWHC 1655 (Ch) suggest that the *ex parte James* principle (not to be dishonest, unfair or dishonourable) should also apply to liquidators in credits voluntary liquidations, at least where they follow administration. The time has probably come for IPs to maintain such a standard in all appointments, and to be seen to do so. Creditors and the public should have no reason to mistrust us.

Chris Laughton is editor of *RECOVERY* and a partner at Mercer & Hole.

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Can the euro survive and how can financial stability be achieved in the Eurozone?

Mark O'Sullivan maintains the currency crisis in Europe demands stringent measures to pull it back from the brink.

As we approach the release of the stress tests on the European banking system, the euro has enjoyed something of a rebound. Recently it has traded as low as €1.1780 against the US dollar before rebounding back towards €1.26. But a word of warning, this has more to do with concerns about a slowing US economy than the markets buying into a revival in the eurozone.

The cause of the crisis

In fact, the pressure on the single currency has not been the typical currency crisis that many have reported. The crisis has come about due to European governments losing credibility with not only the currency but, more importantly, the debt markets. It is the debt markets that have forced weak sovereign states to pay a higher rate of return both to borrow new capital and also to roll over their previous debt obligations.

> "The crisis has come about due to European governments losing credibility with not only the currency but, more importantly, the debt markets."

This has forced the European Central Bank (ECB) to put together its own €700 billion rescue package that, if called upon, would bail out euro members that could no longer raise funds in the open market. To put this into perspective, only three weeks before the €700 billion deal, a €30 billion rescue package to aid Greece was announced. Now we have a package that is 23 times bigger than that on the table. The rescue package has been put in place to safeguard the future of the euro as a currency as well as preventing any further risk of contagion with Spain and Portugal, which are most likely to be the next casualties of a monetary meltdown.

The rescue package created a backstop as the ECB became the lender of last resort, something it has fought hard to avoid. The cause of the crisis in the eurozone had been simmering since the currency's inception with the growth and stability pact, a key clause of entry to the single currency, flagrantly ignored by governments that had overspent and overborrowed.

What is needed now?

The onus now is for governments, especially those in southern Europe, to implement severe austerity measures and bring their deficits back in line with original entry requirements. This is a huge task and can only be achieved by cutting government spending and raising taxes. We have already seen the problems that the Greek government faced with civil unrest and a series of general strikes. Unless drastic action is taken (and the jury is still out as to whether the European governments have the stomach for that) the debt problem and the entire future of the euro as a single currency will be called into question.

The biggest single issue that still remains is the lack of fiscal union among member states. The eurozone will need to commit itself to full-blown fiscal union and proper political institutions that give binding macroeconomic instructions to member states for budgetary policy, financial and structural policies if it has any chance of surviving in its present form. Many doubt it can do this.

Immediate problems with the southern European states still remain and there exists the real potential of a debt default by a sovereign state. The Greeks look like they will have to restructure their debt obligations either by complete default, which is highly unlikely, or a 'haircut' where the amount they owe is trimmed.

Many people will be calling for at least a 30 per cent cut for it to have any real impact. Add to this the complex web of the European banking system where a huge proportion of Greek debt is held, not only by Greek banks but also French and German ones, and any haircut would have a knock-on effect. A complete default would be a disaster, all but ending the euro as a credible currency.

Can the politicians make the changes required?

The outcome of the European bank stress tests will probably raise more questions than it answers. The real future of the euro lies not with the currency markets but with the will of politicians to implement the tough measures needed.

> "The real future of the euro lies not with the currency markets but the will of politicians to implement the tough measures needed."

Ultimately it is unlikely that the euro will break up, but an examination of the members in five years' time is highly likely to reveal more than one country no longer participating. □

Mark O'Sullivan is director of dealing at Currencies Direct.

President's column

Steven Law feels the OFT's market study takes a balanced view of the industry but that the interpretation put on it by others is not always so.

So how was it for you? The Office of Fair Trading (OFT) delivered the results of its study on the market for corporate insolvency practitioners to mixed reaction from IPs, MPs and media. On the plus side, the OFT conceded that many areas are working well (self-regulation as a principle, fees in general, competition, potential conflicts of interest) but raised some concerns over their findings on engagement of unsecured creditors. To address this it has proposed the introduction of an independent complaints body with the ability to assess fees.

Overview of the report

Before addressing this let's step back and remember the OFT is not taking its market study into a second stage, nor suggesting a radical overhaul of the insolvency profession. Outcomes of any market study by the OFT can result in enforcement action by the OFT or a reference of the market to the Competition Commission. Given that the study at the outset looked at the issue of fees, competition among small- and larger-sized firms, and the appointment process, this is not that far off a clean bill of health. However, the interpretation from the OFT differs somewhat to ours; according to their own press release, they are recommending 'far-reaching reforms of the corporate insolvency regulatory regime to build trust in the market and ensure that it works in the best interests of creditors and the wider economy.' Disappointingly the new insolvency minister, Edward Davey, concluded: 'This important report confirms the criticism that insolvency practitioner fees can sometimes be unfairly high.' In fact, as was stated very clearly by the OFT during the presentation of their report, fees were not found to be too high.

Their main proposal, aimed at engaging unsecured creditors, is the creation of an industry funded, independent complaints' handling body with broad powers to review IP fees and actions, impose fines and return overcharged fees to creditors. It remains to be seen whether such an independent complaints' handling body would engage before or after complaints to Recognised Professional Bodies (RPBs). It would seem logical to position this body as a 'next destination' after complaints had been filtered through the RPBs and therefore excercise some sort of quality control. R3's own research, quoted in the OFT's report, shows that 72 per cent of IPs are in favour, in principle, of a single complaints' handling body. R3 hopes to work with the Department for Business, Innovation and Skills (BIS) on this.

Left to right: Andrew Selous MP, Lorely Burt MP, Paul Lewis of Radio 4's Moneybox, Natascha Engel MP and Steven Law, president of R3.

> "Given that the study at the outset looked at the issue of fees, competition among small- and larger-sized firms, and the appointment process, this is not that far off a clean bill of health."

We welcome the additional recommendation to reposition The Insolvency Service as regulator of the RPBs, which is its more important role, and withdraw from its role as a direct regulator of IPs.

Our considered response

We are currently gathering our response to the report. R3 has been pointing out to the media, for instance, that in the same Companies House data (a survey of 500 insolvencies) used by the OFT, that in 80 per cent of cases IPs were not paid in full and in seven per cent of cases, IPs did not receive any fee. On the day of the OFT reaching its conclusions, the *Financial Times* and *The Times* went for neutral comment, the *Daily Telegraph* went negative, but at least carried my own comments in a prominent position, while *The Independent* concluded that this was 'not a story'. Somewhere in the middle lies the truth!

IPs in the spotlight

IPs are understandably in the spotlight now. We all need constantly to remember that what we do and how this is viewed, evaluated and judged by those directly impacted, as well as by interested observers, inevitably reflects upon our industry, our firms and ourselves. Accordingly, where any question or challenge arises as to how we have exercised our powers then it must be quickly, openly and honestly investigated, and our actions explained. For those complaints that are referred to the regulators, we expect those investigating to deal with them expeditiously, fairly and proportionately. And where a sanction is deemed justified, to communicate that fact in sufficient detail to the individual IP, the complainant and other IPs to demonstrate that justice has been done and to act as a deterrent against similar behaviour.

Other key events

Another key event was the R3 Parliamentary panel and workshop event, entitled 'How is debt affecting your constituency?', which took place on 29 June 2010 in the House of Commons (see picture of panel above). There were 29 MPs at the event and a further 10 researchers, which is a very high turnout. The event was successful in engaging MPs with the work of practitioners, demonstrating IPs' expertise and raising awareness of the insolvency profession. Let's hope we can educate the new intake as to the important contribution our profession makes to the UK economy.

Finally, it was a delight for me to introduce the JIEB awards ceremony in June and meet the successful candidates (see page 6). These talented people are the future of our profession and from those I spoke to, I would say that it is in good hands. □

Steven Law is a partner at Ensors.

News update

Monitoring signs of corporate distress

Recent Begbies Traynor's Red Flag research indicates that the sectors most directly dependent on public sector spending include construction, IT, recruitment, advertising and business services. In these sectors alone, almost 52,000 companies were experiencing financial distress in the second quarter of 2010 before the full effects of fiscal tightening initiatives. In particular, construction and IT have shown a much lower rate of recovery than other sectors in Q2, showing year-on-year improvements of 17 per cent and 16 per cent respectively compared with an average improvement across all sectors of 31 per cent.

Other key findings include:

- The number of businesses facing financial distress has fallen by 21 per cent since Q1 2010.
- The £69.5 billion of liabilities at risk of default is up 26 per cent from £55 billion in Q1 2010.
- Average debts of troubled companies have risen 60 per cent to circa £545,000 in Q2 2010 (Q1 2010 – about £340,000).
- Outlook for corporate credit availability for Q2 2010 at its lowest level since the end of 2008.
- The levels of insolvencies are expected to rise again in H1 2011.

Meanwhile in Scotland, the number of companies going bust also continues to rise according to official figures issued by the Accountant in Bankruptcy. The data for April to June shows:

- A rise of 66 per cent compared with the same quarter last year.
- The total number of those being declared insolvent – either voluntarily or being forced out of business by creditors – has risen from 183 to 304.
- In the financial year from April 2009, there were 861 company insolvencies.
- 5,378 individual Scots were declared insolvent between the end of March and June, an increase on the previous quarter but a 15 per cent drop on the same time last year, which was a record high.

Double-dip recession threat

The risk that some of the world's major economies may fall back into recession is foremost among executives' concerns for the second half of 2010, according to new research from the Economist Intelligence Unit. When presented with a series of 11 potential risks to the economy over the next six months, almost one-third of the 680 respondents to a global survey point to double-dip recession as the biggest, ahead of sovereign debt default (20 per cent), market volatility (10 per cent) and weak governance (9 per cent).

The survey of 680 executives, representing a range of industries around the world, forms part of a major new research programme on risk, sponsored by ACE and KPMG, which will culminate in the 2010 Risk Summit in London on 18 November.

European bank stress tests

European bank stress tests were made public after the close of the markets on Friday 23 July. They revealed that only seven of the 91 European banks tested would fail to overcome a major economic shock. These were five Spanish *cajas*, or regional savings banks, Greece's ATE and Germany's Hypo Real Estate.

Regulators assessed how banks would stand up to a double-dip recession and a sovereign debt crisis (see page 35). But several analysts questioned whether the tests were tough enough as banks were only required to simulate losses on sovereign debt held for trading purposes and not on bonds they might hold to maturity.

Britain's four biggest banks, Barclays, HSBC, the bailed-out Royal Bank of Scotland and Lloyds Banking Group, comfortably passed the tests.

More than 100 banks in the US have now collapsed so far this year and another seven were taken over by regulators on the same day as the European stress tests were announced. With rising bad debts

tied to commercial and residential mortgages, the number of US bank failures this year is expected to exceed last year's figure of 140.

Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act, a federal statute in the United States, was signed into law on 21 July 2010. The Act is intended to address specific issues that contributed to the financial crisis and is heavily remedial in nature. However, it also embraces new approaches that seek to change some of the fundamental tenets of regulation in the United States as well as globally.

The Act is the most sweeping change to financial regulation in the US since the Great Depression and significantly reshapes financial regulation. It will create new regulators, regulate new markets, bring new firms into the regulatory arena and provide new rulemaking and enforcement powers to regulators.

Director disqualifications rise

The number of company directors facing disqualification has soared by 17 per cent over the last year. The jump has been largely fuelled by the recession causing directors to make detrimental business decisions in favour of personal interests and a notable rise in cases involving fraud.

According to City law firm Wedlake Bell, 2,169 directors of insolvent companies faced disqualification proceedings in the year to March, up 17 per cent from 1,852 the year before. The law firm said that, increasingly, multiple directors at the same company are facing banning orders because The Insolvency Service is finding more instances of collusion between directors. While 1,047 companies were targeted in the last year the number of directors facing a ban was more than twice as high at 2,169.

A growing number of directors also faced disqualification for underpaid tax, which resulted in 813 banning orders during the year. However, the number of directors banned for criminal matters including fraud and theft also rose by 52 per cent, with 265 disqualifications.

At the same time, The Insolvency Service is cutting 50 investigator roles, prompting fears that cost-cutting would make it easier for delinquent directors to escape scrutiny. R3 considers that company directors should not be able to get away with wrongdoing.

JIEB Awards

Jacqueline Parsons, winner of the IPA prize for first place and the ICAEW prize for the member with the highest marks, receives her prize from Carl Faulds, president of the IPA.

Around 100 of the successful 2009 JIEB candidates gathered at the BMA lecture theatre in London on 25 June to collect their certificates. Each graduate received their award from Les Cramp, deputy director general of The Insolvency Service.

Prize winners also received their gifts from the various prize sponsors. Jacqueline Parsons, Kevin Wall and Sarah Dickson are pictured here receiving their prizes. Unfortunately Caroline Leeds Ruby, winner of the Insolvency Lawyers Association Prize, and Annabel Allison, winner of both the PricewaterhouseCoopers prize for second place and the BBP prize for the candidate with the highest mark in the Personal paper, were not able to collect their prizes in person on the day.

JIEB chairman, Peter Windatt, gave the opening address, by congratulating the graduates and relating his own experience of sitting the exams. R3 president, Steven Law, closed the proceedings by thanking those who had supported the candidates through the difficult exams and recommending membership of R3 as a key means of progressing their careers further. Drinks and canapés were served in the garden.

Kevin Wall, winner of the Leonard Curtis prize for third place, receives his prize from Neil Bennett, Leonard Curtis.

Sarah Dickson, winner of the prize for the member of the ICAS with the highest mark, receives her prize from Murdoch McKillop, Institute of Chartered Accountants in Scotland.

Richard Turton Award

The Richard Turton Award is sponsored by four major insolvency organisations in recognition of the role played by Richard Turton in their formation. It provides the qualifying participant with an educational opportunity to attend the annual INSOL Europe Conference.

In recognition of those aspects in which Richard had a special interest, the award for 2010 was open to applicants who fulfilled all of the following requirements:

- work in and are a national of a developing or emerging nation;
- work in or be actively studying insolvency law and practice;
- be under 35 years of age at the date of the application;
- have sufficient command of spoken English to benefit from the conference technical programme.

Those applying for the award were invited to write a statement detailing why they should be chosen in less than 200 words. A panel representing the four associations adjudicated the applications. The panel members are: Stephen Adamson, INSOL Europe; Neil Cooper, INSOL International; Patricia Godfrey, R3; and Maurice Moses, the IPA.

The committee is delighted to announce that the winner is Maurycy Organa from Poland. Maurycy currently works for Kuzma, Organa and Partners. He studied English and European Union Law at the University of Cambridge and obtained his masters degree at the Faculty of Law and Administration of Adam Mickiewicz University in Poznan, Poland, in 2001. Maurycy is president of the board of Karbowski, Organa Insolvency Practitioners LLC and is the author of numerous professional publications. He is a founding member of the new Polish Chamber of Insolvency, a self-governing body of licensed insolvency practitioners, aimed at developing professional standards and best practice for licensed IPs in Poland.

As part of the award Maurycy is invited to attend the INSOL Europe conference in October in Vienna. The panel congratulates Maurycy on his excellent application and thank all the candidates who applied for the award this year. There were many excellent submissions and the judges' task was particularly difficult.

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Legal update: flipping the bankruptcy law

The extent to which the English court can (or will) apply foreign bankruptcy law is still up in the air, particularly where the foreign provisions are different from our own. Jennifer Marshall explores further, particularly in light of the recent *Perpetual* decisions.

Of all the burning issues in the field of cross-border insolvency law, one of the most interesting (and unsettled) is the ability of the English court to grant relief by applying provisions of foreign bankruptcy law (either directly or by giving effect to a foreign bankruptcy court judgment), particularly in circumstances where there are no directly analogous provisions of English insolvency law. While the answer to this question may be relatively straightforward in cases where Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings (the EC Insolvency Regulation) or section 426 of the Insolvency Act 1986 (section 426) applies, it has not yet been resolved in relation to the Cross-Border Insolvency Regulations 2006 (the CBIR).

The Court of Appeal has just considered this question in *Rubin* v. *Eurofinance SA*. Here, the English court was asked to recognise and give effect to a judgment of the US Bankruptcy Court concerning (among other things) fraudulent conveyances under US bankruptcy law. At first instance, the English court recognised the Chapter 11 proceedings but refused to give effect to the judgment ([2009] EWHC 2129). The Court of Appeal handed down its judgment on 30 July 2010, holding that the proceedings regarding the US clawback provisions should be recognised as part and parcel of the foreign main proceedings and, as a matter of common law (rather than pursuant to the CBIR), the judgment should be enforced in England. It was crucial to this decision, however, that there were analogous provisions of English insolvency law (ie those relating to transactions at an undervalue, preferences and transactions defrauding creditors). The English court is going to be faced with a more difficult task if and when it is asked to recognise the 'flip clause' decision of Judge Peck in the *Perpetual* case referred to below. Here, it is clear from contrasting decisions of the English and US courts that the relevant provisions of insolvency law are different.

This article considers what factors the English court should take into account if asked to apply foreign bankruptcy law, or to recognise a decision of a foreign bankruptcy court, in such circumstances.

Background

As a matter of English law, there are four routes by which the English court may recognise and give assistance to a foreign bankruptcy proceeding:

- **pursuant to the EC Insolvency Regulation** – this provides for automatic recognition, within the EU, of the judgment opening main proceeding and also expressly states that, subject to the commencement of any secondary proceedings, such judgment shall produce the same effects in any other Member State as it does in the so-called 'State of opening' (article 17(1)). Judgments deriving directly from the insolvency proceedings and that are closely linked to them also benefit from automatic recognition, even if they were handed down by another court (article 25(1)). In the context of jurisdiction to hear claims under the EC Insolvency Regulation (rather than recognition) the European Court of Justice (ECJ) gave guidance on what a closely related claim would be (Case 339/07, *Seagon* v. *Deko Martin Belgium NV*). Broadly, if the claim is one that only an insolvency office-holder can bring, then it will be closely connected to the insolvency proceedings. However, this only assists in relation to companies with their centres of main interest (CoMI) in the EU:
- **pursuant to section 426 of the Insolvency Act 1986** – following a request made by the court of a relevant country or territory, the English court is expressly authorised to apply either English insolvency law or the bankruptcy law of the requesting court in relation to comparable matters falling within its jurisdiction. Hence, there is no doubt that the English court can apply foreign bankruptcy law when granting relief under section 426. However, for section 426 to apply, the requesting court must be on the list of relevant countries or territories (sometimes referred to in jest as the 'cricket-playing nations'). This will not assist in relation to cross-border cases concerning the US Bankruptcy Court;
- **pursuant to the CBIR** – this is the main focus of this article and is discussed further below; and
- **at common law** – unfortunately the role of the common law in cases where the CBIR are capable of applying is unclear. This is also discussed below.

The approach of giving the English court a menu of cross-border provisions from which to choose in any particular case is very different from the approach that was taken in the US when implementing the UNCITRAL Model Law on Cross-Border Insolvency (the Model Law) via Chapter 15 of the US Bankruptcy Code. Rather than sitting side by side with the previous provisions for giving assistance to foreign bankruptcy proceedings (under section 304 of the US Bankruptcy Code), Chapter 15 is now the only route by which the US Bankruptcy Court can give assistance. This has the advantage of being clearer but it leads to less flexibility.

> "As a matter of English law, there are four routes by which the English court may recognise and give assistance to a foreign bankruptcy proceeding."

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Common law

The interplay between the common law and the statutory provisions referred to above (including the CBIR) is somewhat unclear following the decision in *Re HIH Casualty & General Insurance Ltd, sub nom McGrath* v. *Riddell* [2008] UKHL 21. The question before the court here was whether it could accede to an Australian request made pursuant to section 426 that the English provisional liquidators be directed to remit English assets to liquidators in the main Australian liquidation. It was accepted that the order of distribution differed under English and Australian law and that some creditors would do better than others depending on which system was adopted. While the House of Lords held unanimously that the assets should be remitted to Australia, their Lordships' reasoning for doing was fundamentally different.

> While the House of Lords held unanimously that the assets should be remitted to Australia, their Lordships' reasoning for doing was fundamentally different.

The approach taken by Lord Hoffmann was to adopt the common law principle of universalism. Referred to by his Lordship as the 'golden thread' of English cross-border insolvency law, the universalist approach requires English courts to co-operate with the courts in the country of the principal liquidation so that the assets of an insolvent company are distributed under one system, so long as to do so would not be inconsistent with English public policy or principles of justice and fairness. Lord Hoffmann held (and Lord Walker agreed) that the English courts had an inherent jurisdiction to authorise the remission of assets and that section 426 was more a reinforcement mechanism than the basis of the English court's ability to apply foreign bankruptcy law.

However, in Lord Scott's view (with which Lord Neuberger agreed), the source of the English court's discretion to order remission was only in the designation of Australia as a relevant country for the purposes of section 426. If the case had not concerned a relevant country, he would not have allowed the appeal. On this approach, the only basis on which an English court could apply foreign bankruptcy law would be under a statutory provision with there being no place for the common law.

Although *HIH* did not concern the CBIR, the same reasoning regarding the role of the common law ought to apply. Hence on Lord Hoffmann's approach, it would always be prudent for a foreign liquidator or representative to seek assistance under both the CBIR and the common law (assuming neither the EC Insolvency Regulation nor section 426 is relevant). This appears to be the view of the Court of Appeal in *Rubin*. Although the proceedings regarding the US clawback provisions were recognised as foreign main proceedings under the CBIR, the decision to enforce, in England, the judgment given in respect of those proceedings was made as a matter of common law. This is in contrast with Lord Scott's approach in *HIH* whereby the only means of applying foreign bankruptcy law would be under the CBIR. This leads to the question as to whether the CBIR allow the English court to do so.

The CBIR

The CBIR implement the Model Law into English law (or more accurately the law of Great Britain although this article focuses on English law). The Model Law is more modest in scope than the EC Insolvency Regulation, which concerns both jurisdiction to commence bankruptcy proceedings and choice of law as well as recognition. By contrast, under the Model Law, there are no restrictions on the ability to commence bankruptcy proceedings in the enacting State but instead it is about the recognition of foreign bankruptcy proceedings (which the court of the enacting State is required to do provided that certain requirements are satisfied). This begs the question as to what recognition actually means. In the view of the author, recognition of the foreign bankruptcy proceedings is not the same as recognition of all judgments handed down or orders made in those proceedings.

Paragraph 159 of the *Guide to Enactment* states that: 'the principle underlying the model law is that recognition of a foreign proceeding does not mean extending the effects of the foreign proceeding as they may be prescribed by the law of the foreign State. Instead, recognition of a foreign proceeding entails attaching to the foreign proceeding consequences envisaged by the law of the enacting State'. In other words, it is up to the enacting State to decide whether the relief granted on the recognition of foreign proceedings should be subject to domestic bankruptcy or insolvency law, foreign bankruptcy law or both. The question, therefore, is what did Great Britain decide when enacting the CBIR?

Upon recognition of either main or non-main proceedings, article 21 contains a non-exhaustive list of the appropriate relief that *may* be granted by the English court. This does not expressly include the application of foreign bankruptcy law (indeed, article 21(g) provides for any additional relief, which would be available to a *British* insolvency office-holder under the law of *Great Britain*). It is worth noting that initial drafts of the Model Law included a provision that would have expressly allowed the additional relief to include the application of foreign bankruptcy law but this was removed as it was felt unrealistic that courts would issue measures pursuant to the foreign law. However, as the list is not exhaustive, the question remains as to whether the application of foreign bankruptcy law would be appropriate relief for the purposes of article 21. This has not yet been decided by the courts.

> It is up to the enacting State to decide whether the relief granted on the recognition of foreign proceedings should be subject to domestic bankruptcy or insolvency law, foreign bankruptcy law or both.

The other provisions of the CBIR that may be relevant in this respect are articles 25 and 27. These provide that the court *may* co-operate to the maximum extent possible with foreign courts or foreign representatives by *any appropriate means*. The Model Law uses the word 'shall' in this context but a deliberate choice was made, on the part of those drafting the CBIR, to change this to a discretion. Thus, these provisions do not take the debate much further as it is still left to the English court to decide what is appropriate in the particular circumstances.

>>

The US experience

The US Bankruptcy Court has been prepared to apply foreign bankruptcy law under Chapter 15 of the US Bankruptcy Code. So in *Metcalfe & Mansfield Alternative Investments* (Case 09-16709), a Canadian plan of reorganisation was recognised and given effect in the US even in circumstances where it was not clear whether the Canadian provisions were consistent with US bankruptcy law. And in *Condor Insurance Limited* (Case 09-60192), it was held that the US Bankruptcy Court had the power to apply Nevis avoidance provisions following the recognition of insolvency proceedings pending in the Federation of Saint Kitts and Nevis.

However, there are key differences between the way in which the Model Law has been enacted in the US and Great Britain that may make these cases of limited relevance to the English court (see box below). Unlike the EC Insolvency Regulation (which is intended to have an autonomous meaning across the EU), it is the enacting legislation that is relevant in the case of the Model Law.

The *Perpetual* debate: a storm brewing

One of the most significant insolvency cross-border disputes arising out of the recent financial crisis is that in relation to the Lehman Brothers' 'flip clause' (see Legal Update, *RECOVERY* spring 2010). Very briefly, the case concerns a priority provision common in structured finance security agreements whereby the swap counterparty, Lehman Brothers Special Financing Inc (LBSF), was to be paid at the top of the waterfall but for its default (including its bankruptcy), but the noteholders were to be paid out first in the event of a default by the swap counterparty. All of the documents were governed by English law and the secured assets were located in England and Australia. The English Court of Appeal held that the clause was enforceable as a matter of English insolvency law (*Perpetual Trustee Co Ltd* v. *BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc* [2009] EWCA Civ 1160). In LBSF's Chapter 11 proceedings, Judge Peck held that the clause was an invalid *ipso facto* clause as a matter of US bankruptcy law and any action to enforce the provision would violate the automatic stay under the US Bankruptcy Code (*Bankr. S.D.N.Y.*, Case No. 09-01242). Both decisions are being, or are expected to be, appealed.

> "It is expected that, at some point, LBSF will seek recognition in England of Judge Peck's decision (or any decision of a higher US bankruptcy court) either pursuant to the CBIR or at the common law."

At the moment, there is no real conflict as each court was asked to apply its own law and the English court was not asked to give any substantive relief. However, it is expected that, at some point, LBSF will seek recognition in England of Judge Peck's decision (or any decision of a higher US bankruptcy court) either pursuant to the CBIR or at the common law. The LBSF Chapter 11 proceedings have already been recognised in England under the CBIR but, as stated above, that does not mean that all judgments handed down as part of those proceedings (including the US flip clause decision) must be recognised; instead, LBSF would need to seek specific relief in relation to the US judgment, either by asking the English court to recognise and give effect to the US judgment or by asking the court to apply US bankruptcy law. The key questions are:

- whether the English court would have the power to grant such relief (the gateway or jurisdiction question) – for the reasons given above, the answer to this question is far from clear under the CBIR and, while there does seem to be such a power at common law, it is not clear what role the common law still plays where the CBIR apply; and
- if it does have such a discretion, whether it would exercise it in this particular case – much as the author would advocate Lord Hoffmann's principle of universalism, the answer to this question must (in the author's view) be no. In circumstances where the documents are governed by English law, the secured assets are located in England and English insolvency law would result in a very different result, it must be pushing universalism too far to apply foreign bankruptcy law.

Conclusion

So where does all of this leave us? It is suggested that, in circumstances where there are substantially similar provisions of English insolvency law, it may well be appropriate to grant relief in the form of the application of foreign bankruptcy law or the recognition of a foreign bankruptcy judgment. This was the approach taken by the Court of Appeal in *Rubin* although it is interesting that the Court allowed the enforcement of the judgment as a matter of common law, rather than under the CBIR. However, where the analogous provisions of English insolvency law would lead to a very different result, the position must be different. The author will leave it to the courts to fight over whether this is a question of jurisdiction (ie a gateway issue) or one of discretion. □

Comparison between UK and US implementation of Model Law

Chapter 15

- 'Foreign proceedings' include proceedings relating to insolvency or adjustment of debt where assets and affairs of debtor are subject to control or supervision by foreign court.
- Automatic stay under art. 20 is very wide and prevents security enforcement, set-off, contractual notices etc (subject to safe-harbours).
- Co-operation provisions under art. 25 are mandatory (the court shall assist the foreign court / representative).

CBIR

- 'Foreign proceedings' must be proceedings relating to insolvency where assets and affairs of debtor are subject to control or supervision by foreign court.
- Automatic stay under art. 20 is limited to stay in English liquidation – does not prevent security enforcement, set-off, contractual notices etc.
- Co-operation provisions under art. 25 are discretionary (the court may assist the foreign court / representative).

Jennifer Marshall is a partner in the global restructuring group at Allen & Overy LLP.

Recent case summaries

Corporate and personal insolvency update from Ben Griffiths.

Personal insolvency

***Feldman* v. *Nissim* [2010] EWHC 1353 (Ch) (Richard Snowden QC)**

Facts Mr Nissim was a Rabbi who engaged in online spread betting on various stock exchange indices. Mr Feldman, who was about 20, made his living as a professional poker player. They met through a Jewish charity and, having a mutual interest in gambling, became friends.

They agreed that Mr Nissim would make spread bets on the Wall Street index on the basis that he would account to Mr Feldman for any profits made and Mr Feldman would indemnify him against any losses suffered. Two days later Mr Nissim informed Mr Feldman that bets placed for him had resulted in a net loss of £92,750. When the losses subsequently reached £140,000, Mr Feldman indicated that he no longer wished to continue with the venture and refused to reimburse Mr Nissim.

Mr Nissim served a statutory demand upon Mr Feldman demanding payment of £140,000 under the indemnity. Mr Feldman applied to have the statutory demand set aside.

Held Mr Feldman's application to set aside the statutory demand was dismissed. It was well established that a statutory demand would be set aside only where the debt is disputed on genuine grounds. There must be 'a genuine triable issue', or a 'real prospect' of the debtor successfully defending the creditor's claim or succeeding on a cross-claim.

As to Mr Feldman's argument that Mr Nissim had retrospectively allocated to him loss-making bets, the deputy judge held that there was no evidence to support such suspicions. Mr Feldman's argument that Mr Nissim had been negligent in his placing of the bets was rejected on the same basis. The deputy judge noted that Mr Feldman had failed to adduce any evidence that any duty of care owed to him had been breached or that he had suffered loss as a result. Although at trial such issues would require expert evidence, Mr Feldman 'ought at least to have produced some evidential basis for [his] suggestion rather than bare assertion'.

Comment *Feldman* v. *Nissim* serves as a reminder that it is not enough for a debtor who is served with a statutory demand simply to allege that liability is disputed or assert a cross-claim or set-off. The fact that the debtor's claim is hypothetically arguable is not sufficient. Rather, the debtor must adduce evidence in support of his or her case. Failure to do so will result in the statutory demand being upheld.

> "A creditor whose future debt to a company has been set-off in part against sums owing by the company remains liable to pay the balance of the future debt in full."

Corporate insolvency

***Re Kaupthing Singer and Friedlander Limited (in administration)* [2010] EWCA Civ 518 (CA)**

Facts The case raised a short but important point concerning the set-off, in a company administration, of future debts owed to a company by its creditors against debts owing by the company.

- Under r2.85 of the Insolvency Rules 1986, where an administrator proposes to make a distribution, an account is to be taken of what is due from each creditor to the company and vice versa. The sums due from the creditor are to be set off against the sums due from the company.
- If, on the taking of the account, a balance is owing to the company, such balance must be paid to the administrator except where the balance results from a prospective debt owed by the creditor, in which case the balance is to be paid if and when that debt becomes due and payable (r2.85(8)).
- Where a creditor has proved for a debt of which payment is not due at the date of the declaration of the dividend, he is entitled to dividend equally with the other creditors subject to the provisions of r2.105. In particular, r2.105(2) provides that for the purposes of dividend (and no other purpose) the amount of the creditor's admitted proof shall be reduced in accordance with the prescribed statutory formula.

The issue before the Court of Appeal was whether, once an account had been taken of sums owing to a company by a creditor and vice versa, the balance of any debt owing to the company was subsequently to be paid in full or was instead to be discounted under r2.105(2).

Held The Court of Appeal, reversing the decision of Norris J, held that the effect of r2.105 was merely to enable the calculation of what should be paid to the creditor by way of dividend and, for that purpose, the making of the insolvency set-off. It does not touch upon what remains due to the company after the insolvency set-off has taken place. This follows from the fact that r2.105(2) expressly provides that it applies 'for the purpose of dividend (and no other purpose)'. Therefore a creditor whose future debt to a company has been set-off in part against sums owing by the company remains liable to pay the balance of the future debt in full. Only that part of the debt that is, when reduced, to be set-off against sums owing by the company should be discounted.

Comment The *Kaupthing* case has real significance for debtors who owe future debts to companies. The effect of the decision at first instance was to release debtors from a substantial part of their indebtedness to the company even though this was not necessary to achieve a set-off of cross-claims. The Court of Appeal's decision, however, requires debtors to pay in full all future debts owing to the company save to the extent that such debts, when discounted, can be set-off against sums owing to them by the company. The Court of Appeal considered this approach to accord with 'a sound policy objective'. □

Ben Griffiths is a barrister at Erskine Chambers.

Technical update

Giles Frampton and John Francis outline the GTC's 'wish list' of legislative changes in response to The Insolvency Service's consultation document.

This is my first article as chairman of the General Technical Committee (GTC) and I should like to begin it by recording our thanks for all that Richard Heis has done for the committee over the last three years. Richard has wide insolvency expertise particularly in the banking and finance field and I am delighted that he has agreed to remain a member of the committee.

I do not envisage any changes to the operation of the committee – if it works, do not fix it! I would, however, take the opportunity to remind you that if you have an interesting technical issue please share it with the committee. We do not provide advice but sometimes we can point you to a statute, rule or some obscure document that may assist. In other cases, it may be that the technical issue is a new one of interest to members generally and requiring resolution. We cannot promise a solution in either event but we will do what we can to assist.

Legislative 'wish list'

In the last edition of *RECOVERY*, Richard Heis wrote about possible legislative changes set out in a consultation document from The Insolvency Service. In this quarter's article we thought it would be of interest to set out the additional suggestions made in the committee's reply.

Power of disclaimer for administrators

Firstly, we think it would be helpful for administrators to be given the power to disclaim onerous property or contracts in the same way as liquidators. This would be of assistance whatever the purpose of the proceedings.

Where the objective is the survival of the company, the ability to disclaim onerous property (as defined in section 178, Insolvency Act 1986) and to crystallise what would otherwise be an ongoing liability, could be a valuable aid to restoring financial viability.

> "We are very concerned that the principle that costs may be payable as an expense under rule 2.67, whether or not they are of benefit to the proceedings, may have an adverse effect on business rescue."

Where the objective is a sale of the business or assets, a disclaimer would allow the administrator to test the market properly without the threat of incurring 'necessary expenses' that bring no benefit to the proceedings. Recent case law, referred to in the next section, suggests that, following the introduction of the statutory administration expenses regime, the courts are moving away from an *Atlantic Computers* approach to expenses and towards a more rigid approach under which costs can be payable as a necessary expense, even where they bring no benefit to the proceedings.

Where the objective is to realise assets for a distribution to secured or preferential creditors and there are no funds for distribution to ordinary unsecured creditors, the threat of incurring 'necessary expenses' that bring no benefit to the proceedings remains. Disclaimer exercised by an administrator in such a case would bring closure.

Administration expenses

We are very concerned that the principle that costs may be payable as an expense under rule 2.67, whether or not they are of benefit to the proceedings, may have an adverse effect on business rescue. The recent cases of *Exeter City Council* v. *Bairstow* and *Goldacre Offices Ltd* v. *Nortel Networks UK Ltd* followed such an approach. In the *Exeter City Council* case, subsequent legislation removed the otherwise statutory requirement for an administrator to pay empty property rates but no attempt was made to alter the effect of rule 2.67 Insolvency Rules 1986. The perceived consequence of the latter case is that administrators may be faced with paying a full quarter's rent and even dilapidations, as an expense of the proceedings, whether or not actual occupation of the premises is relatively brief or partial. We suggested that an urgent review should be undertaken

of the existing legislation with the aim of re-establishing the principle that only costs that benefit the proceedings are payable as expenses of those proceedings.

Discharge of administrator

In a liquidation, the liquidator has his or her release if the creditors have not resolved against their release at the final meeting (sections 173(2)(e) and174(4)(d) Insolvency Act 1986). In an administration the committee or creditors have to approve the date of the administrator's discharge (paragraph 98(2)(b)). We think it would be desirable to make the administrator's release automatic when he or she vacates the office (subject to any extension of time that the court may have ordered).

More harmonisation from the EU?

Is there a need for harmonisation of insolvency law at an EU level? This is the question that has been occupying a committee set up by INSOL Europe at the request of the European Parliament's Committee on Legal Affairs (Legal Affairs resides within Policy Department C: Citizens' Rights and Constitutional Affairs). The committee has now published a 158-page 'note' setting out its findings. According to the abstract, the note 'identifies and outlines disparities between national insolvency laws, which can create obstacles, competitive advantages and/or disadvantages and difficulties for companies having cross-border activities or ownership within the EU.'

The committee carried out a comparative study of various aspects of the insolvency regimes of seven EU Member States: France, Germany, Italy, Poland, Spain, Sweden and the UK. The note does not address thorny issues such as security interests and the common law concept of trusts. It also acknowledges that insolvency law interfaces with many other laws and systems such as land, employment and contract laws and the court systems of each country, and comments that until these are all harmonised (which is surely unlikely in the near future), it will not be possible to harmonise all aspects of insolvency law. The committee, therefore, has serious reservations as to whether full harmonisation would be attainable at present, even if it were deemed possible, but considers that striving for harmonisation of certain aspects of insolvency law would seem to be worthwhile. The note identifies the following areas as apt for harmonisation:

- the rules on the opening of insolvency proceedings including the eligibility of the debtor;
- the rules on the filing and verification of claims;
- the rules on the responsibility for the proposal, verification, adoption, modification and contents of reorganisation plans;
- the rules on the voidness, voidability and unenforceability of detrimental acts;
- the rules on the termination of contracts and rules on the mandatory performance under contracts; and
- the rules on the liabilities of directors, shadow directors, shareholders, lenders and other parties involved with the debtor.

Furthermore, the note recommends that rules on the insolvency of groups of companies should be developed, and that a central database containing relevant court orders and judgments should be made available.

Areas where no harmonisation is required, or is not advisable, include:

- the extent of the stay on creditor actions;
- the management of the insolvency process;
- the scope of the insolvency estate and rules on disposal or sale of assets;
- ranking of creditors;
- post-commencement finance;
- qualification and eligibility to act as an insolvency practitioner.

It is not known how, or whether, these proposals will be taken forward, but it would be unwise to lose sight of them. Euro issues have a tendency to lie submerged beneath the radar for prolonged periods, and then bob up again unexpectedly. Any move towards harmonisation would mean further significant changes to the UK insolvency regime.

> "Confusion has remained about the form to be used for the submission of receipts and payments accounts in liquidations that began before 6 April 2010… the correct procedure is to submit the new form 4.68, suitably amended, and attach to it the content required by the old 4.68."

More forms confusion

Members will be aware that a number of forms, including the forms used for filing documents at Companies House, were revoked by the Insolvency (Amendment) Rules 2010. Forms for delivering information to Companies House have now been prescribed by the registrar under powers conferred by the Companies Act 2006, and they mainly follow the numbering system and format of the previous forms.

However, confusion has remained about the form to be used for the submission of receipts and payments accounts in liquidations that began before 6 April 2010, which is when the Amendment Rules came into effect. For these liquidations, the requirement to submit a statement of receipts and payments under section 192 and rule 4.223 still apply. Old form 4.68, which was used to submit the account to Companies House prior to 6 April 2010, sets out the prescribed particulars within the body of the form. However, that form has been revoked and replaced by a new form 4.68, specified by the registrar, which does not appear apt for submitting the old particulars as it is merely a cover sheet for attaching new-style progress reports. So which form should be used?

We have discussed this with The Insolvency Service, and their view is that the old form 4.68 cannot be used because it has been revoked and the transitional provisions do not allow its continued use, but that the particulars prescribed by the old form still apply. Therefore the correct procedure is to submit the new form 4.68, suitably amended, and attach to it the content required by the old 4.68. □

Technical Bulletin

Technical Bulletin 92 was issued in August. Its contents included:

- Forms for filing documents at Companies House
- ECLAIR
- Third Parties (Rights against Insurers) Act 2010
- Administration extension applications
- Repeated notices of intention to appoint administrator
- Administrators' appointment held to be invalid when made on wrong form
- Costs of dismissed winding-up petition payable as an administration expense
- Wrongful trading – recent case
- Courts Service not liable to trustee for administrative error
- Anti-deprivation principle and contractual indemnity
- Jurisdiction for determining ownership of asset
- Court orders disclosure of documents to foreign office-holder
- Transfer of undertakings – exemption for pre-packaged sale
- Protective awards – maximum award made where administrators failed to consult

Giles Frampton (left) is a partner at Richard J Smith & Co and John Francis is the technical director at R3.

Legal voice

Are you an R3 member? Could you write the Legal Q&A column? If you have advice you could usefully share with your fellow professionals please contact **Sarah Houghton** at GTI (**sarah.houghton@groupgti.com**).

The nature of advice given is general and neither *RECOVERY* nor the writer is responsible for any consequential loss arising in connection with information given in this publication.

Legal Q&A

Jonathan Koschland answers your insolvency queries.

I was recently appointed the administrator of a company out-of-court and carried out a large amount of work on the matter before the company entered administration. Am I entitled to recover my fees for this work as an expense of the administration even though they were incurred outside my appointment?

The short answer is you may be able to but it will depend on for what specific purpose the work was carried out and will also be subject to approval from the creditors' committee, creditors or the court.

The Insolvency (Amendment) Rules 2010 came into force in April this year and have opened the door for the automatic recovery of pre-appointment administration costs in out-of-court appointments.

The 2010 Rules apply to all administrations that commenced on or after 6 April 2010. Under the amended rule 2.33, pre-administration costs are defined as 'fees charged and expenses incurred by the administrator… before the company entered administration but with a view to its doing so'. Unfortunately for any solicitors instructed by the company or the directors, this definition restricts the fees and expenses recoverable to those incurred by the IP alone.

This definition does have a sting in its tail though. The fees must be incurred *with a view* to the company entering administration. This would appear to preclude general insolvency advice given to a company as to its options before the decision was taken to enter administration but will probably include the actual drafting of the statutory forms and other works specifically relating to the company entering administration. Fees and expenses incurred in negotiating a pre-pack may fall within the rule 2.33 definition but each case will need to be judged on its own merits.

In any event, approval of pre-appointment costs will always be needed from creditors or the courts. It is not clear how the courts will interpret the new provisions yet, although in the recent case of *Re Johnson Machine and Tool Company Limited* [2010] EWHC 582 (Ch) (a case decided under the previous rules) the court decided the administrator was not entitled to recover his pre-appointment fees as the pre-pack sale of the company was to a company connected to the existing management and there was no evidence that the costs incurred in negotiating the pre-pack were predominantly in creditors' best interests.

> "Pending further guidance from the courts, IPs should exercise caution when contemplating their entitlement to pre-appointment costs and expenses, particularly in relation to pre-pack administrations."

Pending further guidance from the courts, IPs should exercise caution when contemplating their entitlement to pre-appointment costs and expenses, particularly in relation to pre-pack administrations.

I am the trustee of a bankruptcy estate. Prior to the date of the bankruptcy order, the bankrupt obtained a season ticket loan from their employer, which the employer has continued to recover from the bankrupt's salary since the order. Should this be permitted? Would the position be any different if the loan were to have been described as an advance of salary?

Interest free or subsidised season ticket loans are becoming increasingly popular with employers and are being encouraged by government in an effort to reduce car use for journeys to and from work.

If the employer purchases the ticket on the employee's behalf then the arrangement can be regarded as a true loan. The arrangement is likely to be evidenced by a written agreement allowing the deductions, which will specifically describe the arrangement as a loan. Consequently the strict legal position is that the loan is a provable debt in the bankruptcy – that the bankrupt has no obligation to repay.

So, should the employer be permitted to recover the loan repayments from the bankrupt's salary? The bankrupt's salary is not property comprised within the bankruptcy estate and is not claimable unless you make an application under s310 of the Insolvency Act 1986 for an income payment order. In the absence of an order under s310 the bankrupt is free to apply their salary wherever they see fit, providing such payments are not voidable dispositions such as preferences under s340. However, if you are considering an application for an order under s310 then you may wish to challenge the validity of the deductions to maximise the amount available for all creditors. However, care should be taken to ensure that any confrontation with the employer does not jeopardise the bankrupt's employment or ability to travel to and from work, as this will clearly be detrimental to both the bankrupt and to creditors.

Would the position be different if the season ticket money was described as an advance of salary? This would certainly make it more difficult for you to dispute the deductions, as the employer will argue that the deductions are effectively a reflection of an agreement to pay the employee less each month, and not a loan. But whether you will need to avoid the deductions will depend on whether you are looking for an order under s310.

The overriding consideration would seem to be a pragmatic one. If the bankrupt fails to repay the season ticket loan this may possibly lead to the bankrupt's dismissal and it is surely better to have a bankrupt in gainful employment rather than not. □

Jonathan Koschland is head of corporate recovery at Judge Sykes Frixou.

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Tenant insolvency: current issues for landlords

Richard Anyamene examines the issues in this ongoing, thorny debate and suggests that both tenants and landlords can learn commercial lessons for the future.

Ask any real estate asset manager or property litigator what has been the most constant characteristic of the past two years and they are likely to say tenant insolvency. The first recession since the Enterprise Act 2002 revised insolvency procedure has been a wake up call, causing both expectations and property management practices to change.

While most landlords, insolvency practitioners (IPs) and their advisors have been forced to consider how to apply insolvency law in a practical context, there has been no explosion of court proceedings – with money scarce and litigation often difficult to jusify. Instead landlords have been forced to become more flexible and tactical in trying to preserve their real estate investments. Nevertheless, widely reported cases such as *Goldacre* and *Innovate* have been formative in shaping landlords' attitudes.

The position across England and Wales is not uniform with the retail rental market having been particularly hard hit, the City office sector enjoying more buoyancy and certain hot spots remaining almost unscathed by the downturn. But there are many common themes.

Company Voluntary Arrangements (CVAs)

The purpose of a CVA is to achieve a better outcome for creditors than pre-pack administrations. However, landlords remain sceptical of this approach.

For companies with multiple leases, a standard CVA proposal will involve compromising and ring fencing the claims of landlords of underperforming units. While the debts owed to ordinary creditors, such as suppliers, are crystallised on a company's insolvency (and they can decide whether or not to continue their relationship with it) many landlords feel that they miss out as contingent creditors.

> "Where there is an intention to assign a lease, the first issue is often whether the tenant is in arrears and can a landlord forfeit the lease as a result?"

The perception that a CVA somehow benefits other creditors and the company at the expense of landlords is heightened by the fact that often CVAs will provide for non-landlord creditors to be paid in full, and that under the Insolvency Rules the chairman of a creditors' meeting can value landlords' future claims for voting purposes at a level much lower than the future rent due.

However, the reality does not necessarily reflect this perception. For landlords with 'good leases' of units where the company proposes to continue trading, there is little purpose served by an IP proposing any term that prejudices them significantly, because prior to a CVA being voted in landlords are free to exercise any remedies available to them under the relevant lease, including forfeiture.

The decision is likely to be tougher for a landlord of an underperforming unit whose claim would be compromised significantly under a CVA, because if it takes this unit back, then it may not be able to re-let at all. But it by no means follows that it will be better off if the tenant is wound up. Further, under a CVA a landlord cannot be forced to forfeit or take a surrender of its lease. If premises are unlikely to be re-let, participating in a CVA may be preferable to taking back a unit and incurring liability for rates.

Editor recovery@r3.org.uk | Recruitment recovery@r3.org.uk/recruitment

Administration

The buzz word among most real estate investors and their professional advisors is *Goldacre*, a case decided in December last year. Although most legal analysts believe that the decision was wrong (in that it applied liquidation principles to liabilities such as those under a lease that pre-date administration), it has given renewed vigour to landlords who have previously felt fairly powerless in the face of the statutory protection afforded to tenants in administration.

The court broke new ground in finding that all liability incurred under the lease during the period of the administrator's occupation falls to be paid as an expense, even if he or she occupies only part of the demised premises. Therefore, if an administrator is in occupation on a quarter day, they are liable for the full quarter's rent whether or not he occupies for the whole quarter.

This places the administrator on the defensive. Disputes are now more likely to concern whether the premises have been vacated from a factual point of view. A prudent administrator will ensure that:

- keys or security passes have been sent, or at least offered, to a landlord;
- employees do not continue to use premises;
- any sub-occupiers are asked to pay rent or licence fees direct to the landlord; and
- any sums that have been received by the administrator are passed on.

Yet in practice it is debatable whether *Goldacre* will have any real effect where an administrator is organised, and communicates properly with a landlord. If a landlord is not prepared to be flexible its interests may be prejudiced along with those of the company's other creditors, since an administrator may well choose to vacate premises early rather than seeking to trade out. Given the choice of agreeing not to enforce *Goldacre* rights (and agreeing to accept a reduced rental figure or a monthly rent) and incurring a rental void, landlords with 'bad leases' have a very simple commercial decision to make.

With good leases, where there may be value for the administrator in assigning these on, it is doubtful whether he or she would seek a rental concession when to do so may well invite an application for leave to forfeit the lease.

Pre-packs and lease assignment

Pre-pack sales generally involve the assignment of good leases held by an insolvent tenant. They might bring an administrator into conflict with a landlord even before any steps are taken because, for profitable units, there is likely to be value for a landlord in taking the premises back and re-letting them. But the statutory protection for a company in administration restricts their ability to force the company to vacate.

Where there is an intention to assign a lease, the first issue is often whether the tenant is in arrears and can a landlord forfeit the lease as a result? Arrears that have accrued prior to the administrator's appointment are not recoverable as an expense of the administration. Yet the terms of any pre-pack sale agreement will not necessarily require the purchaser of the tenant's business to repay them.

A landlord wanting to forfeit a lease needs either to obtain permission from the administrator or leave of the court. Whether or not a court application will succeed will depend on the application of the guidelines set out in the Court of Appeal in *Re Atlantic Computer Systems Plc* in 1992, namely – is a landlord suffering significant loss as a result of the breach of covenant, and on the balance of the parties' interests would it suffer undue prejudice by being unable to obtain a forfeiture order?

In practice, if the lease is valuable and sufficient pressure is being brought to bear by a landlord, an administrator may well pay all or part of any existing arrears voluntarily, rather than inviting costly litigation.

What can alienate landlords further is that an administrator will often grant licences to a purchaser to occupy and trade from demised premises pending assignment. Allowing a third party into occupation will almost certainly be a breach of the alienation covenant in the relevant lease, and will again give a landlord the right to apply for leave to forfeit the lease (having served a statutory notice). Again, the guidelines in *Re Atlantic Computer Systems Plc* will apply, but since the decision in *Innovate* last year, landlords' advisors are considerably more wary about exercising their lease rights for tactical purposes.

In practice, the issue is likely to involve a question of fact and degree. Where a third party is allowed into occupation in breach of covenant, and either the administrator fails to pay rent or delays unreasonably in seeking a landlord's consent for any assignment and progressing this, then a court may well have less sympathy than it did for *Innovate*. A well advised landlord will wish to regularise the position as soon as possible, and applying pressure on an administrator is likely to result in an application for licence to assign being made quickly.

An assignment request will open up further issues. A commercial lease will almost certainly prevent an assignment taking place without the landlord's consent and, whether or not the lease provides expressly for this, statute intervenes to prevent a landlord from refusing consent unreasonably, or from delaying its decision.

However, the landlord is only required to consider a request made by the administrator, or with his express authority, and a valid request must contain full details of the proposed assignment, including details of any security to be provided if the purchaser/assignee does not have sufficient covenant strength or is newly constituted. There is no obligation at all on the landlord to accept any variation of the lease as a condition of assignment, and a landlord is only likely to do so if it is likely to face difficulties in re-letting the unit.

Conclusion

Despite *Goldacre*, the prevailing feeling among real estate investors is that insolvency procedures are often prejudicial to their specific interests as creditors, and curtail their ability to exercise their contractual rights as landlords. As a lawyer, my view is that it is the market itself, rather than any insolvency legislation, that produces this result. Where a party owns a solid investment, it is much more likely than not that its rental income and investment value will remain unaffected. Where landlords' proprietary interests are prejudiced, they are entitled to use due legal process to try to avoid this, and there are a number of ways in which well advised landlords can seek to put pressure on IPs and administrators to achieve the results they want. When the UK commercial real estate sector emerges from recession and demand for property increases, the balance of power will undoubtedly shift back towards landlords. However, it is widely predicted by investors that the issues with which the industry has had to contend during the downturn will have led to greater commercial awareness and lines of communication between landlords and tenants, and that it will as a result emerge fitter and stronger. □

"Where landlords' proprietary interests are prejudiced, they are entitled to use due legal process to try to avoid this, and there are a number of ways in which well advised landlords can seek to put pressure on IPs and administrators to achieve the results they want."

Richard Anyamene is a partner at Jones Day.

Real estate workouts: the agency perspective

The amount of debt carried by the real estate sector is almost at an all-time high. Ben Moon examines the current circumstances, reflects on past property recessions and suggests some ways forward.

How should banks go about reducing their massive exposure to commercial and residential property markets in the face of continuingly difficult market conditions? A challenge made even greater as we enter a new age of austerity intended to tackle the nation's unprecedented budget deficit.

By all normal measures the outlook for the UK property market is poor with weakening tenant demand and the prospects of increasing costs of finance as interest rate rises are now on the horizon. With most areas of government facing huge cuts in expenditure and tax increases squeezing the pips of the consumer economy, occupier demand is likely to weaken. At the same time, investors face the ever increasing prospects of interest rate rises within less than 12 months designed to dampen inflationary pressures.

This article looks at the size of the challenge ahead, considers what lessons can be learned from previous property recessions, the response of the banks to date and highlights some innovative solutions that might be adopted by the recovery and restructuring profession to assist the banks in dealing with their distressed property debt.

How big is the problem?

Banks' exposure to the UK commercial property market has been well chronicled over recent years with the widely respected De Montfort survey suggesting that total bank lending to commercial properties stands at between £290 billion and £304 billion.

The Bank of England's own statistics indicate that the amount of debt carried by the real estate sector peaked at £253.7 billion in Q2 2009. While this exposure had been reduced to £251.3 billion by the end of Q1 2010, the sector's overall level of indebtedness remains at unsustainably high levels.

The greatest levels of exposure sit within a handful of UK banks that have spent much of the past two years establishing the internal structures and recruiting or reassigning personnel to their distressed debt or work-out teams. In addition to the massive balance sheet exposure there are also large tranches of commercial mortgage-backed securities (CMBS) debt that require restructuring as they mature.

As large tranches of CMBS stock mature there is a danger of property flooding the market. This is because CMBS loans are difficult and expensive to restructure so forced sales are more likely.

> "The Bank of England's own statistics indicate that the amount of debt carried by the real estate sector peaked at £253.7 billion in Q2 2009."

A-note bondholders will seek full repayment on maturity of their loan agreements, while B- and C-note bondholders with little to lose will try to recoup some of their losses by holding onto their bonds for longer, in the hope that values continue to rise.

> "NAMA has already outlined that exiting from positions held within commercial property will be a major part of its strategy going forward."

This may result in conflict between the parties and might prove difficult to unravel as different classes of note-holder litigate to protect their respective positions. There is also uncertainty on how CMBS loans will be refinanced going forward. The De Montfort lending survey shows that £2.4 billion worth of CMBS loans will need to be refinanced in 2010 alone. In 2012, the amount will peak at £5.5 billion.

Learning from the past

Each of the past three property cycles has its own unique characteristics, but some of the events that took place in the cycles of the 1970s and 1990s have similarities to the current downturn (see Commercial property performance graph).

The property boom of the early 1980s resulted in a rise in development activity that was assisted by the low interest rates of the time. Bank lending to the commercial property sector increased with fierce competition squeezing margins from two to three per cent above LIBOR (London Interbank Offered Rate) in 1984 to one per cent above LIBOR in 1987. However, banks were moving this lending off their balance sheets and disguising the real amount of lending that was taking place.

The boom fuelled a development pipeline that caused a huge oversupply, with vacancy rates for offices in the City of London hitting 20 per cent towards the end of 1989.

However, the banking system proved to be much more resilient than in the 1970s as the loans were predominantly made by large diverse banks that were not over-exposed to property. This time the banks could afford to call in their loans and, while there was a sharp fall in property values, yields rose substantially, attracting pension funds and institutional investors back to the market.

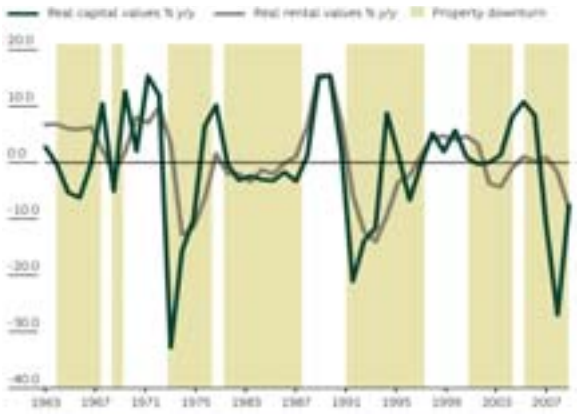
With major government intervention, the restructuring of lenders due to their significant commercial property exposure and banks acquiring assets that they had originally taken as security, we have once again seen history repeat itself.

In the 1970s and 1990s banks dumped assets onto the market and made losses. The flood of property released onto the market reduced values and caused a rush of interest from institutional investors in the 1970s and overseas investors in the 1990s. However, this time round, given the sheer size of their property exposure, banks have been unable to fully realise their losses.

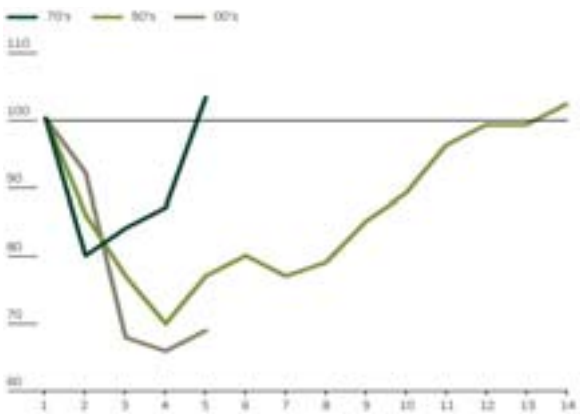
A return to pre-boom values?

After the 1990s recession it took 11 years for property to return to the pre-recession peak and 13 years to exceed it. This time the drop was more severe with a 44 per cent

Commercial property performance since 1963 (% per annum)



Years taken for capital values to recover (index)



drop in values over two years and, despite some early positivity, the market may take much longer to recover (see Capital values graph).

In a worst case scenario of low inflation and low economic growth keeping rents down, values could take until 2025 to get back to the peak values of mid-2007. Of course there will be some sectors that recover faster, such as central London, but when looking across the whole market there is a long road to recovery ahead.

Looking to the future

There are a large number of external factors that will impact on the path to recovery.

The global economy will have a major effect on the pace of the recovery of UK commercial property, with the sovereign debt crisis threatening the recovery of many Eurozone countries. While the UK has the advantage of not being part of the euro, the problems in those countries will affect our own recovery.

The requirement for funds to be repatriated by overseas lenders to deal with economic issues in individual countries will influence the timing of the disposal of assets in the UK. This could lead to a large volume of distressed stock entering the UK market, causing a further depression in values. NAMA, the National Asset Management Agency, set up by the Irish government, has already outlined that exiting from positions held within commercial property will be a major part of its strategy going forward. Additionally, the public sector cuts being made by the UK government will also lead to additional stock entering the market, further exacerbating the situation.

Choosing the correct path

A mass release of property should be avoided since this approach caused values to drop sharply in the 1990s and would do the same today. This time round the banks have far greater exposure to property and could not afford to take the losses. To avoid further shocks to the market properties should be released gradually, with banks taking a long-term view on some and asset managing others.

The recent rises in property values have been focused on the prime end of the market. The secondary and tertiary sectors have suffered from a lack of growth, which is problematic for the banks as these properties will account for large portions of their loan books. While these types of assets are seen as being less attractive by investors, banks will be able gradually to move some of their secondary stock out of their loan books by packaging a mix of prime and secondary into portfolios and releasing them to the market in an orderly manner.

Active asset management

Using experienced recovery professionals including insolvency practitioners, surveying firms and property companies, banks can actively asset manage distressed properties to enhance both income and capital value through the development and implementation of property strategies. This could involve raising the receivable income, reduction of liabilities, re-gearing leases or enhancing the value of the asset through change of use.

On behalf of Lloyds Banking Group, BNP Paribas Real Estate, working in conjunction with Exemplar Developments as development manager and Addleshaw Goddard as legal advisors, recently secured a considerably enhanced planning consent for the Goodman's Field development scheme at Aldgate, close to the City of London.

Goodman's Fields is a seven-acre site previously occupied by Natwest and the Royal Bank of Scotland. The proposed scheme will include over 750 homes, a new health centre, a 337-bed hotel, 660 student apartments, retail space, a restaurant and office/studio space along with an extensive new public open space. By working closely as an asset management team over a number of months a workout strategy was formulated prior to its implementation once a formal insolvency process began. The value of the property was significantly improved.

While it might not be viable for banks to fund asset management on smaller properties, there is an opportunity to work with housing developers on distressed residential schemes. In some cases banks effectively own these properties already and they could use the developers to manage out the schemes through planning, S106 and viability.

Many banks have already begun to manage their core and non-core relationship differently. Banks are focusing on retaining their core experienced borrowers and building relationships with them going forward. While increased financial pressure on the borrower may lead to core borrowers missing payments it will be important for banks to work with them to develop an asset management strategy. This approach will foster a more robust property market with a lower risk profile for the lenders.

> "While it might not be viable for banks to fund asset management on smaller properties, there is an opportunity to work with housing developers on distressed residential schemes."

The insolvency profession has an important role to play working alongside experienced real estate advisors and property companies implementing realistic asset management strategies on behalf of banks seeking to reduce their exposure to the UK property market. □

Ben Moon is a senior director of the Recovery & Restructuring Department at BNP Paribas Real Estate.

Where is all the distressed property?

Edmund O'Kelly believes that this property recession is completely different from the last two; loan defaults are being managed intensively and the lack of distressed property coming on to the market is noticeable.

In the last 18 months, numerous property funds were set up to target the expected flood of distressed sales coming to market in the expectation that banks would foreclose and seek to sell property out of insolvency. According to *Estates Gazette*, it is estimated that 35 funds were set up with a target fundraising of £20 billion. In the end, £12 billion of funds were committed but, more importantly, less than £2 billion of investment purchases have actually been invested. Inevitably, some funds axed their fundraisings after conceding that they had missed the rapid rally, kicked off by London & Stamford buying Denton Wilde Sapte's HQ at Fleet Place in the City at circa 7.5 per cent yield in December 2009.

Funds were also fuelled by the rapid turnaround in property values, which have recovered from the initial 45 per cent fall from their mid 2007 peak in the immediate aftermath of the credit crisis. The recovery is still happening with prime yields in the City of London typically around 5 per cent and the West End just under 5 per cent. A lot of these opportunistic funds have missed the boat to capitalise on the rally in property values.

We can certainly understand the motivation of property funds with total returns year to May showing at 25.3 per cent, compared with equities at 22.9 per cent and gilts at 5.2 per cent. Most of these property deals were in the prime sector with investors chasing limited and selected stock with an abundance of equity thus driving the price up.

The Investment Property Forum estimates property returns of 15.3 per cent for 2010; 6.0 per cent for 2011 and 9.5 per cent for 2012 so growth is still expected, but where is the stock?

Anyone with prime real estate stock was right to hold off selling in the early days of this downturn. Those wise not to sell included the banks holding quality stock. Unfortunately double-digit returns have only been seen in the prime market and a substantial volume of distressed assets are non-prime.

> "Target modelling by CBRE on lending to the sector estimates that almost £80 billion of debt is secured on poor quality property, representing 27 per cent of debt."

'Til debt do us part – who controls distressed property?

By and large, most commercial property is purchased with debt. Once the debt covenants are breached (not least by falling values or tenant defaults) the lender needs to decide what action to take.

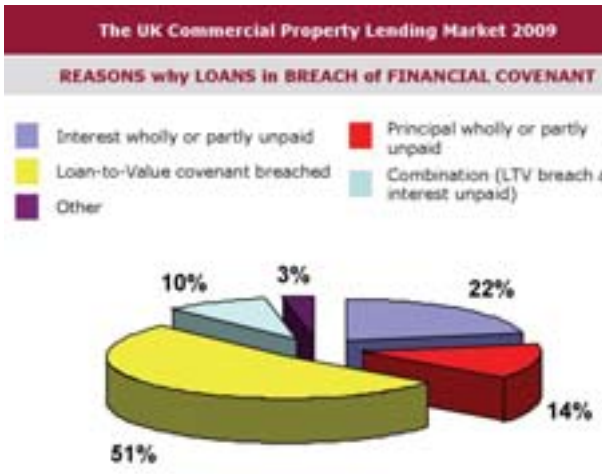
It is interesting to consider the potential scale of distressed property in the UK market. DeMontfort University's latest survey estimates that outstanding debt to UK commercial property is approaching £250 billion, while commercial mortgage backed securities (CMBS) in the UK have an outstanding debt of around £50 billion (approximately 50 per cent of European CMBS). DeMontfort estimates that £120 billion, almost 50 per cent of UK commercial property debt, matures at the end of 2012. This is a market that will have lower loan to value ratios, higher bank margins and fees, and a reduced lender pool. Furthermore 71 per cent of outstanding debt needs to be refinanced within five years. DeMontfort estimates that approximately £50 billion is already in default. The crunch for CMBS will be in 2014 when loan maturities and legal final maturities converge.

CBRE has undertaken some targeted modelling on lending to the sector and has estimated that almost £80 billion of debt is secured on poor quality property, representing 27 per cent of debt. This indeed is a shocking number and indicates the challenge presented in managing assets to improve value; the alternative is that these loans will struggle to get refinanced and could easily fall under an enforcement process. The full impact of refinanced loan maturities has yet to hit the market, particularly for inferior assets. Against this background the DeMontfort survey found that 56 per cent of lenders indicate a willingness to increase exposure to the property sector.

As borrowers struggle to refinance loans and banks are in no hurry to enforce it is just a matter of time before this strategy comes under threat. A great number of loans cannot be refinanced. Some banks will be forced to reduce their real estate loan books in order to comply with their regulatory capital requirements under Basel III. Sooner or later something has to give.

For better for worse – what is happening to distressed property?

Much distressed property is still in the hands of the original borrowers. However, a new trend is starting to develop as borrowers either walk away from the asset or the bank, having lost confidence in the borrower, calls in a specialist asset manager. One such example is the case of Cordatus being appointed to manage some of the Castlemore assets in a ground breaking innovative deal structure. A similar innovative deal is Great Portland Estates joint venture acquisition and debt restructure on Marcol House Regent Street with Eurohypo and Istithmar. Other banks are setting up special purpose vehicles to hold these assets and work them through.



Graphs supplied courtesy of the Department of Corporate Development, De Montfort University.

Notably Lloyds has set up a special vehicle to hold such assets. This is in addition to RBS's West Register that was set up in the last recession and is still taking on new distressed property. Other banks and lending institutions are looking at similar options and are well advanced in seeking board approval for setting up such vehicles.

To take this a stage further, the Irish Government set up NAMA for the Irish banks to transfer certain toxic property loans amounting to €81 billion into a workout vehicle at 50 per cent discount to face value. It is envisaged that this workout process could easily take at least ten years to work through.

Why are banks not calling loans in?

The banks recognised early on that, given the scale of distress in the property sector, it would be adverse to their interests to call in loans and flood the market with property, and thereby create (or exacerbate) the very downward pressure on prices that would increase their potential losses. Furthermore, as many distressed loans had interest rates hedge swaps, the cost of breaking these swaps would have been a heavy additional loss for the banks. There was little incentive to call in such loans, and they have been seeking alternative ways of preserving value and minimising losses.

Where next?

Banks cannot hold onto commercial property loans indefinitely. The recent Financial Stability Report from the Bank of England has stated that UK banks will need to refinance or replace around £750 billion worth of all commercial term loans and liquid assets by the end of 2012. Commercial property will require £120 billion to be refinanced by the end of 2012. If banks become unwilling or unable to refinance this exposure as they seek to strengthen their own balance sheets, this could trigger a round of foreclosures resulting in a renewed fall in prices.

The G20 Summit in Toronto agreed plans requiring the UK banks permanently to set aside up to £130 billion on their balance sheets to withstand seismic shocks, similar to that experienced in the aftermath of the collapse of Lehman Brothers. The previous Basel I and II required the banks to hold 8 per cent of safe capital, largely comprised of equity. The new ruling will act like a throttle restrictor, limiting the speed with which banks can lend and grow. Basel III is due to be ratified at the G20 meeting in November, with implementation to start 2012. There is speculation that this timetable might be deferred if undue market stress is likely to be caused.

Those assets that are transferred into workout vehicles could remain in such structures for at least five years or more as the hoped for recovery takes hold. Some banks appear to have started their disposal programme with the sale of the Cumberland Hotel in London to London & Regional/Starwood for £215 million and Lazards appointment to sell a £3 billion real estate loan book. Maybe the first to market will be sure to capture the appetite and funds that currently exist.

There is unlikely to be a surge of enforcements in distressed property. Banks have been right in not enforcing on distressed property and have enjoyed some price improvements on selected assets with prices improving significantly for prime assets.

> "Distressed property assets will be off-loaded onto the market or workout vehicles eventually. It may take more than a year before assets are offered into the marketplace, probably more than two."

The refinancing of commercial property is a ticking time bomb and nobody knows how much time is remaining. Banks have not flooded the market with forced sales but this could just be storing up a bigger problem for the future. In order to address the huge upcoming refinancings and to comply with Basel III, banks will have to deleverage their balance sheets and this will inevitably lead to off-loading property consensually or non-consensually. Properties will ultimately have to be put on to the market. As property debt will still be scarce, equity will have to play a big part. The pool of equity that is hunting for deals is not a bottomless pit and will be focused on prime assets.

Life after debt – time supposedly heals but does it?

Distressed property assets will be off-loaded onto the market or workout vehicles eventually. It may take more than a year before assets are offered into the marketplace, probably more than two.

The key to successful exit from unwanted exposure to commercial property is to asset manage intensively to maximise returns, sell selectively and tap into current buying appetite. Importantly, the equity in the marketplace should not be ignored; it will not last for ever. The banks' orderly exit from commercial property is likely to last for at least the next five years and possibly much longer. Time will go some way to healing the pain but will lessons have been learned? □

Edmund O'Kelly is director in real estate restructuring at KMPG.

Receivers and administrators: historic contamination

Claire Sheppard examines the liability to remediate contaminated sites and what this means for receivers and administrators.

As a receiver or administrator, green issues may be the last thing on your mind when doing your job. However, historic contamination risks in the context of an appointment should not be overlooked.

This article focuses on historically contaminated land, which includes associated water pollution. Liability to remediate contamination can arise from on-site risks or because of risks to off-site receptors, such as watercourses, protected habitats, crops or property. These can arise from past, ongoing or threatened migration of contaminants from a site. Liability can also arise for damages where harm is caused to third parties or their property by contamination.

Whether or not a receiver or administrator is at risk of personal liability for contamination will depend on the particular circumstances, but insolvency practitioners need to be aware of contamination risks.

Environmental Protection Act

The main statutory liability for historically contaminated land arises under part 2A of the Environmental Protection Act 1990. This imposes liability for remediation on:

- Class A persons being persons who caused or knowingly permitted the presence of the relevant contaminating substances.
- If such Class A persons cannot be found, then Class B persons, being the current owner or occupier for the time being.

As office-holders act as agents of the company, the starting point is that they ought not to incur personal liability. However, if their acts or omissions 'cross the line' they could be personally liable.

Part 2A provides that an insolvency practitioner, of the types specified in the legislation, acting in their capacity as such shall not be personally liable unless the remedial action necessary 'is as a result of any act done or omission by him which was unreasonable for a person acting in that capacity to do or make'. Similarly they will not be guilty of a criminal offence for failing to comply with a remediation notice.

Office-holders

The office-holders benefiting from this provision include a person acting as an IP, within the meaning of section 388 of the Insolvency Act 1986; for example liquidator, provisional liquidator, trustee in bankruptcy, administrator, administrative receiver or nominee/supervisor of a CVA and a person acting as a receiver or receiver and manager, whether acting under statute, court order or an appointment. Although the purpose of this provision is to afford some protection from liability, the logical consequence is that it is envisaged that in some circumstances an office-holder can incur personal remediation liabilities. The ambit of the protection is not clear. However, a regulatory authority might argue that an office-holder should be personally liable where, for example, there is contamination causing significant ongoing damage to the environment or posing a severe risk to human health and they do not take minimum steps to control it.

> "When accepting an appointment over potentially contaminated or industrial sites the prudent IP should evaluate the risks and consider obtaining an indemnity from their appointor."

Evaluation

When accepting an appointment over potentially contaminated or industrial sites, the prudent IP should evaluate the risks and consider obtaining an indemnity from their appointor. Alternatively, when dealing with a portfolio of sites, a receiver could seek to exclude the high-risk sites from their appointment. Also, they need to be aware that environmental liabilities can exceed the value of the assets to which they relate.

For receivers there is the risk that the borrower goes into liquidation, at which stage, the receiver's agency will terminate and they will then be acting as principal. If they have not previously obtained an indemnity from their appointor, they should seek to agree one at that stage.

An administrator should also consider what protections they may need. Unlike a receiver, they will not be able to pick and choose which sites are covered by the appointment and any liability for remediation that arises will either be an administration expense or a personal liability for which they will want indemnity cover.

Office-holders should also ask third-party purchasers to provide a contaminated land indemnity to cover the risk of the office-holder incurring personal liability in relation to properties that are being sold.

Criminal liability

Contaminated land situations can potentially give rise to criminal liabilities, for example where the condition of the land causes water pollution a criminal offence may be triggered. The relevant legislation contains no express provisions dealing with the responsibility of IPs. Accordingly, a receiver or administrator needs to consider the extent to which their actions or omissions will involve the company in committing or continuing to commit a criminal offence. An officer of a company, which includes a manager and a person purporting to act in such a capacity, may also incur criminal liability where the offence committed by the company involved their consent, assurance or neglect. It is possible in situations where an office-holder was actively involved in a polluting incident that a regulator may seek to impose personal liability on the office-holder.

This short piece has focused on the part 2A regime for historically contaminated land (ie where the office-holder inherits an existing situation). It does not address the new risks arising from pollution or breaches of law arising during the course of an appointment. Many other types of environmental issues can arise in relation to different businesses and sectors. The control of pollution from current industrial processes is regulated under other legislation and in some cases under environmental permits, which may contain extensive compliance and improvement obligations. □

Claire Sheppard is a partner at Addleshaw Goddard LLP.

Home Owner and Debtor Protection (Scotland) Act 2010

Changes to Scottish law will come into force at the end of September. These are intended to protect homeowners but practitioners should be careful as they could be caught out.

What is the Act?

The Home Owner and Debtor Protection (Scotland) Act 2010 (the Act) is one of the fastest pieces of legislation to have been drafted, scrutinised and passed by the Scottish government. It is a response to the economic downturn, with the policy aim of ensuring that borrowers are protected from repossession where possible. It brings the protections available to Scottish homeowners in line with those afforded by the voluntary pre-action protocol in England and Wales. However, the Act goes further than the pre-action protocol as it is mandatory. It received Royal Assent on 18 March 2010 and will come into force on 30 September this year.

> "It is apparent that the Act will mean that banks will need to pay careful attention to their commercial approach and process management (especially record keeping standards) when handling distressed residential property connections in Scotland."

It is apparent that the Act will mean that banks will need to pay careful attention to their commercial approach and process management (especially record keeping standards) when handling distressed residential property connections in Scotland.

What does it do?

The Act affects standard securities (the means by which security is taken over land in Scotland).

The major difference made by the Act is that it will no longer be possible for a secured creditor to (i) sell or (ii) enter into possession of a property and recover rent where the property is used to any extent for residential purposes unless:

- there is voluntary surrender of the property; or
- an order from the court on an application under section 24 of the Conveyancing and Feudal Reform (Scotland) Act 1970 (the 1970 Act).

At present, if a property is unoccupied, a secured creditor can serve a calling up notice and, on the expiry of the two-month calling up period, change the locks and market the property for sale (ie in many cases under the current regime a secured creditor does not need to instruct court action to recover possession). It is only when the debtor is in occupation that court action by a secured creditor is required to remove the debtor from the property. Often that is dealt with by way of action of declarator of calling up (asking the court to hold that the secured creditor has called up) and warrant for ejection of the debtor. This approach will disappear from September in respect of residential properties.

Voluntary surrender

From September, a calling up notice can be served and a secured creditor can seek voluntary surrender of a property. This is only possible when the property is unoccupied. A number of people including:

- the debtor;
- the proprietor (if not the debtor); and
- the non-entitled spouse or civil partner of the debtor if the subjects are the matrimonial / family home;

must certify that they:

- do not occupy the subjects;
- are not aware of the security subjects being occupied by any other person;
- consent to the exercise by the secured creditor of its rights on default; and
- that their consent is given freely and without coercion.

It would seem unlikely that the debtor, and others required to do so, will sign off in the terms required by the Act in most recovery cases. Accordingly, court action is likely to be required in most, if not all, cases where a secured creditor is seeking to recover against a residential property asset, irrespective of whether the subjects are occupied by the debtor.

An application under s24

The Act will also make significant changes to the way in which a secured creditor goes about making an application to the courts to obtain possession.

The current regime has always allowed for a secured creditor to apply to court for warrant to exercise remedies on debtor default. Such an application routinely includes a crave for warrant to remove the debtor from the property.

This involves raising a court action and serving it, together with various notices, on the debtor and occupier of the property, and the local authority in which the property is situated. Such an application is likely to become the norm for all residential repossessions once the Act comes into force, potentially both increasing lenders' costs of recovery and introducing uncertainty around outcomes and timing.

The Act provides that before making such an application the secured creditor has to comply with the pre-action requirements. The court is expressly not permitted to grant an application unless it is satisfied that the secured creditor has complied with the pre-action requirements.

Pre-action requirements

These are set out in the Act and amplified by a Scottish Statutory Instrument and guidance issued by the Scottish government. In terms of the Act, the secured creditor must have regard to this guidance. The guidance is currently in draft form.

> "The Act will also make significant changes to the way in which a secured creditor goes about making an application to the courts to obtain possession."

Information on sums due

The secured creditor has to provide the debtor with clear information about:

- the terms of the standard security;
- the amount due to the secured creditor (including any arrears and charges in respect of late payment) and a >>

description and the nature of any charges that may be incurred if the default is not remedied, ie a total arrears statement; and
- any other obligation under the standard security in respect of which the debtor is in default.

The above information must be provided as soon as reasonably practicable upon the debtor entering into default. It is expected that the information will be sent to the debtor as soon as they fall into arrears. The secured creditor must ensure that the information is clear, not misleading and that the correspondence is written in plain English. Secured creditors should communicate with the debtor in a language that the debtor can readily understand.

Attempt to agree proposals

The secured creditor must also make a reasonable effort to agree with the debtor proposals in respect of future payments. The secured creditor must:
- make reasonable attempts to contact the debtor to discuss the default. The guidance suggests that the method of contact should include written contact. The secured creditor should consider, where possible, a face-to-face meeting with the debtor. They must also make a reasonable number of attempts to contact the debtor, while avoiding undue pressure through an excessive number of attempts;
- provide the debtor with details of any proposal made by the secured creditor, set out in such a way to allow the debtor to consider the proposals. The secured creditor should not exert undue pressure on the debtor to agree any particular proposals;
- allow the debtor reasonable time to consider any proposal made by the secured creditor. Where a proposal is made in writing it is recommended that the debtor be given a period of not less than ten working days to consider it. In deciding what is a reasonable time the secured creditor has to factor in time for the debtor to seek independent advice;
- notify the debtor within a reasonable time of any decision taken by the secured creditor to accept or reject a proposal made by the debtor. Where the secured creditor rejects a proposal made by the debtor they must provide reasons for the rejection in writing to the debtor within ten working days; and
- consider the affordability of the proposal for the debtor taking into account, if known, the debtor's personal and financial circumstances.

Any proposal made by the secured creditor should be clearly communicated and set out in sufficient detail. Where the proposal is for arrangements relating to repayment the secured creditor should ensure that the proposal details how much is to be paid; the frequency of the payments; when the arrangement will

commence; and the duration of the arrangement.

A proposal made by either the debtor or the secured creditor could include:
- changing the date of regular payments under the loan;
- changing the method by which payments are made, eg from direct debit to standing order;
- extending the repayment period;
- changing the type of repayment under the security, eg from capital and interest to interest only;
- deferring payments of interest due under the security; and
- capitalising the arrears in the security.

The secured creditor should not have a blanket policy in relation to proposals and each case has to be considered on its merits. The secured creditor must specifically consider the causes of the default and whether these are temporary or long term. The secured creditor should also consider any decisions made by the courts in relation to whether efforts to agree proposals have been reasonable.

For all agreements, especially those made over the telephone, suggested good practice is for the secured creditor to offer the debtor time to reconsider what has been agreed when it is for a long-term payment plan.

The secured creditor has to bear in mind that it will have to demonstrate to the court that it has made a reasonable number of attempts to contact the debtor and agree proposals. The secured creditor will need to ensure it has procedures in place to keep track of and be able to evidence attempted or actual contact with the debtor.

A statutory form will have to be signed to certify that the pre-action requirements have been complied with. It may become necessary to produce evidence of compliance to the court.

Breached agreements

Where an agreement is reached with the debtor but the debtor fails to comply with it, *on the first occasion*, the secured creditor must do the following before making an application to court:
- give the debtor notice in writing of the decision to make an application and the grounds of the proposed application;
- wait for 15 working days beginning with the date on which the debtor is deemed to receive the notice; and
- *not* make an application if the failure by the debtor to comply with the condition of the agreement, constituting the ground of the proposed application, is remedied during that period.

If the debtor subsequently breaches the agreement the secured creditor could proceed to court without the need to issue a further notice.

A secured creditor should not make an application if steps are being taken by the debtor

The secured creditor must not make an application if the debtor is taking steps that are likely to result in payment within a reasonable time of any arrears or the whole amount due under the loan.

The debtor is required to provide documentary evidence to the secured creditor of the steps being taken. Upon examination of this evidence, if the secured creditor is satisfied that the steps are being taken and, unless one of the exceptions applies, the secured creditor is not entitled to commence an application to court. The steps are:
- The debtor is making a claim to an insurer under a mortgage payment protection policy that has a reasonable expectation of eligibility for payment.
  - *a court application could be made if the debtor is unable to meet any shortfall not covered by the policy; the application is not decided within a reasonable time or is refused.*
- The debtor is making an application to a mortgage support scheme and the debtor has a reasonable expectation of being eligible for support. The secured creditor need only consider applications to schemes in which it is participating.
  - *A court application could be made if the debtor is unable to meet any shortfall not covered by the support scheme or the application is not decided within a reasonable time or is refused. An application could also be made if the secured creditor does not agree with any term of or does not agree to a sale of the property in accordance with such a scheme. If a debtor refuses to provide the secured creditor with a copy of the application this might allow the secured creditor to make an application.*
- If the debtor or an agent acting on his behalf is marketing the property for sale. The documentary evidence should demonstrate that the property is being marketed at an appropriate price and reasonable professional advice was sought when assessing the price.
  - *A court application could be made if the debtor rejects a reasonable offer; the property does not sell within a reasonable time or the debtor refuses to provide the*

secured creditor with details of any agent acting for him or authorise the agent to communicate with the secured creditor such that the secured creditor cannot ascertain whether the debtor has rejected reasonable offers or has not sold the property within a reasonable time.

Information about sources of advice

The secured creditor must also provide the debtor with information about sources of advice and assistance in relation to the management of debt such as a Citizens Advice Bureau or other advice organisation and must encourage the debtor to contact the local authority in whose area the property is situated. Where the security is regulated the secured creditor may provide the debtor with any relevant information published by the appropriate regulatory body.

Changes to process court application

Mortgage rights factors to be considered in defended action

Where the debtor appears or is represented in a court application by the secured creditor to exercise its remedies on default, the court must have regard to a variety of matters. These factors are essentially those that have to be taken into account where the court is considering a mortgage rights application. The effect is that if the debtor appears or is represented he does not have to make a separate mortgage rights application and the court must automatically take these factors into account. The factors are:

- the nature and reasons for the default;
- the ability of the debtor to remedy the default within a reasonable time;
- any action taken by the secured creditor to assist the debtor;
- the ability of the debtor and any other person residing at the property to secure reasonable alternative accommodation; and
- *this is new*: participation by the debtor in a debt payment programme approved under part 1 of the Debt Arrangement and Attachment (Scotland) Act 2002.

It is in the applicability of mortgage rights factors that there is a vulnerability in the drafting of the Act.

Under the Act, a debtor need not show that the property is his or her sole or main residence before the court must take account of the mortgage rights factors. This is a requirement under the current Mortgage Rights (Scotland) Act 2001 that will be substantially revoked on 30 September.

This might mean that if the debtor is a company that owns a residential property as an investment asset, the debtor company could look to the mortgage rights factors when the court is determining whether to make an order. This does not seem to be the intention of the Act, and any corporate debtor running such an argument may ultimately receive short shrift from the court, but until this matter comes before the court for determination it remains unclear. Any secured creditor seeking to realise value in secured property held by such a corporate entity may of course look to other recovery methods under the corporate insolvency regime to avoid such concerns.

Entitled residents

There is provision for parties other than the debtor who could currently make a mortgage rights application to be heard by the court in terms of the Act. These parties will be called 'entitled residents' and will be able to apply to the court to continue the proceedings or for the court to make any other order it thinks fit, despite not being called as a defender in the application. Essentially, what we now call a mortgage rights application will still be able to be made by third parties but the terminology will be different.

An entitled resident who does not make an application can seek recall of a court order at any time before the order has been implemented in full. This is a change to the current situation where only the debtor, as defender, could seek to recall any decree granted and a mortgage rights' application by a third party can only be made during the course of the action, before decree had been granted. The result is that an entitled resident will have a longer period of time in which to make representations to the court to seek to suspend the secured creditor's rights.

Forms of notice

As a process point for secured creditors and their advisers, the Act amends all notices that a secured creditor might issue when seeking to exercise remedies; there are new forms of calling up notice, notice of default and notice that court action is being raised. The new notices are for residential and non-residential cases.

The effect of the Act

It is clear that the Scottish ministers view a repossession action as a last resort and have enacted a piece of legislation to implement that policy aim.

The Act will make it more onerous for secured creditors to exercise their remedies under standard securities of residential properties, particularly in terms of what must be able to prove the creditor has been done before raising court action. The secured creditor will have to be prepared to demonstrate that it has complied with the pre-action requirements and that all other reasonable attempts to resolve the position have failed.

When the Act comes into force, where the property is used to any extent for residential purposes, it will probably be necessary to make an application to court for warrant to exercise remedies and, where the debtor is in occupation, to seek warrant to eject. Calling up notices in respect of residential property are likely to fizzle out.

It is worth noting that the Act has no transitional provisions. This means that if a secured creditor has already called up in respect of a property that will come within the ambit of the Act but not yet made a realisation, that secured creditor has only until 30 September 2010 alone to exercise its remedies (and not the five-year period from the date of the calling up notice that the 1970 Act provides for) as at that point the calling up will cease to be effective. After 30 September, the secured creditor will have to go to court and, in doing so, comply with the requirements of the Act, potentially compounding existing enforcement cost and adding delay.

> "A debtor need not show that the property is his or her sole or main residence before the court must take account of the mortgage rights factors. This is a requirement under the current Mortgage Rights (Scotland) Act 2001 that will be substantially revoked on 30 September."

It is important to consider any cases where calling up notices have been issued for properties that are used to any extent for residential purposes and decide whether the secured creditor wants to try to sell the property before the end of September. The Act provides that the secured creditor cannot sell the property without voluntary surrender or a court order. It is arguable that the secured creditor sells a property when it enters into missives. However, it can also be argued that the secured creditor does not sell until completion takes place. To avoid any argument, it is safest to complete the sale, with title being transferred, before 29 September. □

Lorna Richardson is a solicitor in dispute resolution and Andrew Hinstridge is an associate in debt, restructuring and recovery at Dundas & Wilson CS LLP.

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OFT study: focus on the bigger picture, not the quick headline

The last major reviews of the UK's insolvency law were the Insolvency Act 1986 and the Enterprise Act in 2002, with a view to promoting rescue. Alan Hudson asks if the time has now come for more change?

As officers of the court the ultimate goal for an insolvency practitioner (IP) is to rescue the company as a going concern and to achieve the best outcome for creditors of the insolvent business. When economies are in good health, the insolvency profession is rarely in the public eye. But with companies struggling to obtain loans from banks, finding their supply chain under pressure and facing shrinking consumer demand the skills of a corporate restructuring specialist are very much in demand. We are also in the headlines as the media focuses on the failures of household names, the unfortunate job losses that ensue and the IPs charged with sorting out a mess they did not create.

The OFT's market study

It's not surprising that this has attracted increased focus from politicians and in turn the Office of Fair Trading (OFT). The OFT's market study into the insolvency profession, released on 24 June 2010, focused on the appointment, actions and fees of corporate IPs. While some of their recommendations have been welcomed and promoted by the industry, such as simplifying regulation and encouraging more involvement from unsecured creditors in the process, some of their conclusions are misleading and unsubstantiated.

The study states that IPs earn approximately £1 billion in fees from corporate insolvency processes, in doing so realising about £5 billion worth of assets and distributing some £4 billion to creditors.

Drawing attention to fees may create a good headline, but without also recognising the wide range of situations, obligations and statutory duties of IPs, it draws attention solely to cost as opposed to any focus on the value being delivered or the complexity involved – businesses rescued, jobs saved and recoveries for creditors.

Ernst &Young's review of their insolvency appointments

Ernst & Young conducted a review of insolvency appointments we have taken over the last three years and we see an anticipated average return to secured and unsecured creditors of 79 per cent and 41 per cent respectively. We also expect fees to equate to an average of 2.4 per cent of these recoveries, nowhere near the 20 per cent that is claimed in the OFT study.

The UK continues to be one of the world's most transparent insolvency regimes and all fees paid to IPs are governed and approved by the creditors of the insolvent business or the court, with SIP 9 requiring detailed narrative on all fees charged. They are also subject to scrutiny by the IP's regulator, who is independent and acts to ensure that not only is the IP compliant with the regulations surrounding fees but that the creditors are treated fairly and with transparency.

The OFT study's conclusions

Secured creditors and other major stakeholders in formal insolvency processes are often sophisticated serial buyers of IP services and are therefore able to negotiate commercial discounts. This is not unusual in this or many other business arenas, and the majority of our engagements will see a discount to the firm's standard costs. It is unclear in some of the statements made in the OFT report on this issue what exactly these findings conclude about the way the profession works with secured creditors. But it points to an effective open market that regularly involves firms in competitive tendering.

One of the conclusions of the OFT report is about the lack of involvement from unsecured creditors. We would certainly welcome unsecured creditors becoming more engaged in the process and believe that there is the potential for unsecured creditors to play a more active role than they do currently. The framework is already there, with no need for further legislation, but IPs cannot force creditors to engage. The suggestion made by the OFT for unsecured creditors to co-ordinate their actions could be a workable and welcome solution, but it still needs them to want to take part.

Another concern the study raises is that unsecured creditors do not understand the process. IPs of companies in UK administration are already obliged to provide proposals to creditors within eight weeks of appointment. This will then be followed with regular updates through the course of the assignment. These are sent to all creditors of the company and are required to set out clear guidelines on the process, such as voting and fee approval. It is questionable how much more can realistically be done to inform, although we do all need to bear in mind our audience when reporting, be they financiers, trade creditors or members of the public, and communicate the messages appropriately.

Another matter discussed in the report was the extended duration of insolvency. While we must all continue to look at how we can more efficiently progress and conclude insolvencies, IPs will, quite properly, request an extension from the court if more time is required to realise the best return for creditors. Both *Heritable Bank Plc* and *Kaupthing Singer & Friedlander* have had the period of administration extended for three years, as the appropriate strategy agreed with the creditors is to run off the various loan books to maximise recovery. The OFT does acknowledge in the study that they cannot establish whether procedures are often taking longer than they should without a detailed analysis of each case.

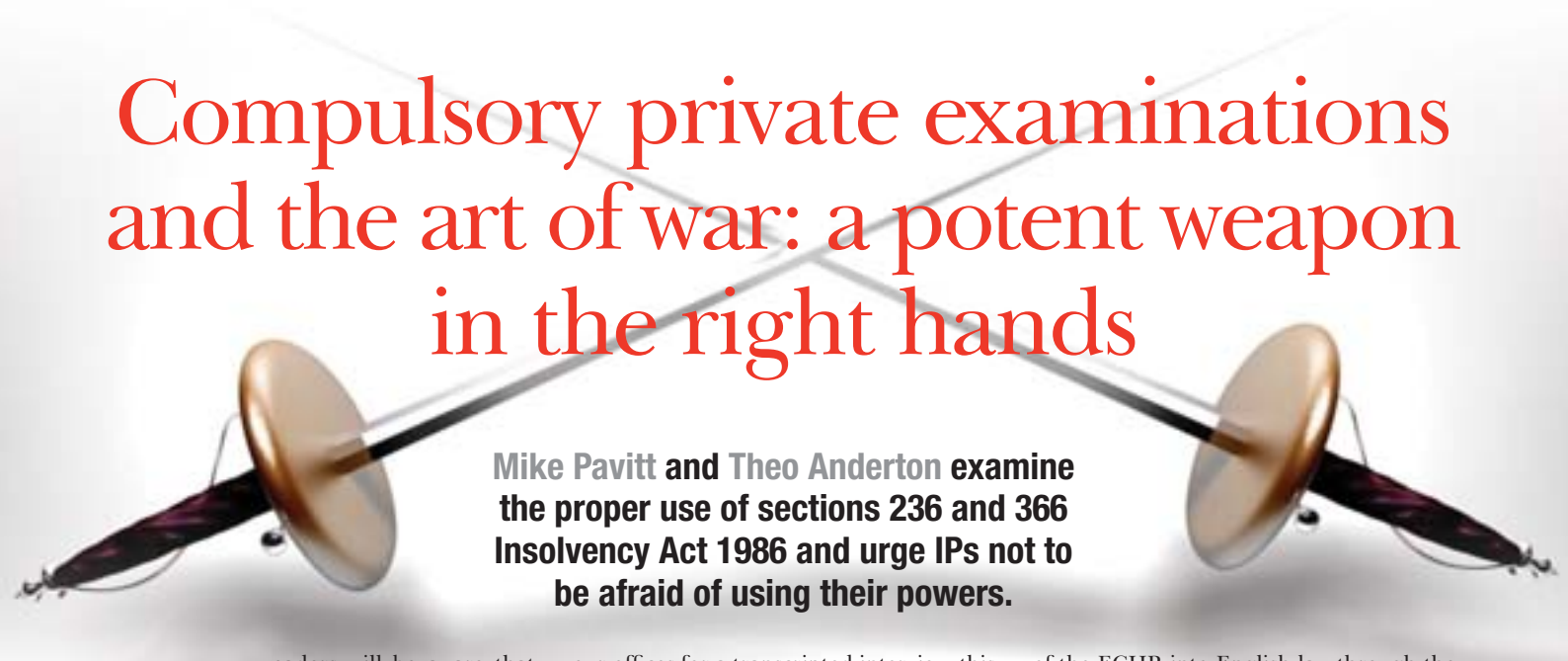
The study recognises that there is fluid competition in the market. It also recognises that the nature of some appointments will mean that only a limited number of firms will have the right level of expertise and resources to take on an insolvency appointment; the administration of Nortel Networks across 18 European jurisdictions is a good case in point.

Focus on the big picture

The regulatory regime for the insolvency profession is extremely important and actions to make it simpler are welcomed and we would also encourage greater engagement of all creditors in the process. However, the more sensational statements are misleading and politicians, regulators and commentators would do well to focus on the relative efficiency, effectiveness and competitiveness of the UK's insolvency regime and industry. □

Alan Hudson is a restructuring partner at Ernst & Young.

Compulsory private examinations and the art of war: a potent weapon in the right hands



Mike Pavitt and Theo Anderton examine the proper use of sections 236 and 366 Insolvency Act 1986 and urge IPs not to be afraid of using their powers.

Readers will be aware that the power to apply to court to compel reluctant or unco-operative parties to produce information on pain of arrest has long been one of the most valuable weapons in an office-holder's armory. By any measure its potential is immense, affording us the opportunity to force others to help us put together the missing pieces of a jigsaw that could allow us to produce a more acceptable return for creditors.

By and large, the power has stood the test of time, despite the rise of human rights legislation. Recent changes to the Insolvency Rules have left it largely untouched. On the face of it, the court's discretion is unfettered, yet the actual *use* of this power by practitioners remains comparatively rare.

An underused power

The power suffers from a perception among many lawyers that case law is now so well settled that the counter proposition (that an application would be oppressive or unnecessary) is generally arguable. Also, it is all too easy to advise that IPs cannot fairly be criticised if they elect not to proceed, particularly where the application would be unfunded. It can also suffer from a perception among many IPs that it is a risky and/or expensive route to follow.

Owing largely to these perceptions, the weapon's edge has become dulled by disuse. Although the sabre is often rattled, threats to bring an application are often seen for what they are, a blunt device employed by someone with limited funds and no real intention of spending them, designed to 'shake down' the easy target.

There is, of course, nothing wrong with threatening the use of the power in appropriate circumstances. This is particularly so where there is a realistic prospect of producing the desired information or evidence without recourse to the courts; if we can persuade the other party to produce the documents or attend our offices for a transcripted interview, this will generally be the ideal outcome. However, to be effective, the threat must be real and we must therefore be ready and willing to follow through.

Time to break free

So how do we use these powers to best effect? Our suggestion is that – as with any swordplay – this can best be achieved by:

- preparing your weapons;
- training; and
- putting what you have learned into practice.

> "Although the sabre is often rattled, threats to bring an application are often seen for what they are, a blunt device employed by someone with limited funds and no real intention of spending them."

Repeating these steps should help us to achieve the goal so that, when we threaten to make an application, most prospective respondents will co-operate. Those who ignore us will face an application that is well constructed and well aimed, and those who seek to deflect the application will be subjected to an order. We will achieve a successful outcome and an order for costs.

Step one: know your weapon

Before we even consider actually drawing the sword, we need to know if it is fit for purpose? Can we trust it not to shatter when it meets resistance?

Sections 236 and 366 have a long and distinguished pedigree. They have existed in some guise since before the birth of modern insolvency law, yet they sit squarely within the context of international and European law, and in particular human rights law. Here they have been tested both by direct challenge under the European Convention on Human Rights (ECHR) and by continuous application by the English courts notwithstanding the incorporation of the ECHR into English law through the Human Rights Act 1998.

The powers of compulsory examination have consistently passed scrutiny, even where applicants have sought to extend the scope of the section (for recent examples see *Pantmaenog Timber Co Ltd* [2004] 1 AC 158 (s236) and *Rottmann* v. *Brittain* [2009] EWCA Civ 473 (s366)). A detailed consideration of how human rights pervade the relevant case law is beyond the scope of this article but we would ask the reader to take it as a given that the tests employed by the English courts reflect closely European thinking and that in order to predict the courts' approach to new issues practitioners would do well to look to Strasbourg.

Step two: it's how you use it

Even the surest of blades will be useless unless we also learn how to wield it, and how not to hurt ourselves in the process.

The parties entitled to use the power are a liquidator (including a provisional liquidator), an administrator, an administrative receiver or a trustee in bankruptcy. Even experienced practitioners need to remember the basic principles before embarking on a new application. They should start with the recognised legitimate purpose for which we are entitled to use the powers.

The best statement of the legitimate purpose, cited with approval by the House of Lords in *Re British & Commonwealth Holdings plc* [1993] AC 426 remains that of Buckley J in his 1968 judgment of in *Re Rolls Razor Ltd*, which can be summarised as follows:

- to help the office-holder 'discover the truth' of the circumstances of the insolvent

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entity in order that they can, 'as effectively as possible and… with as little expense as possible… complete their function';
- to put the affairs of the insolvent estate in order;
- to identify and recover assets; and
- to discover facts surrounding potential claims, including claims against the potential respondent to the application.

Over time, the courts have also added additional and less obvious legitimate purposes:
- to reconstitute accounting or other business records;
- to obtain information from third parties to enable contracts to be completed; and
- to investigate the causes of failure and the conduct of the respondent in contributing thereto with a view, for example, to disqualification proceedings.

Getting a good footing

The skilled applicant will recognise that they are asking the court to make a delicate judgment between the competing interests of an office-holder in requiring information and/or documents and the need not to impose an unnecessary and unreasonable burden on any respondent. They will know that factors such as inconvenience, the burden of work upon a respondent or potential exposure to future claims are not a bar to an application, but factors that will weigh differently in the balance of whether an order should be made. They will appreciate that the more distant the connection between a respondent and the insolvent, the greater the justification they will be required to produce in order to obtain an order.

The skilful applicant will therefore have done a good deal of preparation before the application is issued, pursuing all appropriate and/or proportionate lines of investigation first in order to demonstrate to the court why the balance should be struck in their favour. They will normally have given an appropriate level of advance notice to the respondent and flushed out and/or dealt with any potential defences, such as privilege.

The unskilled applicant, by contrast, may get their footwork all wrong. For example, they may apply for the production of documents with the purpose of the insolvent entity benefiting from work to which it would not have been entitled but for the insolvency, as in *Colishaw* v. *O&D Building Contractors Ltd* [2009] EWHC 2445 (Ch), or by betraying a settled intention to pursue before they have all the information necessary.

Making your strike

The strike itself is all about timing and accuracy. If the applicant moves too fast or too soon (eg by issuing when they could easily and/or at lower cost have obtained some or all of the information from elsewhere) they will lose their balance and the strike will easily be deflected. If they miss their aim (eg by failing to follow the rules on service of the order before an arrest warrant is issued), they will expose themselves to a counter-strike (eg an order for costs).

The application itself should be made by way of Form 7.1A. This and supporting evidence should identify the respondent and specify the order sought, including whether it is for an oral examination, clarification/additional information, a witness statement (with details of the matters the witness statement is to cover) or for production of books, papers or other records (in which case they should be specified). Merely requesting an account of all dealings by the respondent with the insolvent company/bankrupt will not suffice.

The application may be accompanied by others (where proper grounds exist) for ancillary orders in the form of interim injunctions, such as a 'no say' injunction (restraining the respondent from disclosing the order to third parties), an order restraining the respondent from leaving the jurisdiction pending examination or a search and seizure order.

> "There is no question that the judicious use of compulsory examination powers can and does yield increased returns."

The skill in making a good application will often be shown in how the applicant presents their evidence in support, whether they include a separate annex confidential to the court, and whether they elect to apply with or (exceptionally) without notice.

Step three: know your opponent

Every new opponent deserves respect and differing opponents demand different styles. Even an inexpert swordsman may defeat an unarmed man, but an unarmed opponent may employ a skilled blade, such as another IP or solicitor. Likewise, an armoured opponent will feel only the best aimed strike. The applicant must be wary of these special cases and plan their attack accordingly.

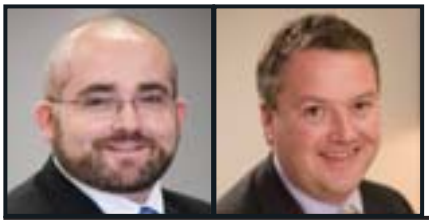
Banks and solicitors in particular may, in certain circumstances, have legitimate concerns about confidentiality. Often both will offer to co-operate so long as they are compelled to do so by court order and, if the terms of the proposed order can be agreed, they will often take a neutral stance. The legitimate concerns that need to be addressed to avoid a failed application and/or an expensive costs order in these cases include:
- a desire to limit the scope of the order sought, in the first instance, to documents;
- a desire for the documents or classes thereof sought to be specified with particularity;
- a concern that the documents sought are voluminous such that their production might be sought and ordered in stages;
- the need to exclude sensitive information including evidence of criminal activity and/or money laundering reports; and
- where the cost of compliance with any order made is likely to be significant, the question of how the respondent's reasonable costs of compliance are to be met.

Demonstrating value by results

The insolvency profession is under increasing scrutiny, from the OFT and elsewhere, and is challenged to show that it provides value to creditors, particularly unsecured creditors. One way of demonstrating value is by results. There is no question that the judicious use of compulsory examination powers can and does yield increased returns. In terms of the use of the powers to provide evidence in support of claims, very often the process will yield, at relatively minor cost compared with the cost of funding a full-blown piece of litigation, the evidence that will justify to solicitors, counsel and after-the-event insurers that a claim can properly be pursued on a conditional-fee basis. Therefore, it is a route to securing access to justice for creditors.

Creditors may also perceive that they have obtained value because directors or other respondents have been put through the ringer and forced to account for their actions. In appropriate cases, following *Re Pantmaenog*, these examinations may yield evidence that the Secretary of State can use to secure a disqualification.

We believe that the more frequent use of these powers will increase their effectiveness, not just in terms of the overall number of applications, but in terms of their impact on a case-by-case basis. If we have convinced you, we look forward to meeting you on the field of battle! □



Mike Pavitt (left) and Theo Anderton (right) are partners in the Insolvency and Business Recovery team at Blake Lapthorn.

Restructuring a charity: as easy as ACBD?

On his first day as managing partner, Finbarr O'Connell and his colleague Nimish Patel were appointed administrators of ACBD. Together with Anne-Marie Piper, they explain the chain of events that led to the charity being restructured.

ACBD

Age Concern Barking & Dagenham (ACBD) is a registered charity and a very valuable supplier of services to the elderly of Barking and Dagenham. It is part of the national federation of Age Concern entities. The national organisation is now called Age UK following the merger of Age Concern and Help the Aged. ACBD is a totally separate legal entity from Age UK. The main cause of the insolvency of this charity was its very substantial pension deficit liability.

ACBD succumbs to its pension deficit

In September 2009 *Third Sector* magazine, which reports on charities and voluntary organisations, announced that the UK's top 20 charities could be sitting on pension deficits totalling in excess of £600 million. This estimate was based on the accounts of the top fundraising charities who predicted a shortfall in their pension funds. According to the pension's actuary, Alexander Forbes, this equated to an increase in deficit of over £100 million for those top 20 charities. At the end of 2009, Ian Chivers, finance director of NSPCC, reported that his charity was looking at a pension deficit of about £50 million. This has resulted in the charity closing its pension scheme to future accrual.

Brian Devlin, chairman of the board of trustees ACBC, commented in April 2010: 'It saddens me to see what is happening across the country to the charitable sector. Never before during my time in this industry have charities been treated so badly. With local authorities having to manage their own poorly performing pension funds coupled with funding cuts from central government, putting pressure on charities is now being seen as a real soft option.

> 'It saddens me to see what is happening across the country to the charitable sector. Never before during my time in this industry have charities been treated so badly.'
> *Brian Devlin, chairman of the board of trustees, ACBD.*

'In order to manage reducing annual budgets, some local authorities across the UK have been electing to transfer staff under TUPE (Transfer of Undertakings (Protection of Employment) Regulations 1981) to the private sector and charitable organisations (such as Age Concern Barking & Dagenham). When funding cuts from the local authority to the charity are subsequently implemented, it is the charity that has to take the decision to reduce its own staffing levels in the form of redundancy; a decision no employer likes to make. This situation is further exacerbated by the poorly performing pension funds of the charity that have been hit by the continuing global financial crisis. ACBD has seen its local authority funding cut from £1.8 million to £800,000 in two years, which in turn has resulted in a shrinking pension fund. This is a situation that is common across the UK and one that is, sadly, not going to get any better. This is the primary reason why Age Concern Barking & Dagenham was put into administration.'

ACBD calls in specialist advisers

As charity restructuring advisers, the key thing is for us to be consulted as early as possible in order that we can work with the trustees to try and preserve as many of the remaining charitable services as possible. ACBD and its specialist charity legal advisers at Farrer & Co got R10 involved to provide restructuring advice as soon as the seriousness of the solvency issue was identified.

The legal perspective

Like much work of this kind, Farrer & Co's involvement with ACBD began when the audit partner at the accountants used by the charity called because he feared it was getting very close to the edge financially and he thought that the trustees and senior management team needed to understand their legal position.

ACBD is a company limited by guarantee, which means that its trustee/directors (hereafter referred to as the trustees) have all the duties of company directors under company law and all the duties of charity trustees under charity law. At a meeting with the trustees and senior managers we explained that, while a charity is solvent, the trustees are required to act in the best interests of the charity (rather than its beneficiaries) but that at the point of insolvency this duty switches to acting in the best interest of the creditors.

Trustees of charities are like their counterparts in the commercial world in that they often soldier on in the hope that they will be able to trade through a difficult period and/or persuade grant agencies or other funders to fill the gap in the charity's finances. However, unlike their commercial counterparts they are unpaid volunteers and, as a result, often find challenging times more stressful than they would do if it were simply part of the day job; perhaps because they have less time to devote to the detail. It is our experience that a charity is more likely to be capable of being rescued if insolvency advisers are brought in sooner rather than later. It also helps the trustees to know that if they act in accordance with specialist advice, they will have fulfilled their duties from that point on, even if the charity can't be saved.

In the case of ACBD, due to the very substantial pension deficit, a review of the options led to the conclusion that the charity needed to proceed into administration. RE10, as administrators, set about trying to maximise the value of the available assets for the benefit of the creditors while, at the same time, Farrer & Co assisted them in trying to preserve as many of the charity's remaining services to the elderly as possible.

There were some interesting technical issues as well as a great deal of local politics. One such issue was the fact that ACBD had bid for and won a contract to deliver certain health services. The delivery of these services was *ultra vires* the charity (because the objectives of the charity were restricted to assisting the elderly and the new services were not necessarily only for the elderly). The accountants had spotted this problem and had sensibly advised ACBD to route the contract through a wholly owned subsidiary company. However, although the charity had established the company, the trustees had not put in place the necessary arrangements to ensure that all monies due under the contract were paid direct to the trading company. Consequentially, at the point when ACBD ceased to be solvent it was holding funds that ought to have been in the trading company. Although everyone recognised that these funds ought to have been in the trading company, we had to advise the administrators that, as a matter of law, these funds were available to them, rather than to the trading company, due to the inadequacies of the arrangements.

What could the administrator save?

In a normal trading administration the imperative is to sell the assets of the company, including goodwill, for as high a figure as you can. In such a case, a short-term trading loss is acceptable as long as the recovery made from trading-on exceeds the forced-sale value of the assets. In trading a charity, the normal commercial considerations are more difficult to apply. The business of the charity does not normally generate a profit; at best it breaks even. Consequently, the strategy in this administration was to ensure that the trading activities did not result in a loss and that as many as possible of the services provided to the elderly were preserved.

ACBD has three trading divisions:

- Homecare, which provided paid services to the elderly such as nail clipping, personal bathing and domestic cleaning services;
- A holiday business, which arranged group holidays and insurance for the elderly; and
- Uniquecare, a division that provided outpatient support services, including home visits and counselling for elderly patients who had undergone operations. The Uniquecare service was funded under a contract with a Primary Care Trust.

To ensure that trading would be cash positive, at the commencement of the administration, we took steps to consolidate all trading operations into one premises and, sadly, we had to make some administrative staff redundant.

While Homecare and the holiday services closely resembled a normal commercial business in that sales income was generated from paid-for services, Uniquecare was a totally funded service. Unfortunately, the funding contract under which the Uniquecare services were provided expired in mid August 2010. Despite our best efforts, we could not secure an extension of this contract to allow the transfer of these services to another charity. In the face of uncertainty of a future contract for the Uniquecare operation coupled with the certainty of loss of income from August onwards it was impossible to transfer these services to another charity and the ten employees in this division were made redundant in August.

For the remaining two services, there were a number of interested parties happy to take them over, albeit for a consideration of only £1. Again, this is different from normal trading administrations in that we were not faced with a number of different interested parties offering different levels of consideration for the businesses being transferred. Here the business is not operated with the intention of making a profit but only of providing a service. As administrators, we had to take a close look at the organisations making the offers and satisfy ourselves that transfers were being made to a charity that provided the best host for the services and the maximum opportunity for success. The final choice was for a *neighbouring* Age Concern affiliate, which can expand its existing services into the Barking and Dagenham area. This has resulted in 35 jobs being saved. The resulting reduction in employee claims in the administration means that the transfers of the two remaining services, albeit for no consideration, will be for the financial benefit of the creditors as a whole.

> "35 jobs were saved and the resulting reduction in employee claims in the administration means that the transfers of the two remaining services, albeit for no consideration, will be for the financial benefit of the creditors as a whole."

All restructuring work is for the good of society but when you see first hand the very beneficial work carried out by charities such as ACBD it is very fulfilling to be able to assist in the continuation of that work in a new host charity. The process of restructuring charities has its own challenges and so, yes, it is as easy as ACBD, which means 'not very'. □

Finbarr O'Connell is managing partner and Nimish Patel is a partner at R10, Anne-Marie Piper is a partner at Farrer & Co.

14th October 2010
BNP Paribas Real Estate Offices, London

recovery 2010 summit

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08:30 Registration and refreshments

09:00 Opening remarks

09:05 Keynote address: Recovery? The economic outlook and impact on UK property market
Lucy O'Carroll, Senior Economist
Lloyds Banking

09:35 How can banks make the recovery sustainable? What is the outlook for the property sector in the coming months?
Nick Robinson, Consultant
Blackstone Group

10:00 PANEL DISCUSSION: Banks: Where next?
- How are banks dealing with problematic loans?
- Banks releasing property stock onto the market

Stephen Eighteen
Head of Non-Core Real Estate
RBS
Scott Stuart, Regional Director - Real Estate, London & South East
Santander Corporate Banking

10:40 Refreshments

ANALYSING THE RECESSION

11:10 Market analysis by sector
- How has each sector been impacted by the recession?
- Opportunities and risks for each sector

Malcolm Frodsham
Research Director
Investment Property Databank

11:35 Market analysis by region
- Analysing the effects of the recession on the UK regions
- Comparing the UK market with Europe: What can we learn?

Richard Gwilliam, Deputy Head of Property Research, PRUPIM

12:00 PANEL DISCUSSION: Occupier and tenant relationships
What are the prospects for the trading environment in the future? How will these tough conditions be managed through better communication and working relationships between occupiers and tenants?
Howard Morgan, Managing Director, Real Service
Justin Snoxall, Head of the Business Group, British Land

12:40 Lunch and networking

RECOVERY PROCESS

13:40 Rights and wrongs of restructurings
Moving beyond the process of CVAs, how can they be beneficial to you? How does it work and what timescales are involved? What position will you be in post-CVA?
Brian Green, Restructuring Partner & CVA Supervisor, KPMG
Ian Fletcher
Director of Policy (Real Estate)
British Property Federation
Peter Hansell, Director
Cairn Capital

14:20 PANEL DISCUSSION: Asset management for recovery
- LPA receiver
- Propco
- Surveyor

Jon Gershinson
Managing Partner, Allsop
Martyn McCarthy
CEO – Europe, Valad
Matthew Grefsheim
Director – Special Servicing
Hatfield Philips
Andrew Blackshaw
Director, Deloitte

14:50 Refreshments

15:20 What is the future of CMBS?
- Where we are now and what to expect
- What have we learned?
- Future trends
- What solutions are in place?

Peter Sudell, Executive Director
BNP Paribas Real Estate

16:00 PANEL DISCUSSION: Projected scenarios: How does this recession compare?
What lessons can be learnt from past recessions? What opportunities are available? Is this recovery sustainable?
Joe Pitt
Head of Recovery & Restructuring
BNP Paribas Real Estate
Barry Gilbertson, Partner, PwC
Richard Barkham, Group Research Director, Grosvenor

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The scope of mediation in the insolvency field

Nick Pearson explains why the use of mediation in resolving problems in the insolvency field is now recognised as an invaluable tool in many jurisdictions.

As cost saving and efficiency become ever more critical in the context of managing insolvencies so the use of mediation as a tool for dispute resolution, both in the UK and cross-border, becomes ever more common.

What is mediation?

Mediation is a process through which an independent neutral (mediator) works with the parties in a dispute to identify its scope, and helps them find a binding solution.

The process is confidential and off the record. It can take place alongside litigation or instead of it and enables the parties to put their cards on the table and work with the mediator to achieve a settlement suited to their needs. It differs from litigation and arbitration in that the mediator makes no legal determination; the focus being more on a commercial outcome than a legal precedent. In short, mediation works to achieve an acceptable resolution through aided negotiation and facilitation.

> "To encourage the parties to seek to reach a speedy compromise, mediation is now quite commonly mandated as a dispute resolution process in commercial contracts."

When can mediation help?

Mediation is ideally suited to insolvency cases where the claims made need to be settled quickly and where the creditors, having already lost money, want to find ways of reaching solutions cost effectively.

In many insolvencies there are disputes between the insolvent entity (in liquidation, bankruptcy or administration) and third parties. Specific insolvency-related remedies may be sought, eg misfeasance claims against directors, preference claims and claims to set aside transfers at undervalue.

Insolvency will often bring the parties to mediation earlier in the dispute than might otherwise be the case. This can be helpful as there may be limited funds available in the insolvent party and a need to bring matters to a speedy resolution if there is no prospect of ongoing business relationships.

Most insolvency practitioners and office-holders are very experienced negotiators and well able to see and separate the trees from the wood, but they are not all trained as mediators and can find that the use of an independent mediator adds real value. However much the office-holders may be independent of the insolvent company they represent, they may still be seen to be fighting its cause and, inevitably perhaps, drawn to one side only of the dispute.

The vast majority of disputes within the insolvency field are suitable for resolution through mediation; even fraud claims are successfully mediated, although you may have to allow some time to elapse after the fraud for anger to subside. What is important, though, is for the parties to attend mediation with authority to settle, and steps may have to be taken in advance to ensure authority is provided by the court or creditors' committee.

The only type of dispute that would not be suitable for possible resolution through mediation would be one where the office-holder needs a ruling from the court, so that a precedent is set that will enable other similar or identical cases to be resolved.

Support for mediation in insolvency

In the UK, the courts have made it clear that they support the use of mediation in insolvency matters and encourage its use at any stage in the process. It is not necessary for formal legal proceedings to be underway for mediation to take place. Practitioners will be looking for any appropriate time to try and find a solution to a problem, and often this is at the outset before costs build up and entrenched positions are taken.

In the USA mediation is very common in the insolvency field. Its use in the *Lehman* insolvency has been made compulsory. On the Continent mediation is increasingly used. France and Greece provide for the use of 'conciliation' – a similar, confidential, process for compromising claims. In Belgium a mediator may be appointed to facilitate a reorganisation. Mediation is positively encouraged through the UNCITRAL Model Law on Cross-Border Insolvency.

The benefits of mediated settlements

The benefits of mediated settlements are clear: huge savings in time and cost, and proven success rates. A recent audit conducted by the Centre for Effective Dispute Resolution showed about 75 per cent of cases settling on the day of mediation with another 14 per cent shortly thereafter.

The process enables the parties to take hold of the legal process themselves and, although their respective legal positions will provide the backdrop to discussions, to focus on the commercial imperatives without conceding ground should mediation fail. If successful it can also mean a quicker and greater return to creditors. □

Case study

In proceedings under s239 of the Insolvency Act a liquidator sought to recover £400,000 alleged to have been paid as a preference. The proceedings were defended by the recipient who argued that the payment had been made in the usual course of business in an attempt to avoid the presentation of a winding up petition and not with a view to prefer. Further, it was said the payment had been approved by a colleague of the liquidator in pre-insolvency discussions. Neither side trusted the other. Large legal bills had been incurred.

The case was settled at mediation. The liquidator and principal defendant were able to talk directly to each other for the first time in the presence of the mediator. Explanations for the payment and the background to it were provided in a forum where each side could better appreciate each other's positions, thus enabling a compromise to be reached.

Nick Pearson is a licensed IP and mediator for the Centre for Effective Dispute Resolution.

Is it just the old Italian *Commedia*?

Francesco P Ruggeri Laderchi hopes that Italy is out of the frying pan.

The magnitude of the recent crisis of confidence in several euro area economies, the herculean adjustment facing their governments, the dramatic shift from boom years fuelled by asset bubbles to the bust resulting from the financial crisis and the collapse of the real estate market, have been the subject of debate among experts, written about in this publication and the source of great headlines.

Having experienced an estimated five per cent drop in GDP in 2009, Italy is undoubtedly 'undergoing the worst recession since WW11' (IMF Staff report for the Article IV consultation, Washington, DC, 11 May 2010). The financial crisis has hit a fragile economy hard as it has structural weaknesses and follows a decade of anaemic growth, persistent inflation differential with other euro-area countries and a steady erosion of its competitiveness.

The situation in Italy

The situation, nonetheless, is quite different from the one of Portugal, Ireland, Greece and Spain, as the Italian government, somewhat undiplomatically, keeps repeating.

Rather than causing a tragic change of fortunes the international crisis has exposed some long recognised weaknesses of the Italian economy. Reading the reports from international organisations the *leitmotiv* is: inefficient labour markets and public administration, heavy burden of regulation coupled with often low quality public services, structural bottlenecks, high and unfairly distributed tax burden, widespread tax avoidance, low investment in human capital and a divided and often inconclusive government. Turning back to the pages of Dante's *Purgatorio,* quoted above, one would hastily conclude that such weaknesses, already decried seven centuries ago, are so much part of our national character as to be part of the immutable plot of a never ending *Commedia*.

Largely due to the collapse in international trade from 2008, Italian firms, especially those in the manufacturing sector, were hit significantly: industrial output fell a staggering 18.3 per cent in 2009 while 63 per cent of manufacturers lost more than 10 per cent of their turnover and industrial capacity dived to a paltry 66.7 per cent.

Firms, especially the SMEs, the fabric of the richest regions of Italy, are traditionally financed by the banking sector and suffered greatly by the combined tightening of the credit conditions and the increase of the already significant delays in payments by clients. While the extent of the Italian 'credit crunch' is hotly disputed, it is hard to deny that, notwithstanding the moral suasion by the government on the banking sector, firms encounter difficulties in obtaining long-term finance and even the essential working capital facilities.

> *"Ah! servile Italy, grief's hostelry!*
> *A ship without a pilot in great tempest!*
> *No Lady thou of Provinces, but brothel!"*
>
> (Dante, *Purgatorio* VI, 76–78. translated by H W Longfellow)

The combination of a collapse in turnover and tighter financing conditions has imposed significant debt restructuring to nearly all leveraged operations as well as consolidation of short-term finance, partial debt for equity swaps and other forms of workout.

Reform of the 1942 bankruptcy law may help

The recent reform of the 1942 bankruptcy law has proved timely. New light-touch instruments, namely certified rescue plans and restructuring agreements, proved particularly successful and allowed us to overcome the rigidities of an inefficient and outdated law. They attenuated the main hurdles, such as possible civil and criminal liability and an extensive claw-back regime, which made rescuing valuable, though ailing, businesses dangerous and uncertain for financers and directors.

Even if any practising insolvency lawyer experienced a growing number of insolvencies procedures with the swelling dockets, which increase the duration and the inefficiency of court-directed insolvency procedures, the macroeconomic picture seems to indicate that the majority of firms have been able to weather the storm. Largely thanks to state-funded, temporary redundancy schemes, unemployment has stayed relatively tame at 7.8 per cent in 2009 (with a peak of 8.4 per cent in March 2010).

With economic indicators showing that the cycle hit its bottom in mid-2009, the modest growth registered in the first quarter of 2010 (0.8 per cent on an annual basis) may lead us to believe that the crisis has passed.

The challenges of recovery

Unfortunately, the recovery appears fragile and the high level of public debt (115 per cent of GDP) makes Italy vulnerable to a double-dip recession, a reversal in market sentiment or contagion of investors' distrust in other Mediterranean euro countries.

In such context the bitter medicine of staying a course of fiscal consolidation has no alternative. The real challenge is coupling the short-term view and the somewhat indiscriminate and unsustainable cost cutting of the emergency measures the government is expected to ram through parliament by the end of July, with structural reforms allowing for a more vigorous and efficient economy. The reintroduction of compulsory minimum tariffs for lawyers and road hauliers does not bode well in this respect. However, the economic adjustment of the 1990s or the modest success of the bankruptcy reform show that reforms are indeed possible.

Causes for optimism?

There are other reasons for optimism. Italy has not experienced any significant asset bubble. The conservative and not particularly competitive financial sector, thanks to a business model based on lending/deposit activities, strong customer relationships and a solid supervisory framework, proved resilient and had a limited exposure to toxic assets. Italian banks were able to withstand the turmoil with limited government support. Similarly, the high rate of private savings and the fact that the government launched one of the smallest stimulus packages among the developed economies are factors that place Italy in a position to profit from the recovery of the global economy. The recent weakening of the euro will also enhance opportunities for Italian firms that have been able to adjust to globalisation and export high value added niche products.

Notwithstanding severe structural problems, Italy has areas of excellence that make one hope that, true to the character of the *Commedia*, its economy may one day come 'forth to re-behold the stars'. □

Francesco P Ruggeri Laderchi is a partner at Labruna Mazziotti Segni Studio Legale.

Why is sovereign debt out of control?

Tim Morgan maintains that governments, businesses and individuals have developed an excessively relaxed attitude to debt and that it's now pay-back time.

If anyone had doubted that the banking crisis of 2008–2009 was the outrider for the sovereign debt crisis of 2010, recent events have surely put the issue beyond doubt. Greek public debt has been reduced to junk-bond status by the markets and the rating agencies, and fears over the viability of a string of other borrowers, including Ireland, Portugal and Spain, have prompted a sharp fall in the value of the euro, even when measured against other hardly robust currencies such as the dollar and sterling. Governments are switching the emphasis from stimulus spending to deficit containment, and the reservations on this issue expressed by the US administration are as much about style as about substance.

Bank for International Settlements' report

Are governments right to prefer deficit reduction over stimulus? In our opinion, they have no realistic choice because, unless resolute action is taken, debt ratios would get out of control. In a report published in March, the Bank for International Settlements, customarily a bastion of calm conservatism, pointed to the development of ominous exponential trends that now characterise the outlook for a string of developed-world sovereign borrowers. The report shows that even if reasonably resolute action is taken, debt-to-GDP ratios are heading inexorably upwards. They are likely to be nudging 200 per cent within a decade and anywhere from 300 to 500 per cent not all that many years after that.

Be under no illusion that such ratios are not remotely sustainable. Even based on recent real interest rates, debt service will absorb fast-rising proportions of national budgets, locking governments into an ever-worsening vice in which the sheer scale of debt service obligations permanently embeds escalating deficits into fiscal balances. On top of this, perceptions of an out-of-control debt progression are likely to be self-reinforcing if, as expected, interest rates are driven upwards by investors unwilling to meet increasing appetites for debt.

Systemic problems

Is this, as some believe, simply the fall-out from the banking crisis? After all, the response to the 2008 crisis transitioned huge quantities of toxic debt from bank to state balance sheets. In fact, our research indicates that bank rescues, although they have not

helped, have played a pretty modest role in the take-off of sovereign debt. Structural deficits are the real cause of the problem. And, though there are some individual cases – such as Greece, Ireland and the UK – in which the process can be blamed on recent profligacy, the sheer breadth and scale of the sovereign debt problem suggests that something more systemic is going on.

As populations age, demographics are worsening fiscal balances by pushing age-related expenditures upwards. Again, and although it doesn't help, the impact of ageing is a gradual and a predictable fiscal process, which cannot be identified as a principal cause of the problem.

Our view is that an excessively relaxed attitude to debt is the real problem, applying fairly equally to governments, businesses and individuals. Debt, properly considered, is 'anticipated consumption'. In other words, the borrower consumes at above-income levels now on the understanding that, at some unspecified point in the future, consumption will have to be foregone in order for the debt (plus interest) to be repaid.

Generational theft

But Western societies seem to have been succumbing to a psychology that decrees that 'tomorrow doesn't matter, at least until it arrives'. In our research, we have identified one particularly pernicious aspect of this mind-set, which we term 'generational theft'. Today's generation is piling huge debts onto coming generations, with an attitude that amounts to 'want it now, let the kids pay for it tomorrow'.

Over the past quarter-century, while debt ratios have broadened successively, governments and regulators have been at best negligent. They have slackened and then removed credit limits, maintained unrealistically low interest rates and applied tax policies that discourage saving. At the same time, they have incentivised borrowing and removed the barriers that previously separated commercial and investment banking activities.

Governments, corporates and individuals alike, have forgotten the time-honoured adage that says: while asset values are variable, debt is immutable. Throughout history, debt crises have always followed the bursting of asset bubbles, and bubbles have been a recurrent feature of financial markets. But while the bubbles of the past tended to be well separated in time, the economy is now displaying a *sequential* bubble-creating tendency. This process began with the Asian financial crisis and has since engulfed dotcoms, property and derivatives.

> "Our research indicates that bank rescues, though they have not helped, have played a pretty modest role in the take-off of sovereign debt. Structural deficits are the real cause of the problem."

A belated recognition of exponential debt risk has made fiscal tightening the order of the day, not just in Europe but across the developed world. Keynesian-minded economists point out that fiscal retrenchment at a time of weak economic performance is a recipe for slower growth, impaired output, increased business failures and higher unemployment. Within its limits, their analysis is right, but, as a prescription, it presupposes that debt can continue to rise. It can't. Tomorrow has now arrived. Borrowing means over-consuming now at the expense of under-consuming later. Welcome to later. □

Dr Tim Morgan is global head of research at Tullett Prebon plc.

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Economic snapshot: North West Region

Matt Dunham reports that although the North West has seen some significant insolvency events, there is hope that its manufacturing sector, nuclear industry and media involvement will help it survive a feared 'double dip'.

With an economy of almost £120 billion, the North West is the largest region in the UK after London and the South East and a bigger force than 15 EU countries, as well as Hong Kong and Singapore.

The region, which is home to almost seven million people and a quarter of a million businesses, accounts for around ten per cent of the UK's gross value added. Despite the decline in traditional industries, it still has the UK's largest manufacturing sector with key strengths in aerospace, chemicals and food manufacture.

It is also a major commercial centre. Manchester, which worked hard to modernise its economy after the 1980s slump, now sees itself as the UK's second city and is certainly the northern hub for banking, law and accountancy.

Meanwhile Liverpool, which has undergone a more recent renaissance, is recognised by the *Financial Times* as the third largest centre for wealth management after London and Edinburgh.

The affect of the recession

There is no denying that the downturn has taken its toll on the region and the property and retail sectors have been decimated. Many shops are lying empty, along with numerous apartments in Manchester and Liverpool city centres, which have both been the subject of over-enthusiastic property development.

One consequence is that our insolvency profession has become one of the region's largest residential landlords, a role we never anticipated when we sat the exam.

Manufacturing has suffered too, although fortunately the major motor manufacturers have all survived intact. The effects have also extended to financial and professional services where law and accountancy practices have numbered among the business failures.

But although there have been job losses, so far they have not been as heavy as initially feared. Unemployment currently stands at 8.6 per cent. As with the rest of the country, insolvencies are also lower than expected.

In part this is probably due to HMRC's Time to Pay scheme keeping the failure rate artificially low – currently over 88 per cent of applications are accepted, many no doubt from businesses in decline. In part it reflects the reluctance of creditors to liquidate assets while values remain low.

However, it is also evidence of the success of IPs themselves. CVAs, administrations and pre-packs have proved invaluable rescue tools. There is also evidence that, despite the lack of liquidity, buyers with access to funding are extending their portfolio.

What does the future hold?

Around one in five of all acquisitions in the North West currently involves a business in distress (one in six in 2009). In each of these cases, the deal represents a new chance to save the business and the jobs involved.

The recession may be officially over but the key questions now are whether insolvencies will rise, as they have following previous recessions, and what effects government spending cuts will have.

> "Liverpool is recognised by the *Financial Times* as the third largest centre for wealth management after London and Edinburgh."

In a recent R3 poll, businesses here expressed concern over a 'double dip', with 28 per cent fearing it could tip them into insolvency. Although we are not as dependent on public sector jobs as some other regions, the North West is bracing itself for more job losses.

On the positive side interest rates remain low and there is hope for the future too. Manufacturing appears to be one bright spot, with Chamber of Commerce figures showing a strong revival in order books. The region, once criticised for being overly dependent on manufacturing, may find this sector a real strength as it emerges from recession.

There are also new growth sectors. The North West is already a major player in the global nuclear industry, and is now building its reputation in the energy and environmental sector. It is internationally recognised for its biomedical industry, another expanding sector given the North West's ageing population.

The North West is also Europe's second largest media hub. It is now hoping the £3 billion MediaCityUK development, the BBC's new base, will project its creative and media industries onto the world stage. Despite the current adversity, North West plc is optimistic in looking to the future. □

A centre for the insolvency profession

The North West is a major hub for the insolvency industry, with Manchester the centre for corporate insolvency and some of the large IVA firms also based in the region. Given this and the region's strong business base, it's no surprise that some of the key insolvency-related events have taken place here.

- The CVA of Rochdale-based Turner & Newall (T&N) in 2006 was one of the most complex insolvency cases in history and was handled by IPs in the region. The former asbestos manufacturer had liabilities estimated at £8 billion.
- The CVA of Wigan-based JJB Sports, which was soon followed by that of Focus DIY, encouraged a marked rise in the number of CVAs.
- In the personal insolvency area, the North West's IVA providers have faced challenges in recent years due to tighter bank criteria and a number have run into difficulties. The IVA protocol has helped by laying down guidelines but firms that have continued to operate have had to be more efficient than ever and now focus heavily on quality in terms of both service to clients and returns to stakeholders.

Matt Dunham is the chair of the R3 North West Regional chair and a partner at Grant Thornton.

R3 research looks at director disqualification and whether lessons can be learned from corporate failure.

Will Black updates members on R3's latest research on personal and corporate insolvency.

Cost cutting at The Insolvency Service may reduce the number of company investigations

The recent announcement of an 11 per cent cut in the running costs of The Insolvency Service may be an unavoidable necessity in this climate but R3 is concerned that it will lead to a reduction in the number of insolvency and live company investigations The Insolvency Service is able to pursue. The cut comes at a time when the number of cases of suspected misconduct by company directors has nearly doubled in 2009 to 2010.

R3's members believe that, in more than half of the cases they put forward, the decision not to disqualify a director was wrong.

Instances of fraud rise during a recession and many of these cases will not yet have filtered through, as The Insolvency Service has two years to follow up a referral. Although The Insolvency Service has been asked to make cuts in line with other departments, reductions in resource for company investigations is the equivalent of taking police off the beat. It is a matter of public interest that The Insolvency Service has the resources to deal appropriately with all the cases it receives; the key areas of investigations and enforcement should be ring fenced, and the cuts imposed elsewhere within The Service. Company directors should not be able to act wrongfully without fear of repercussion.

Surveys by ComRes show that bad management is to blame for nearly 60 per cent of corporate insolvencies

Incompetence or bad management of company directors causes 56 per cent of corporate failures, while nearly 40 per cent of businesses could have been saved if professional advice had been sought earlier, according to a poll of insolvency experts carried out by R3[1].

R3 is concerned with the level of personal debt. There are estimated to be almost as many people struggling with debt but who have not sought help as those who either have sought help or are formally insolvent. The earlier people seek help the more likelihood there is of being able to manage their debts and avoid formal insolvency.

Steven Law comments: 'Regardless of the economic circumstance, no business will survive with poor management in place. I have seen a good workforce let down and sometimes laid off due to management that does not admit and correct its mistakes.'

R3's research also reveals that a further 60 per cent of insolvency practitioners think the UK's insolvency regime is overly forgiving towards directors who fail and over half think all directors should receive mandatory financial education before they even open a business[2].

However, R3 members believe there are some lessons that can be learned from the experience, as 74 per cent of insolvency practitioners consider corporate failure can drive directors to be more successful. A staggering 84 per cent of IPs also believe it can heighten business acumen[2].

Steven Law concludes: 'For some directors, the experience of failure can clearly drive them onto greater successes, but I would share concerns that the current regime is, if anything, too forgiving to directors who have failed. Clearly it would not be practical to educate every director before they are appointed, but there must be enough checks and balances to ensure that directors of failed companies should not put creditors and jobs at risk if they are allowed to repeat their mistakes.' □

[1] Figures from online survey of R3 members in the UK conducted by ComRes between 10 and 26 May 2010. One in six IPs responded.

[2] Figures in these two paragraphs from an online survey of R3 members in the UK conduced by ComRes between 4 and 23 February 2010. One in five responded. For full tables go to www.comres.co.uk.

Will Black is the communications manager at R3.

Personal insolvency in England and Wales

A North–South contrast is shown by new personal insolvency data.

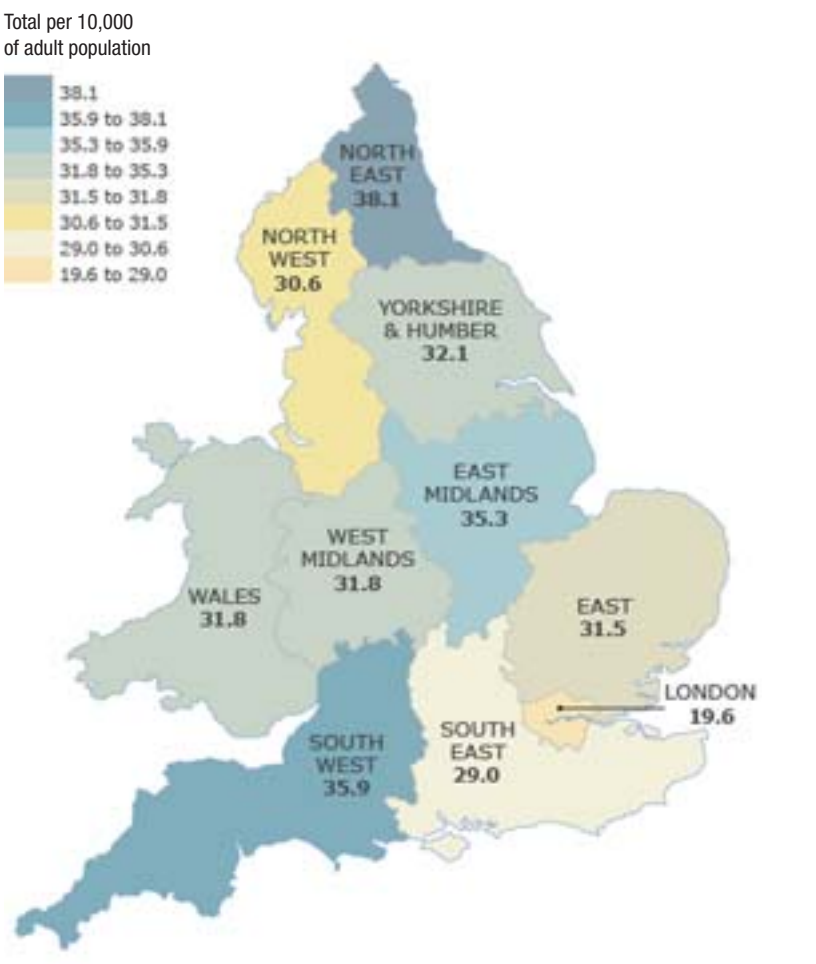
Personal insolvency numbers are currently at record highs, in part owing to people finding themselves out of work and with debts in the downturn, reports the BBC.

New data from The Insolvency Service shows the hot spots for personal insolvencies in England point to a North–South divide in 2009. The highest rate of personal insolvency, such as bankruptcies and individual voluntary arrangements, was in the North East of England and the lowest level was in London.

The figures

The data for England and Wales gives a breakdown of the geographical areas in which personal insolvencies are most prevalent. This shows that the highest levels were in the North East where there were 38.1 personal insolvencies per 10,000 adults in 2009. This was higher than the average in England and Wales of 31.1, and considerably higher than the lowest: 19.6 in London. The same two areas were also the locations for the highest and lowest rates of personal insolvencies in 2008.

Personal insolvency rates in England and Wales 2009



Source: Insolvency Service

'Prior to the recession, the North East had a higher than average unemployment rate and the region's construction industry was badly hit during the economic downturn so it is understandable that personal insolvencies are more common there,' said Steven Law, president of R3.

However, the previous year, the South West of England was at the highest level. This region remains the second highest in 2009, with 35.9 personal insolvencies per 100,000 of the population.

On a more local level, Ealing and Wandsworth in London had the lowest personal insolvency rates, apart from the City of London, although the numbers were up slightly in 2009 compared with 2008.

What the records show

Although these figures show the picture in 2009, data already published shows that large numbers of people are facing debts in 2010. The number of people being declared insolvent in England and Wales has been at record highs for five consecutive quarters. There were 35,682 personal insolvencies in the first three months of 2010, a 17.9 per cent increase compared with the same period a year earlier.

> "There were 35,682 personal insolvencies in the first three months of 2010, a 17.9 per cent increase compared with the same period a year earlier."

Debt charities are urging people to approach advice agencies for help as soon as they realise they are facing financial difficulties. □

Personal insolvency information from R3

R3 has recently sent out a press release about this and produced a colour-coded map of the personal insolvency hot spots in England and Wales. This information can be found on our website: **www.r3.org.uk/newsandpress/default.asp?page=1&i=523&id=445#PressStory**.

R3 events, courses and conferences

Date	Event title	Venue
September		
6	North West Regional Meeting	
7	JIEB Student Workshop	Lawrence Graham LLP
7	South West & Wales Regional Meeting	Aztec Hotel and Spa, Bristol
7	Yorkshire Women's Group Breakfast Briefing	Zolfo Cooper, Leeds
8	JIEB Student Workshop	Lawrence Graham LLP
8	North East Regional Meeting	
14	Introductory Programme Liquidations 1	etc Venues, London
14	Introductory Programme Liquidations 1	Deloitte, Birmingham
16	Introductory Programme Liquidations 1	Irwin Mitchell, Leeds
21	Personal Insolvency	Cedar Court Hotel Huddersfield
21	JIEB Student Workshop	Ernst & Young LLP
22	JIEB Student Workshop	Ernst & Young LLP
23	Midlands Regional Meeting	
23	Yorkshire Regional Meeting	
28	Business & Options Reviews	CCT Venues Barbican, London
30	Lite Conference	Royal Bath Hotel Bournemouth
October		
5	Introductory Programme Liquidations 2	etc Venues, London
5	Introductory Programme Liquidations 2	Deloitte, Birmingham
5	Personal Insolvency	Cheltenham Chase Hotel
7	Introductory Programme Liquidations 2	Irwin Mitchell, Leeds
14	Southern Women's Group Dinner	
26	The A–Z of Tax in the decline curve	Hilton Tower Bridge, London
26	Introduction to structured finance for IPs	Hilton Tower Bridge, London
November		
2	South West & Wales Regional Meeting	
4–5	SPG Conference	Hilton Birmingham Metropole
6	Introductory Programme Liquidations 3	etc Venues, London
6	Introductory Programme Liquidations 3	Deloitte, Birmingham
8	Introductory Programme Liquidations 3	Irwin Mitchell, Leeds
1	Buying a Business	R3, London
11	Yorkshire Quiz Night	
12	London & South East Ladies Lunch	
16	The A–Z of Tax in the decline curve	Royal York Hotel
16	Introduction to structured finance for IPs	Royal York Hotel
17	Yorkshire Regional Meeting	
23	Personal Insolvency	Holiday Inn, Bloomsbury
24	London & South East Regional Meeting	
30	The A–Z of Tax in the decline curve	Hilton Birmingham Metropole
30	Introduction to structured finance for IPs	Hilton Birmingham Metropole

For further information on R3 courses and conferences, please visit the R3 website **www.r3.org.uk**, where you can download the full 2010 programme. Alternatively, call the Courses team on 020 7566 4234 to request a programme by post.

regional events R3 events

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R3 contacts

Staff R3, 8th Floor, 120 Aldersgate Street, London EC1A 4JQ
Tel: 020 7566 4200 **Fax:** 020 7566 4224 **Website:** www.r3.org.uk

President ..... Steven Law *e-mail:* steven.law@ensors.co.uk
Vice-president ..... Frances Coulson *e-mail:* fcoulson@moonbeever.com

Administration

Chief Executive Officer ..... Graham Rumney *e-mail:* grumney@r3.org.uk
Executive Assistant ..... Gabriella Pizzichemi *e-mail:* gpizzichemi@r3.org.uk
HR and Office Manager ..... Alan Roberts *e-mail:* aroberts@r3.org.uk
Assistant Office Manager ..... Tasneem Choudhury *e-mail:* tchoudhury@r3.org.uk

Finance

Finance Manager ..... Ryan Porter *e-mail:* rporter@r3.org.uk
Finance Assistant ..... Alex Coles *e-mail:* acoles@r3.org.uk

Membership & Marketing

Head of Marketing & Member Services ..Cynthia Matthews *e-mail:* cmatthews@r3.org.uk
Marketing Executive ..... Helena Douglas *e-mail:* hdouglas@r3.org.uk
Membership Marketing Assistant ..... Katherine Bassett *e-mail:* kbassett@r3.org.uk
Regional Administrator ..... Rinisha Bhagat *e-mail:* rbhagat@r3.org.uk
Database & IT Administrator ..... Rashed Ghadache *e-mail:* rghadache@r3.org.uk

Communications, Public Affairs and Policy

Director of Communications & Public Affairs ..... Victoria Jonson *e-mail:* vjonson@r3.org.uk
Communications Manager ..... Will Black *e-mail:* wblack@r3.org.uk
Policy Manager ..... Esme Harwood *e-mail:* eharwood@r3.org.uk
Communications Officer ..... Addy Frederick *e-mail:* afrederick@r3.org.uk
Public Affairs Officer ..... Laura Harvey *e-mail:* lharvey@r3.org.uk

Education, Courses and Conferences

(Tel: 020 7566 4234; Fax: 020 7566 4225)
Training Director ..... David White *e-mail:* dwhite@r3.org.uk
Head of Courses and Conferences ..... Angela Stannard *e-mail:* astannard@r3.org.uk
Courses and Conferences Organiser ..... Natalie Harvey *e-mail:* nharvey@r3.org.uk
Courses and Conferences Co-ordinator ..May Ghaghda *e-mail:* mghaghda@r3.org.uk
Course Administration ..... Maggie Dean *e-mail:* mdean@r3.org.uk
Course Bookings ..... *e-mail:* courses@r3.org.uk

Technical

Technical Director ..... John Francis *e-mail:* jfrancis@r3.org.uk

Committee Chairs

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Regional Representatives on the R3 Council

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- Access to the members' section of the R3 website
- An invitation to the R3 annual conference
- Continuing professional education at discounted rates

Please see below for details of the different categories of membership:

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Associate members are individuals who do not meet the requirements for full membership but work significantly within the business recovery sector.

New Professional (Student) members are individuals preparing to take the examination of the Joint Insolvency Examination Board (JIEB) or Certificate of Proficiency in Insolvency (CPI). Pass students of these exams are eligible to apply for full R3 membership.

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Richard is a Fellow of R3 and has many years' experience of both domestic and cross-border restructuring and insolvency work. He joins from Holman Fenwick Willan.

Toby Stroh, Head of Druces' Corporate Department comments: *"We are delighted to welcome Richard to the firm. Druces has a successful tradition of acting for clients in complex restructuring and insolvency matters. The expertise Richard brings will supplement our existing strengths and enhance our services to our clients"*.

www.druces.com

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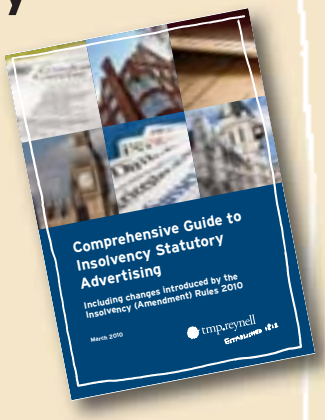

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Download our guide from
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Interview with Richard Favier

Sarah Houghton spoke to Richard Favier at the PPF about the things that concern IPs.

How does the PPF operate?

The Pension Protection Fund (PPF) was established in April 2005. It delivers compensation to members of eligible defined benefit pension schemes when their employer has gone bust. Funding comes from the pension protection levy, pension scheme assets, dividends, proceeds of restructuring and revenue generated by investment of these funds.

The number of cases has remained fairly stable at 100 each year since 2005. Surprisingly, it did not go up during the recession, although the size and profile of the schemes grew. For example, we took on Nortel and Woolworths.

Since its inception, the PPF has recovered about £825 million in assets. This is split about 50:50 between insolvencies and proceeds from restructuring. It gives an average dividend rate of 7.25 per cent.

The levy has been held at the current level for the last three years. Last year we set up an industry steering group to help us look at a new long-term levy formula. Calculating the levy is very complex.

What are your views on contribution notices and pre-packs?

The Insolvency Service's consultation paper has stimulated debate on pre-packs. IPs need to be able to explain why a pre-pack is the right way to go. When the creditors' report comes into the PPF and we see there is a pre-pack, if there is a connected party involved, we report it to the regulator in case they wish to investigate. This happened in the case of Bonas.

It appears there may be a divergence of views between the PPF and tPR concerning pension liabilities. Could you explain this?

Reporting of the Reader's Digest administration has not been strictly accurate. The PPF discussed a reconstruction with Reader's Digest but only agreed to go ahead with it if the regulator informed us that they couldn't get more for the pension scheme by using their powers. It was always a conditional agreement. The PPF and the Pensions Regulator (tPR) work closely together on every transaction.

What is the PPF's attitude to zombie companies?

We are prepared to discuss these provided they've spoken to the regulator and insolvency is inevitable. We would expect a return beyond that of the otherwise inevitable insolvency as that's in the interests of the PPF and the recipients. There are criteria that companies have to meet before we will agree to participate in a restructuring. If they can't tick all the boxes then we cannot proceed. In cases where insolvency is not inevitable, the regulator helps the trustees and the corporate to find a solution.

> "If we think that IPs are not notifying us in time we will report the facts to their RPBs. However, many RPBs are too sympathetic to IPs who haven't asked basic questions."

How can the PPF and IPs improve their working relationship?

We have introduced a web-based tool that IPs should use to check if any employer has a pension scheme – so it's not difficult. IPs should do this on day one of a case. Notification has improved recently but it's not great.

If we think that IPs are not notifying us in time we will report the facts to their RPBs. However, many RPBs are too sympathetic to IPs who haven't asked basic questions. For instance, they are not always very proactive in checking if any moneys have gone out of a company. The PPF keeps a spreadsheet on defaults, which is passed to the Secretary of State monthly.

Some IPs are better than others, and some are excellent. Many are better at the front end of an administration than the back end; getting a case closed doesn't always seem to be a priority.

If IPs wish to discuss anything they can always phone the PPF. As the PPF is often their largest creditor it makes sense to discuss any concerns before the meeting.

Richard Favier

Richard Favier is a senior insolvency advisor at the Pension Protection Fund. Before joining the PPF he was a policy maker in the Policy Directorate of The Insolvency Service where he advised government ministers on UK, European and international insolvency policy. Prior to that, he was an official receiver and a manager in the insolvency/recovery practice of a major international firm of accountants.

What is your view on IPs' fees?

Some of their charges don't always seem to equate with the time worked, and lately charges have got very high. The way we see it, every pound gone in remuneration is a pound off someone's pension pot. Creditors should vote on the remuneration of IPs but the problem is they don't always have sufficient transparency and cannot always judge if what they are being asked to pay is good or bad value for money.

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It will be difficult to resolve the issues the OFT enquiry has brought up. Perhaps firms should be asked how much, on average, they have recovered in relation to their remuneration. But this could be difficult, as some corporates have very few assets to recover. However, the PPF is largely content with the way things work at the moment. It is often easiest to deal with the IP by a phone call and then exercise our vote at the creditors' meeting.

How will the government's plans to change the private pension inflation link affect the PPF?

The government has indicated that it intends to apply CPI to the PPF's compensation instead of RPI, and the PPF will have to look at the legislation when it comes out and put it into effect. Essentially, the PPF has to deliver government policy. □

Comments from Stephen Soper at the Pensions Regulator

The Pensions Regulator (tPR) has just issued its first contribution notice against a company. Does this suggest there will be many more to come?

The regulator's approach is described as 'educate, enable, and enforce' – educating those who run pension schemes, giving them support to enable them to carry out their role to the highest possible standards, and using enforcement powers as a last resort and only when no other solution can be found.

As well as providing guidance on our expectations, we carry out both proactive and reactive case work where we believe that there has been an attempt to avoid pension liabilities. We will continue to work with schemes and sponsors to resolve issues before stepping in to exercise our powers, closely scrutinising all situations where we feel there is the potential for avoidance activity before we act.

Under what circumstances will tPR seek to use its moral hazard powers after a pre-pack?

Typically the use of moral hazard powers focuses on events leading up to a pre-pack.

If the business was marketed and the connected party made the best offer, would tPR still use its moral hazard powers?

This would depend on the individual circumstances of the scheme and the transactions relating to the event.

Stephen Soper

Stephen Soper is the head of both Risk & Funding and Pensions Administration & Governance at the Pensions Regulator. He is responsible for mitigating risks to scheme members' benefits and promoting better administration of pension schemes through trustee, employer and advisor relationships. He is a chartered banker (ACIB) and has worked for a number of major banks and insurance companies in senior roles.

What is your view on zombie companies and do you have any statistics on them?

Low security schemes are a segment the regulator is aware of. The classification is dynamic, and a function of the employer covenant, scheme liabilities and assets. In the current economic environment it is difficult to provide exact numbers for this segment.

We would take the following principles into account when assessing any restructure of schemes and companies in this segment:

- Abandonment should not be contemplated unless it appears certain that the scheme will default on its members in some way due to sponsor non-viability, barring exceptional positive developments.
- Whether members and/or PPF are significantly better off than if no insolvency takes place.
- Whether members and/or PPF get a sufficient stake in any future business to ensure no exploitation of them post-abandonment. Where gain is available, members and/or PPF get no less than *pari passu*.
- If we are sure that use of our moral hazard powers could not obtain a better result for members.
- Whether the risks to the PPF of any proposals are acceptable in the context of our broader duties to members as well as the PPF.
- Whether the proposal demonstrates that a proper account has been taken of the members' interests, especially where the risks have increased, and appropriate ongoing arrangements are in place to manage those risks.
- Ensuring that any restructuring costs are proportionate and fairly shared among parties.

What is tPR's view of the impact on DB schemes of the shift from RPI to CPI?

The impact of the changes is likely to be scheme specific. For the time being, the current scheme funding regime and associated processes will continue and payment schedules should remain in force. We will continue to assess recovery plans on the current basis and all other regulatory discussions will also continue on this basis.

If the proposed changes result in lower estimated liabilities for schemes, we would expect that this would generally lead to shorter recovery plans – which would result in greater security for members and greater certainty for employers.

It is presently unclear how the changes will affect schemes under the PPF. This would be a matter for the PPF and it would be inappropriate to comment further at this time.

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IN A CHANGING WORLD IT PAYS TO SEE BOTH SIDES OF THE EQUATION

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