Winter 2021

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Association of Business Recovery Professionals R3 Rescue Recovery Renewal

RECOVERY

Sustainability and supply chain

The semiconductor crisis
Read an exclusive interview on risk management at a major automotive manufacturer

Adult social care
Find out what crisis points are facing the sector today and how the new market oversight scheme works in action

Legal update
A look at cross-class cram down through the courts

An interview with… Louise Durkan, chair of the R3 new professionals steering committee
Find out how the association is organising to work with the professionals of the future

What do you think? Readers' views are welcome. Have an opinion about a burning issue? Want to comment on articles or *RECOVERY* itself? Please contact me on **membership@r3.org.uk.**

> **Supply chain distress is at the centre of our current economic woes and continues to push up inflation, which is going to result in an increase in interest rates, and which will all mean less bang for our buck in the new year.**

From the editor

I am not saying that you should ask them to pick your lottery numbers, but the editorial board's soothsaying skills are amply demonstrated by this edition.

When the board sat down at the start of September to choose the theme – supply chain distress – for this edition, they could not have foreseen the petrol crisis, extravagant gas and oil price increases, staff shortages or supply difficulties that have been at the centre of the news in the last couple of months… or could they?!

Supply chain distress is at the centre of our current economic woes and continues to push up inflation, which is going to result in an increase in interest rates, and which will all mean less bang for our buck in the new year. For an economy based on consumer spending, that translates into an economically challenging year ahead and beyond, even if we can tie up the remaining Brexit difficulties with our European friends.

Supply chain distress is therefore a source of work, but also a reason why there will be an increase in demand for our services going forward.

On that topic, board member Dan Hurd of EY interviews Michael Aiers of Stellantis on the effect of supply chain distress in the automotive sector on pages 14–16. Samantha Reeves and Pippa Hill look at the effect on the social care sector on pages 18–19 and we have an article from Stuart Dean, director of the CQC's market oversight team, on their role on page 25.

On the legal side, David Mohyuddin QC and Andrew Brown provide their latest instalment on the court's approach to restructuring plans (pages 6–8) and Alex Jay and Ryan Hooton look at the exchanging of information between insolvent estates with the same office-holders (pages 28–29).

We also hear from Louise Webb on the effect of ESG factors on the pensions industry (pages 20–22) and Anton Chambers and Mark Trottier on US-style stalking horse agreements (pages 30–31) in the aviation sector and what consequences these could have for our industry in the UK.

From Europe, Frank Tschentscher looks at continued issues with zombie companies across the continent, an issue we know well, and the potential fightback that might need a double dose of vaccine!

Our interview starting on page 39 is with Louise Durkin, chair of R3's steering committee on working with the new professionals group. On that topic, we are looking for a new professional to join the editorial board so if you are interested or know someone who might be interested, let us know.

Enjoy this edition, assuming that supply chain distress does not prevent delivery! I hope you and your families have a relaxing and enjoyable Christmas and new year.

NEIL SMYTH is a partner at Mills & Reeve and is the editor of *RECOVERY*.

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RECOVERY

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Printed by Stephens & George

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

RECOVERY is the quarterly magazine of R3, the Association of Business Recovery Professionals, 3rd Floor (East), Clerkenwell House, 67 Clerkenwell Road, London EC1R 5BL.
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***RECOVERY* on the web**
RECOVERY is distributed to R3 members as part of their membership benefits. After an issue of the magazine has been sent to members, a PDF of the previous issue is uploaded onto the R3 website. This is so that the information may be disseminated to all the insolvency and restructuring community.
www.r3.org.uk/recovery

Published on behalf of R3 by
GTI Futures, The Fountain Building, Howbery Park, Benson Lane, Wallingford, Oxon OX10 8BA
www.groupgti.com, Tel: 01491 826262

President's column

Colin Haig is happy to see the profession back together face to face!

All the signs seem to suggest some semblance of normality is returning. As I was writing this column, we were into the third month of restriction-free living, and life after lockdown appears to be slowly returning to how it was before the pandemic.

The same applies to R3. We've held our first face-to-face event for more than 18 months, the Training Academy has introduced a range of new courses and our Virtual SPG Forum has been as successful as its predecessors.

Bringing the profession back together

At the start of October, R3 held its first face-to-face event since the start of the pandemic. The Getting Back to Business Lunch saw more than 450 people from across the profession come together to network, catch up and discuss the latest trends and challenges in their part of the marketplace.

For me, that's a critical part of what R3 is about: bringing all elements of the profession together to network, swap expertise and discuss potential new ways of working and working together.

But another key aspect of the lunch was the fundraising element. I was very touched by the donations attendees made to Aspire, the spinal cord injury charity, who do fantastic work helping people affected by spinal injuries.

To everyone who donated: thank you. We raised more than £4,000 to support Aspire and the people they help – a great result.

> **The Getting Back to Business Lunch saw more than 450 people from across the profession come together to network, catch up and discuss the latest trends and challenges in their part of the marketplace.**

Recognising members' contributions

Our Getting Back to Business Lunch was also a time to recognise members for their help with and support of R3 and its work.

I was delighted to present Tim Cooper with the R3 Excellence Award for his sterling service as chair of R3 in Scotland. Well done Tim and thank you for all your support! Whoever takes over from you in Scotland next year has big shoes to fill.

But Tim wasn't our only award winner. I was hugely pleased to be able to recognise Stewart Perry, Alison Goldthorp, Mark Shaw, Mark Phillips QC and Paul Zalkin for their work on our Back to Business UK campaign by presenting them with the 2021 President's Award.

Back to Business UK has been a key project for R3 this year. It wouldn't have achieved anywhere near as much as it did without the contribution of this group. Members have spoken on webinars, they've written protocols and guidance and they've provided training for members and people from the wider business community.

This support has been invaluable to the campaign, which has educated management teams about the profession, its work and the importance of early engagement. More is planned in the coming weeks and months.

Celebrating the SPG community

November saw us hold our 2021 SPG Forum. It took place online again as 2020's virtual conference was such a success.

As usual, we had a range of fantastic sessions and speakers, but for me the highlight was hearing Trevor Williams' views on the impact of the pandemic on the economy and how he thinks it will fare over the next 18 months.

It was also great to hear from the Insolvency Service about the latest changes to the policy landscape, and the FCA's guidance for IPs on working with regulated firms.

As ever, thank you to everyone who attended and who made the conference a success. Hopefully we'll be able to do the next one in person.

Evolving our training offering

The R3 Training Academy has been going great guns in its first year. We've launched certifications, developed bootcamps and put on a number of successful virtual training events.

Our Restructuring Week in September saw us run eight sessions on a range of topics from an analysis of the restructuring plan to the future of complex pension schemes, and was attended by more 120 people.

This was the third of these themed weeks we've run this year – hopefully all three will be repeated in 2022, as they have all been a tremendous success.

> **One thing I think we can all agree on is that the profession's skills and services will be more in demand over the next year than they have for the last ten.**

Changing, challenging times

One thing I think we can all agree on is that the profession's skills and services will be more in demand over the next year than they have for the last ten.

Covid-19 has taken a toll on people both personally and financially, and it will be our job to help them find a way out of any financial distress they encounter.

That's going to mean we'll be under scrutiny. How we handle the next two years will shape how the profession is seen and talked about for the next 20.

Now is the time to be as innovative, organised and collaborative as we can, so we can show what we're really about and the difference we make to individuals, businesses and the economy.

But before that, there's the Christmas break. Have a good one, folks. Something tells me 2022 is going to be busy. □

COLIN HAIG is the president of R3 and head of restructuring at Azets.

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Sharpening the corporate restructuring tool – a follow up

David Mohyuddin QC and **Andrew Brown** revisit the corporate restructuring tool in the wake of *Virgin Active* and *Hurricane Energy*.

Time marches inexorably onwards, which for the law provides steady refinement and clarity through argument, judicial analysis, and case law (or so the theory goes). For the writers of legal update articles, the remorseless march of time results in a constantly moving, and never achievable, target of being up-to-date with the law. Such is the case for the ourselves and our article in *RECOVERY* of summer 2021 (page 6 of that edition) exploring the case law relating to the restructuring tool one year on from its inception. No sooner had we submitted our article for publication than the courts published two new judgments considering for the first time contested sanction hearings: *Re Virgin Active Holdings Limited* [2021] EWHC 1246 (Ch) and *Re Hurricane Energy Plc* [2021] EWHC 1759. The effect was to render our article in need of its own update. This article will explore those two judgments, their impact upon our understanding of contested restructurings, and specifically upon the most likely issue to be considered by the courts at such hearings.

Sanctioning a restructuring plan

As previously discussed in our June article, the restructuring tool is a mechanism under part 26A of the Companies Act 2006 to enable a company to reorganise its liabilities when it is, or envisages that it soon will be, in financial distress, by way of a compromise or arrangement with its creditors. The novel feature of the tool is its ability to 'cross-class cram down' (or up) dissenting groups of creditors, an option allowed in other jurisdictions such as the US, but not previously allowed in the well-trodden domestic fields of schemes of arrangement. The court process is multi-staged, with two successive court hearings sandwiching a creditors'/members' meeting. The first hearing is called a convening hearing, and its primary purpose is to satisfy the court that class meetings of creditors and/or members should be convened, that they have been given sufficient and appropriate information, and that the classes of creditors/members are appropriately constituted. The second hearing is to consider whether the plan should be approved, including any consideration of any cross-class cram downs or the views of dissenting creditors/members.

> “The courts published two new judgments considering for the first time contested sanction hearings: *Re Virgin Active Holdings Limited* [2021] EWHC 1246 (Ch) and *Re Hurricane Energy Plc* [2021] EWHC 1759.”

The cases explored in our previous article mostly concerned matters arising at the first convening hearing, namely issues of class composition and the applicability of the restructuring tool when faced with foreign elements from outside the jurisdiction. This article will focus on contested sanction hearings where a class of creditors or members takes an active legal role in attempting to prevent the sanction of a plan by challenging the financial conditions necessary to allow a cram down.

Re Virgin Active Holdings Limited

Snowden J, as he then was, handed down judgment in *Virgin* on 12 May 2021. As is obvious from the name, the case concerned the restructuring of the Virgin chain of gyms, which faced significant financial issues as a result of Covid-19-related lockdowns. The creditors were divided into seven classes: the secured creditors (who would receive 100% of their debt, but have the maturity date for their lending facilities extended by three years), five sub-groups of landlords divided by the profitability of their particular gyms (the difference in approach to each group included no substantial difference for the class A landlords, changes in leases to turnover-based rents, or zero-rent leases in exchange for a single pay out of 120% of the return expected in the relevant insolvency alternative – administration), and unsecured creditors (who would receive a payout equivalent to 120% of that expected in an administration).

Unsurprisingly, the secured creditors and class A landlords – who would receive no significant financial detriment if it was sanctioned – voted to approve the plan. Those landlords and unsecured creditors who would only receive payouts in relation to the relevant alternative vehemently rejected the plan. Thus, Snowden J was faced with the question of whether to sanction a cross-class cram down despite the objections of a significant number of creditors who were being treated differently from the supporting creditors.

Part 26A of the Companies Act 2006 allows the cross-class cram down only where certain conditions are met. These can be divided into two conditions:

- **Condition A:** the court must be satisfied that none of the members of the dissenting class would be any worse off than they would be in the event of 'the relevant alternative'. The 'relevant alternative' is whatever the court considers would be most likely to occur in relation to the company if the restructuring plan were not sanctioned. This itself involves a three-step process:
  - First, identifying the likely future of the company if the plan were not sanctioned (step 1);
  - Second, determining what the consequences would be for creditors/members in that postulated future (step 2); and
  - Third, comparing that outcome with the likely outcome and consequences for creditors/members were the plan sanctioned (step 3).
- **Condition B:** the restructuring plan must have been approved by 75% in value of at least one class of creditors or members who would receive payment or have a genuine economic interest in the company in the event of the 'relevant alternative' (the 'in-the-money creditors').

> “The lessons to be learned from *Virgin* are that those creditors who have an economic interest in the relevant alternative will be the ones to whom the court gives its favour.”

In *Virgin*, condition B was clearly met by the secured creditors and class A landlords approving the plan. The case turned on condition A, and the 'relevant alternative'. The company submitted that the relevant alternative was administration involving the accelerated sale of the most valuable parts of the companies' businesses. In support, the company submitted evidence of various valuations and calculations, which the court considered to be reasonable and capable of being relied upon for the purposes of determining whether to sanction the plans. The dissenting landlords provided no competing evidence. Based on the evidence, each dissenting class of plan creditor would be no worse off under the plans than in the relevant alternative.

Ultimately, Snowden J sanctioned the plan for various reasons, but primarily based upon the economic evidence tendered by the company. He noted that part 26A gives little guidance on the factors that are relevant when the court is exercising its discretion, but since the opposing landlords would be out of the money in the relevant alternative, the court attached little weight to the numerical opposition to the plans in the lower-ranking classes. Instead, it was for those creditors who are 'in the money' to determine how to divide up any value that might accrue post-restructuring. The differential treatment between landlord classes was accepted due to the variable profitability and commercial importance of the relevant clubs. Snowden J further held that there was nothing inappropriate in choosing to use a restructuring plan rather than a CVA (where a CVA was likely to be blocked by the landlords' votes). Finally,

> **The judge disagreed with the company, and held that there was also a realistic prospect that it would be able to meet its payment obligations to the bondholders (through potential refinancing of any shortfall in payment), while leaving assets with at least a potential for exploitation.**

the retention of equity by the shareholders was predicated on substantial 'new value' offered by them, where the court accepted that the new money lent by the shareholders could not have been obtained on the same or better terms from any other source in the market.

The lessons to be learned from *Virgin* are that those creditors who have an economic interest in the relevant alternative will be the ones to whom the court gives its favour. This is not a surprising outcome in the insolvency sphere, but an important reminder that if one challenges the sanctioning of a plan then they must consider filing evidence disputing the company's financial projections.

Re Hurricane Energy Plc

Zacaroli J handed down judgment in *Hurricane* on 28 June 2021, and it provides a useful counterpoint to *Virgin* on approaches to the consideration of 'relevant alternatives' when considering whether to sanction a cross-class cram down. In 2017, the company raised US $230m (£172m) through the issue of convertible bonds. This was done with the intention of embarking on the discovery and extraction of oil. The maturity date for the bonds was July 2022 with the hope that sufficient oil would be discovered and extracted so as to repay or refinance the bonds. However, as the maturity date approached, the company realised that its oil wells had significantly fewer reserves than previously estimated.

In response to this impending financial cliff, the company proposed a restructuring under part 26A. Under the plan, the maturity date of the bonds would be extended to December 2024, and the capital amount due would be reduced to $50m (from the original $230m). The company would issue shares to the bondholders in exchange for the haircut to the value of the bonds, with the result that the bondholders would hold 95% of the diluted equity, with the existing shareholders retaining only 5%. The company would then undertake a wind-down and liquidation of its assets. Unsurprisingly, the plan was opposed by 90% of shareholders, but approved by 100% of bondholders. To add fuel to the fire, the company's annual meeting was due to be held in June 2021 with the likely replacement of the directors by a new board (at the behest of aggrieved shareholders), who were unlikely to pursue a restructuring plan. The current board of directors, through the company, submitted this was a reason for urgency. Further, the company submitted that the relevant alternative was a near-term insolvency, and adduced a report by PwC containing a detailed analysis of the financial position of the company, and the relevant alternatives such as liquidation.

After considering condition A and its relevant substeps, Zacaroli J refused to sanction the plan. He held that there was no apparent threat of imminent liquidation under step 1, and the company could continue to trade profitably for another year. With regard to steps 2 and 3, the judge disagreed with the company, and held that there was also a realistic prospect that it would be able to meet its payment obligations to the bondholders (through potential refinancing of any shortfall in payment), while leaving assets with at least a potential for exploitation. That was enough to refute any contention that the shareholders would be no better off under the relevant alternative than under the plan. To retain 100% of the equity in a company that was continuing to trade, with a realistic prospect of being able to repay the bonds in due course and a potential share in eventual profits, was a better position than immediately giving up 95% of the equity with a prospect of a less than meaningful return as to the remaining 5%.

> **Whereas in *Virgin*, the company got it right in providing appropriate evidence (which was not challenged), in *Hurricane*, the company got it wrong and jumped the gun too early.**

Nor did the judge take a favourable view of the company's submissions on the likely change in directorship. He held that unless the company entered formal insolvency proceedings, the issue of directorship was ultimately one to be decided by the shareholders. Further, the bondholders were unsecured creditors with no right to opine upon the control of the company.

As with *Virgin*, the court will be acutely concerned with the evidence of the company's finances and the relevant alternative, where there is much scope for argument. It will pay close attention to the issues of the hypothetical impact on dissenting creditors/members inside and outside of any plan. Whereas in *Virgin*, the company got it right in providing appropriate evidence (which was not challenged), in *Hurricane*, the company got it wrong and jumped the gun too early. □

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ANDREW BROWN is a barrister at Radcliffe Chambers.

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Legal Q&A

Dominic Offord answers your insolvency queries.

Q Who is entitled to challenge liquidators and trustees in bankruptcy conduct under the Insolvency Act 1986?

A Office-holders' conduct is increasingly under the microscope. Those who are affected by a liquidation or bankruptcy often have their own views about how a liquidator or trustee in bankruptcy (office-holder) should discharge her or his duties. When these views do not align with those of the office-holder, they may want the court to intervene.

Section 168(5) of the Insolvency Act 1986 (the Act) provides that an application to court may be made by *'any person'* who is *'aggrieved by an act or decision of the liquidator'*. On such an application being made, the court can *'confirm, reverse or modify the act or decision complained of, and make such order in the case as it thinks just'*. Similar provision is made in respect of the conduct of trustees in bankruptcy at s303(1) of the Act, although the word *'dissatisfied'* rather than *'aggrieved'* is used.

At first blush, the class of people who can challenge the office-holder's conduct appears wide. The wording of both provisions is broad, and one aspect left unclear is whether or not a particular *'person'* will have standing to challenge the liquidator or trustee in bankruptcy.

The recent Court of Appeal case of *Brake* v. *Lowes*, set against rather complex and interweaving background facts, provides some clarity. The judgment relates to two appeals, both concerned with the disposal of a property and an adjoining strip of land by the joint liquidators of partnership (Stay in Style) and the trustee in bankruptcy to two former partners of the partnership (Mr and Mrs Brake). The Brakes bid to acquire the property and land in their capacities as trustees of a family trust, but their bid failed. They alleged collusion between the trustee in bankruptcy, the liquidators and the ultimate purchaser and brought claims against the liquidators under s168 of the Act and the trustee in bankruptcy under s303 of the Act, with a view to obtaining an order setting aside the sale and requiring their bid to be accepted.

The High Court held that the Brakes had no standing to make either application. Undeterred, they appealed that decision.

The Court of Appeal found that:

- The Brakes did not have standing in either the bankruptcy or in the liquidation to make the challenges.
- Merely being a bankrupt or former bankrupt was not enough on its own to give standing to apply.
- The test is whether the bankrupt can show that they have (i) a substantial interest that has been affected by the conduct complained of and (ii) a direct interest (not necessarily financial) in the relief sought. A surplus of funds could be one way of establishing a substantial interest, but is not the only one.
- Similarly, the Brakes in their capacity as trustees of the family settlement were neither contributories nor creditors in the liquidation and they did not have a substantial interest in the relief sought such that they would be regarded as aggrieved. Merely being a bidder in a sale process was insufficient.
- Similarly, two unsecured creditors, funded by the Brakes, were also found not to have standing for the purposes of s168(5) on the basis that they were not aggrieved and were seeking only to advance the Brakes' case on their behalf.

This case is a useful illustration that, although the wording in s168 and s303 of the Act about who can make a challenge to the office-holders' acts or omissions appears wide, the court is not going to allow challenges by applicants unless they can establish a justifiable and legitimate interest. Merely being a bankrupt does not entitle an individual to interfere with the trustee in bankruptcy's administration of the estate, neither is being a creditor in itself sufficient to create standing. The creditor must establish that they have been aggrieved and the court will be unimpressed by the use of creditors by outsiders to attempt to create standing for the pursuit of their own complaints.

In an age where office-holders face challenges with increasing regularity, this case provides some comfort that the court will not allow challenges to their conduct by persons unless strict criteria are met. □

> **"Section 168(5) of the Insolvency Act 1986 (the Act) provides that an application to court may be made by *'any person'* who is *'aggrieved by an act or decision of the liquidator'*."**

DOMINIC OFFORD
is a partner at
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Recent case summaries

The latest insolvency update from **Jeremy Richmond QC** and **Benjamin Joseph**.

Andrew* v. *Kingsway Asset Finance

In *Andrew* v. *Kingsway Asset Finance* [2020] BPIR 1069 the respondent to a bankruptcy petition, Mr Andrew, applied under s284 of the Insolvency Act 1986 for a validation order for the proceeds of the sale of two properties to be paid (i) to discharge certain mortgage arrears, and (ii) to meet his past and future legal costs (£42,600 and £54,400 respectively) and ongoing living expenses (£6,700 per month). A supporting creditor, Kingsway Asset Finance, opposed the application and was represented at the hearing by the author, Jeremy Richmond QC. The petitioning creditor was formally neutral as to the application.

Section 284 of the Insolvency Act 1986 provides that where a person is adjudged bankrupt any disposition of property made by that person between the presentation of the petition and the bankruptcy order is void except to the extent that it is or was made with the consent of the court, or is subsequently ratified by the court. It was common ground between the parties that the principles concerning the validation of payments in the context of corporate insolvency were applicable by analogy – *viz* whether there is some special circumstance that shows that the disposition in question will be or has been for the benefit of the general body of unsecured creditors such that it is appropriate to disapply the usual *pari passu* principle. As for the question of the validation of legal expenditure, however, the judge drew a distinction between the principles applicable in the context of corporate and personal insolvency respectively. The judge considered that the court had broad discretion in the context of personal insolvency to validate the payment of legal fees in relation to bankruptcy proceedings and, particularly, in relation to legal fees incurred in contesting the existence of the petition debt. The rule was said to be justified by the '*dictates of humanity*' in *Re A Debtor* [1937] Ch 92 and *Rio Properties Inc* v. *Al Midani* (August 2, 2002, unreported).

The judge dismissed Mr Andrew's application concerning the sale of the two properties on the basis that Mr Andrew had not provided sufficiently cogent or detailed evidence to justify the court exercising its powers under s284. The judge also rejected the application as far as the legal costs were unrelated to the bankruptcy proceedings but validated a payment of £500 per month as regards Mr Andrew's solicitor's outstanding fees relating to the bankruptcy proceedings. The judge also validated a payment of £500 per month for Mr Andrew's living expenses.

"The judge considered that the court had broad discretion in the context of personal insolvency to validate the payment of legal fees in relation to bankruptcy proceedings and, particularly, in relation to legal fees incurred in contesting the existence of the petition debt."

Re Bedzhamov

In *Re Bedzhamov* [2021] EWHC 2281 (Ch), the court conducted a detailed examination of authorities relating to the recognition of foreign insolvency proceedings at common law and the effect of such recognition. The judgment provides useful guidance which is particularly pertinent in the wake of the UK's exit from the EU.

The applicant (A) was a trustee in bankruptcy appointed in Russia in respect of the respondent (B). A applied for an order recognising A's appointment in Russia, and for the right to take possession of and sell B's English assets, including (perhaps unsurprisingly) valuable immovable property in Belgrave Square.

The UNCITRAL Model Law and the Cross-Border Insolvency Regulations 2006 (CBIR) regime did not apply, as B was resident in England, and as such the Russian insolvency proceedings (the Russian proceedings) did not take place in the country in which B had his centre of main interests or an establishment.

The court was therefore asked to recognise the Russian proceedings at common law. The court held the application for recognition at common law was to be decided for the most part in accordance with the ordinary principles of recognition of foreign judgments.

The court found that B had submitted to the jurisdiction of the Russian court by submissions that were made on his behalf in the Russian proceedings and that B could not impeach the Russian proceedings on the basis of (i) fraud, (ii) natural justice or (iii) public policy. The court interpreted those exceptions on the basis of well-established authority in the context of recognition of foreign judgments, and decided that there were no applicable bars to recognition on the facts.

Snowden J went on to consider the effect of common law recognition of a foreign insolvency. Upon recognition of a foreign bankruptcy, the bankrupt's moveable property is treated as *automatically* vesting in the foreign trustee, without any further assistance or relief of the court, provided that (i) the law of the foreign bankruptcy provides for its extraterritorial effect and (ii) property passes subject to any existing charges upon it recognised in England.

By contrast, the court found that (a) there was no general power at common law to make an order vesting English immoveable property in the foreign trustee in bankruptcy and (b) that it would be wrong to extend the common law by granting such relief as would be available under the CBIR by analogy or as if the CBIR did apply, in line with the restraint urged by Lord Collins in *Singularis Holdings* v. *PwC* [2015] AC 1675.

While A's application for recognition was therefore successful, its application for further assistance in relation to the immoveable property failed. □

"The court held the application for recognition at common law was to be decided for the most part in accordance with the ordinary principles of recognition of foreign judgments."

JEREMY RICHMOND QC is a barrister at Quadrant Chambers.

BENJAMIN JOSEPH is a barrister at Quadrant Chambers.

Behind the automotive semiconductor crisis

Dan Hurd speaks to **Michael Aiers** to find out how the automotive industry is managing risk and financial pressure in the midst of a semiconductor shortage.

This edition of *RECOVERY* explores the impact of supply chain shortages on UK businesses and how they can arise. In the below Q&A, *RECOVERY* editorial board member Dan Hurd speaks to Michael Aiers, senior manager in supply risk management at global automaker Stellantis, to find out how decarbonisation and semiconductor shortages have placed unprecedented strain on the industry, and what part restructuring professionals have to play in a solution to the problem.

Tell us a little about Stellantis, as it's not an original equipment manufacturing household name in the UK.

The UK will know Stellantis because of Vauxhall, but the Stellantis group is relatively new. It was created in January 2021 with a merger between PSA Group and FCA and includes a list of brands that most people will know including Jeep, Chrysler, Fiat, Alfa Romeo, Maserati, Citroën, Peugeot, Vauxhall and many others.

My role is within supply risk management across the Stellantis group covering all the brands. While I am based in the UK, 99% of my work is outside the UK.

How would you describe your day-to-day role in 'normal times'?

Well, in normal times, I would be looking at where the risks may emerge and trying to predict where those risks will come from. However, at the moment they are finding me because of the semiconductor shortage that we have.

What do you typically do to monitor those sorts of risks?

We look at a number of outside inputs, whether that is banks, credit agencies etc, and information from the company itself to make a first assessment on the financial stability of the supplier in question. Typically, that assessment is 12 months old, so that's the first obstacle at the moment. If you look at things prior to Covid-19 then, of course, they didn't reflect the impact of Covid-19 and the current situation with a microprocessor shortage. They're certainly not reflecting the downturn in volumes. That will be our starting point. Then we have to overlay on top of that some industrial intelligence: how dependent are we on this supplier? What type of parts does the supplier provide? Who are the customers? How would we react to an insolvency? And, as a result, we come up with an assessment of both the financial risk and the industrial risk of that particular supplier.

> **"The impact of the semiconductor shortage on industry has been far greater than Covid-19. Stellantis is no different and we are working hourly and daily to secure capacity."**

So the sector is being disrupted by the semiconductor shortages and a maelstrom of supply chain issues. How much tangible impact is that having on Stellantis, across the UK, Europe and globally, and what are your expectations in the medium term on this?

In terms of volume, and I stress in terms of volume because we can't underestimate Covid-19's impact on people, the impact of the semiconductor shortage on industry has been far greater than Covid-19. Stellantis is no different and we are working hourly and daily to secure capacity. It is in the DNA of Stellantis to reduce the fixed cost of the business. Clearly, that was necessary to compensate for the capital expenditure (CapEx) requirements of a transition to a non-internal combustion engine environment. However, the loss of volume caused by the semiconductor crisis has intensified this endeavour.

There have been some interesting side effects of this shortage of microprocessors. There is less stock at our dealerships and there is less cash tied up in vehicles. We've got (as an industry) extended order banks and you will have seen an increase in prices for used vehicles.

We anticipate microprocessor availability to normalise during 2022. There's some debate about when that may be, but we can see the inflationary pressure building as well. Input pricing is proving a challenge and simple things such as shipping parts are proving a challenge in terms of pricing and availability.

What I have learned in risk management is that these metaphoric 'perfect storms' are becoming more commonplace, such as the issues created when the Evergreen vessel blocked the Suez Canal, for instance. This is a perfect example of such unexpected issues and reinforces the need for a robust balance sheet to withstand these perfect storms.

Picking up on that point about the robust balance sheet, how is this then impacting suppliers? And do they have the resilience to cope with the disruption in demand at the moment?

Well, despite the financial crash that we had in 2007 and 2008, I would say that we've experienced a fairly benign financial environment. We've had low interest rates, finances have been relatively easy to come by and we've had robust, in some areas even record, volumes. I mentioned before the CapEx challenges to transform to a non-internal combustion engine environment. In the midst of these inflationary pressures, potential interest rate hikes and lower volumes, I fear that resilience will be tested. Now, after around ten years of this benign environment, the skills required to restructure both financially and, importantly, operationally have not been exercised at many suppliers.

My background is within manufacturing, not finance, and this has provided me with a very fulfilling career. It is paramount that the industry protects the suppliers and the respective jobs as best as we can. We must ensure that we maintain a robust UK-embedded supply chain to position the UK automotive industry as we make the transformation to electric vehicles (EVs).

But, let's not forget that it's not all bad news. The UK has an exemplary track record of entrepreneurs and creative spirit. We need to support such creative energy and industrialise these ideas. I'm personally convinced that we have the collective experience to make this happen. What I observe, however, is that we need to improve

What I have learned in risk management is that these metaphoric 'perfect storms' are becoming more commonplace, such as the issues created when the Evergreen vessel blocked the Suez Canal.

our communication as an industry to allow good business decisions. To that end, I'm working with the Institute for Turnaround and R3 to bring this all together so that we at least know with whom we can speak. As a result of that, we've created a safe harbour process to allow a more collaborative approach that exposes issues earlier.

Can you tell us a little about the safe harbour process and how you expect this to be used across the UK?

As I mentioned, most of my work is outside of the UK. Having experienced that, I've been struck by the difference in stakeholders' attitudes towards a distressed company. In many countries, the attitude at the start the process is 'How do we protect jobs?' or 'How do we preserve this company?', whereas in the UK we often see each stakeholder protecting its own position and, as a result, that company is ultimately lost or liquidated. The demand for the product is actually still there, but the business is often relocated outside the UK and the jobs, the skills and the added value are permanently lost.

I was sitting in an industry meeting at Worcester Rugby Club, of all places, and I thought we needed a far more collaborative process. That was over ten years ago. And, when I suggested such an idea, the competition lawyers were ready to lock me up!

However, I never lost sight of the objective and the safe harbour idea. Now, the Covid-19 pandemic has allowed us to revisit it and the Competition and Markets Authority has given us a framework to have this collaboration outside of an insolvency. In my experience, the earlier the stakeholder can engage, the more options we generally have. Thanks to the Society of Motor Manufacturers and Traders listening to the idea and championing this, we are at the point where we released a process last year.

I'd encourage every supplier to use the process if they are in distress and need to transform their business. I have to say that there is still some reluctance from suppliers to raise their hands but the sooner they do, the better the potential outcome. And, of course, I'm more than happy if other industries want to take this idea and this approach and it will be free of charge.

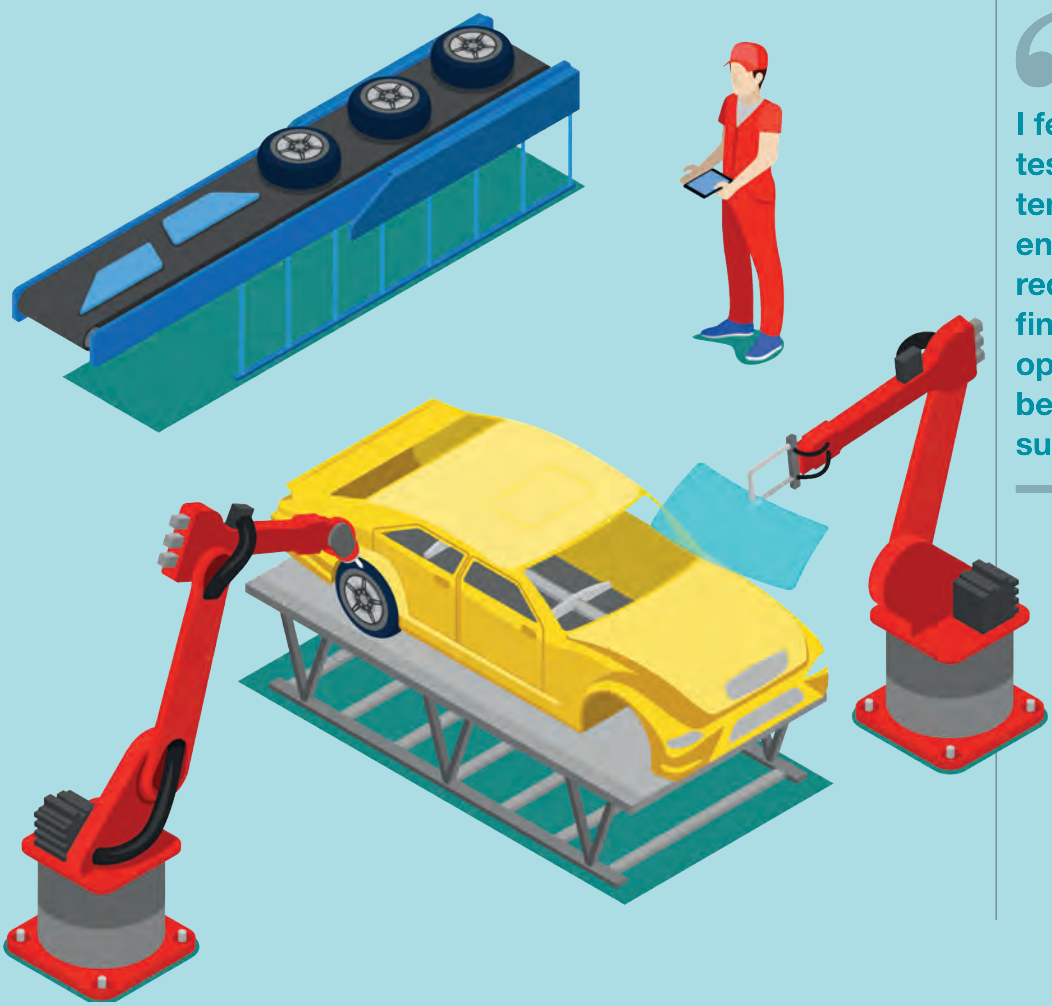
Moving on from safe harbour and thinking about some of the long-term changes in the industry – you mentioned the move to electrification. It'd be great to hear more about how Stellantis is responding to that and how you think the supply chain is going to ultimately move along with it.

Stellantis is committed to the transition to EVs. This will be hugely capital intensive and, consequently, scale is extremely important in this business.

Some companies thought that having a CSR declaration in the company report was sufficient to satisfy the green agenda. It is clear from the softer political pressure and direct regulation that this is no longer sufficient. The automotive industry has always taken this issue seriously. Indeed, the penalties for breaching the CO^2 exhaust regulations are severe.

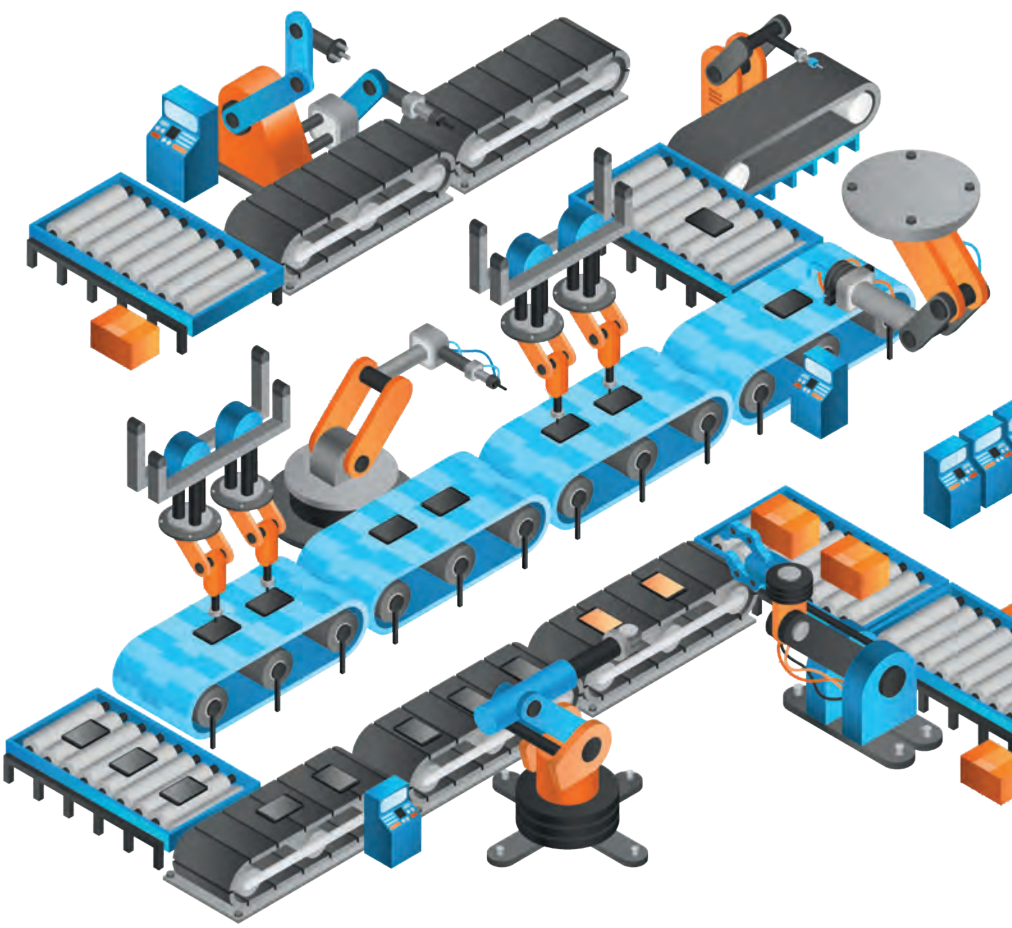
Stellantis has taken the position that it will totally comply with these regulations and change its vehicles to meet them, therefore, it will not be liable for any penalties. Ellesmere Port has been nominated as the first wholly EV plant within the Stellantis group, and will start to produce the 100% electric small van in 2022.

The UK government has taken a leading role in ending the sale of purely petrol or diesel new cars and vans from 2030. We can see that regulation will only tighten. This is a huge opportunity for the industry



I fear that resilience will be tested. Now, after around ten years of this benign environment, the skills required to restructure both financially and, importantly, operationally have not been exercised at many suppliers.

> **With all the challenges we've talked about, restructuring professionals have a key part to play – not only with financial restructuring but operational restructuring.**



to generate new jobs with new skills. Not only that, but the infrastructure opportunity is a significant one – for me it's things like putting charging points in – although I fear this opportunity has not been so readily taken up.

Can you imagine in ten years' time the need to go to a petrol station? Or planning a journey to include a stop for charging? In the UK, public transport is not as popular as some other countries. Indeed, the Covid-19 pandemic has stopped people travelling or if they do, many people want the hygiene security of travelling alone. This is somewhat contrary to an efficient transport mode but has also created a latent demand for passenger cars (personal or family vehicles). Moreover, the demand for light commercial vehicles (such as delivery vans) has rocketed as a result of home delivery.

Those companies and suppliers that seize this opportunity will succeed but it requires considerable planning. As mentioned, the CapEx burden is significant, but the prize is also there. This business has always been tough but the added value to the UK economy is considerable.

From a restructuring person's perspective, is it too late for suppliers to switch to this reduced volume for internal combustion engine parts? Or what could they be doing to transition?

Well, a number of suppliers have recognised the need to make a transition if they are currently wholly dependent on the internal combustion engine. They recognise that and make plans accordingly with their product portfolio. For new vehicles, the government has put forward regulation to ban the production of those vehicles, but there is still going to be an ongoing demand for some years. And there's also going to be after-sales care to service those vehicles. I think we can expect some form of consolidation over time, because the demand is still going to be there for a little while.

What do you think are the key considerations and skills required of restructuring professionals in responding to these challenges and supporting the automotive sector to navigate these short- and long-term challenges?

With all the challenges we've talked about, restructuring professionals have a key part to play – not only with financial restructuring but also with operational restructuring. Now, being a 'manufacturing guy', my mantra has always been 'the financial results are a product of what happens on the shop floor not the other way round'. If the company is operating efficiently, the financial results will follow. That is not to say financial management should be ignored but financial performance is sometimes viewed as a dark art. It is not; one needs to get the basics right. If I can learn it, anyone can! A collaborative approach is essential and the restructuring professional can act in this role.

We can all be guilty of making things too complicated. I remember when I started in this role sitting in one of the key banks as green as grass. I asked, 'What's a CDO?' Can you imagine the answer that I received?! My reflection after 35 years in this industry is: keep it honest, keep it direct, keep it simple and leave your ego at home. ◻

> **Financial performance is sometimes viewed as a dark art. It is not; one needs to get the basics right.**

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Social care – overview of the challenges

Samantha Reeves and **Pippa Hill** explore the landscape for adult social care in the wake of Covid-19.

The Covid-19 pandemic has created significant challenges across many industry sectors, none more so than adult social care. For a sector that was already under pressure, the pandemic has further exacerbated those pressures, threatening the financial viability of some providers and the uninterrupted provision of services once Covid-19 restrictions are wholly phased out.

The Care Act 2014 established the market oversight function of the Care Quality Commission (CQC) that monitors the financial sustainability of large adult social care providers, which, if they were to fail, could cause disruption to the continuity of care in the local authorities in which that provider operates. The CQC published its paper entitled 'The state of health care and adult social care in England 2020/21' (CQC report) on 21 October 2021, which sets out some of the challenges for the adult social care sector. This article summarises some of the challenges identified in the CQC report and comments on the potential impact from a restructuring and insolvency perspective.

Sustainability challenges – occupancy

One of the primary factors that influences the financial sustainability of adult social care providers is occupancy rates. The CQC report identifies that the restrictions put in place as part of the Covid-19 pandemic control measures had a substantial impact on occupancy, as they severely limited the ability of providers to take in new residents. Added to this was an inevitable reluctance of families to place their elderly relatives into residential care environments during a pandemic and with stringent visiting restrictions in place.

The CQC report identifies that occupancy levels have dropped by approximately 10% in the period from January 2020 to March 2021. A few percentage points' change in occupancy can have a significant impact on revenue and therefore profitability, so shifts of this level can have an incredibly detrimental impact on providers. Substantial reductions in occupancy coupled with ever-increasing costs has squeezed profit margins and cash flow for businesses operating in this industry. The CQC report identified that the decline in profit margins between October 2020 to March 2021 was the lowest level since the CQC market oversight scheme began in 2015. While government funding was put in place for the adult social care sector to help ease the cost burden of infection control measures, this is a stopgap only and will not solve the problem of how providers recover occupancy rates and consequently profitability over the coming months and years.

Staffing

The rising costs of staffing have placed an increasing burden on the sector for a number of years. The requirements to self-isolate in the event staff contracted Covid-19 or came into contact with anyone who tested positive exacerbated staff shortages and placed extreme pressure on existing staff.

The adult social care sector has historically been challenged recruiting and retaining staff, as other industries can often offer higher salaries with lower emotional stress. Before the pandemic, Brexit was already impacting the size and quality of the staffing pool and providers were becoming increasingly reliant on expensive agency care workers to meet staffing shortfalls, an approach which has its own long-term sustainability issues. The CQC report identified that providers have seen an increase in staff vacancies from 6% in April 2021 to 10.2%, with London seeing one of the highest vacancy rates of around 11%. This indicates that healthcare professionals may be leaving the industry either temporarily or permanently and that there is a difficulty attracting new people into the sector.

As the government requirement for all people working in CQC-registered care homes to be fully vaccinated against Covid-19, including agency staff, comes into place staffing challenges will heighten in early 2022. Added to this, 1 April 2022 will see a 6.6% rise in the National Living Wage (to £9.50 per hour).

Recruitment, staff retention, training, pay and rewards and creating a positive working environment will therefore all be key challenges to the adult social care sector over the next few years.

Funding mix

The CQC report also identifies a change in the funding mix of adult social care providers as a result of the pandemic, with non-specialist care homes seeing the proportion of privately funded beds decrease relative to those funded by local authorities or the NHS – with the latter generally paying a far lower amount per bed. This trend (reversing the position before Covid-19) could have a long-term impact on the sustainability of providers dependent on the higher level of private fees as part of their business model. The fact that providers have been cutting back on all but necessary capital expenditure over the period of the pandemic will have a resulting impact on the quality of services provided and the ability to justify increases in care fees, particularly to private fee payers.

Leasehold estates

The cost of potentially overrented leasehold estates has been a thorn in the side of many care providers for a number of years. While many providers have been relatively cash rich during the pandemic due to cash deferrals and government support, there are inevitably some that have been reliant on the prohibition on commercial rent arrears recovery, forfeiture and winding up on the basis of commercial rents. As these are all anticipated to come to an end in March 2022, it remains to be seen how such providers will deal with rent arrears, either looking

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to make individual deals, implementing company voluntary arrangements or potentially using the new rent arbitration process.

Impact on other sectors

Financial sustainability issues in the adult social care sector could also have knock-on effects on other sectors. While many providers will use large companies for the provision of equipment and PPE, other day-to-day operational support services may often be provided by regional companies who are more vulnerable to customer closures. This may include catering companies, maintenance, IT support and software services and health and beauty professionals. Conversely, difficulties in other sectors may further exacerbate the problems facing the adult social care sector. In particular, providers are likely to feel the impact of the recent sharp increases in energy prices, particularly as we head into the winter.

Future for adult social care

As identified in the CQC report, the adult social care sector has so far managed to avoid widespread home closures and the cancellation of home-care contracts notwithstanding the issues created by Covid-19. However, providers in the market have to a large extent been protected by short- to medium-term funding, including infection prevention and control of almost £1.5bn from the government, together with support for testing of almost £400m. Furthermore, some will have made use of tax deferrals to shore up cash flow and the various government guaranteed loan schemes.

With many providers having relied on government support measures and short-term funding solutions to weather the pandemic, the CQC report identifies that the reduction in revenue and profit due to occupancy decline will have undoubtedly created financial difficulties for some providers in meeting their existing debt and rental obligations.

It is anticipated that the market will see more restructuring activity in this space moving into mid-2022. This may include the transition of adult social care businesses or specific care homes to alternative operators, potentially through the use of insolvency tools such as administration. There presently remains a lot of capacity in the financial markets and adult social care businesses could prove to be interesting potential targets for private equity investors who focus on the distressed end of the market, particularly international investors who are looking to expand their healthcare portfolios to the UK.

Market oversight

The market oversight function at the CQC monitors large providers which, if they were to fail, could cause significant capacity issues for local authorities in ensuring continuity of care for all vulnerable service users. Market oversight monitors the financial sustainability of providers within the scheme and has a statutory duty to notify local authorities in the event that cessation of care because of business failure is likely. This is designed to give local authorities advance notice of a potential insolvency to enable them to adopt contingency plans in the event the provider was in fact to fail.

However, market oversight only monitors difficult to replace providers (ie large or with a substantial market share or specialist skills set) and therefore it is possible that the market may see insolvencies of small care home businesses where alternative restructuring solutions cannot be found or creditors are unwilling to provide any further accommodation. In the event such providers have insufficient funds to enable the business to trade for a period of time, this could result in the closure of care homes at short notice.

At present, there is no special administration regime or other process for the adult social care sector to enable the government to step in in the event an adult social care provider was to fail or for an insolvency process to be pursued with a sector-tailored objective.

Future budget constraints, particularly as a result of the cost of the pandemic, will make it difficult for local authorities to plan their forecast expenditure on adult social care beyond the current financial year. This makes it challenging for providers to forecast local authority revenues and therefore whether they will be able to maintain financial sustainability over the coming months and years. It also impacts the quality of services in the future, as those that are financially stable at the moment will be cautious of investing in their businesses by way of increases in capital expenditure on quality improvements and staff training and remuneration packages in light of the financial uncertainty. Strong business plans and the support of creditors is likely to be vital to enable adult social care providers to weather the storm and return to profitability.

In September 2021 the government announced a new 1.25% health and social care levy to support UK health and social care bodies. However, this is unlikely to have a substantial impact on the adult social care sector in the short term. In the absence of further investment both from government and the private sector, practitioners can expect to see a rise in adult social care mandates as we move through 2022.

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The future for pensions is green

Louise Webb looks at the covenant-related ESG issues and how sponsors, trustees and advisers will need to adapt to the new world.

With COP26 just over, it's strange to think environmental, social and governance (ESG) issues might not top everyone's priority list. For pension trustees, ESG factors in investment decisions have long received air time but their impact on the sponsor's covenant is a newer consideration.

It's common knowledge that the primary focus of a defined benefit (DB) pension scheme trustee is to pay members what they are due at the right time. However, the promise to pay benefits was generally made in a bygone era and, with various corporate restructurings and M&A in its wake, the mothership may have shed the paternalistic sentiments of her forebears. This can make the trustee's task challenging.

Enter the pandemic

When a global pandemic was thrown into the mix, for those schemes with 31/03/2020 valuation dates, things looked pretty dismal. It was unclear what impact Covid-19 would have on death benefits and liability management. As the global economy ground to a halt, corporate insolvencies were anticipated and trustees waited for the inevitable wave of contribution payment holidays. The Pensions Regulator (TPR) issued guidance for trustees on deferrals of deficit contributions and pension transfer lockdowns were announced. Cyclical economic turmoil is to be expected, but this was unfamiliar territory.

With hindsight we now see that bank lending hit record levels, low interest rates staved off insolvency and government support in the form of furlough, VAT and rates relief supported businesses. Some even thrived from the switch to online, reporting high performance and profitability. Reports for the month to 30 September 2021 showed that the deficits of UK pensions schemes against long-term funding targets reduced by £34bn in the month due to a favourable mixture of high gilt yields, equities bouncing back, low interest rates and rising long-term inflation expectations to approximately 4% in Q4 2021. Ironically, for many schemes, funding levels are now at the highest level for some time.

> **"Climate change and ESG factors have accelerated up the issues list with a growing expectation that they may have a bigger long-term impact for businesses – and the DB schemes they support."**

Despite this, the fallout from Covid-19 (and Brexit) is yet to be understood and material uncertainty remains. In the meantime, climate change and ESG factors have accelerated up the issues list with a growing expectation that they may have a bigger long-term impact for businesses – and the DB schemes they support.

When it comes to understanding the implications of ESG, trustees bring an understanding to the table, but their knowledge has evolved in an investment landscape where decisions are a choice, and disinvestments and diversification an option. The mindset of the trustee and sponsor, and their advisers, will need to adapt to the exercise of considering ESG on the potentially more fundamental sponsor covenant.

ESG and trustee duties: a historic view

Historically, ESG was considered in the context of the trustee's duties and powers of investment. A run of court cases (*Scargill*, *Church Commissioners* and *Cowan*) established that:

- Trustees should take advantage of a full range of investments in the best interests of the beneficiaries, which are normally their best financial interests.
- Non-financial factors are not generally relevant to achieving the purpose of a scheme's investment power (including factors motivated by moral, ethical, social or political concerns).
- An exception was permitted 'if the only actual or potential beneficiaries of a trust are all adults with very strict views on moral and social matters'.

Covenant was a secondary concern. The primary questions were whether a sponsor's covenant was sufficiently strong to justify the trustees taking non-financial considerations into account; and if the sponsor's covenant could support an ESG strategy that was expected to result in lower investment performance.

Pre-pandemic: investment focus

Pre-Covid-19, trustees became accustomed to building ESG factors into investment strategy. ESG became mainstream, with TPR encouraging trustees to reflect it in investment principles, reporting, operations and journey planning. It was discussed in the context of asset diversity and allocation, good stewardship, investor engagement and voting. There was also a developing belief among investors and investment managers that corporates with good ESG performance metrics fare better in the long term.

The tables had really turned. Trustees were no longer forced to account for the potentially adverse consequences of ESG-focused investments. Instead they were chastised for failing to anticipate the impact of ignoring ESG, as illustrated in 2020 when a beneficiary challenged the Australian Retail Employers Superannuation Trust by claiming the trustees had breached their duty to act with reasonable care and skill in managing scheme investments by failing to provide adequate information on a fund's exposure to climate change risk. In the

UK, the Association of Member Nominated Trustees made its position clear, updating its redline voting policies to cover a range of ESG considerations from executive remuneration, board diversity, modern slavery and human rights considerations and task force on climate-related financial disclosures (TCFD) reporting requirements.

ESG now: trustee and sponsor focus

Fast forward to today and there's a lot going on for trustees of DB pension schemes. The Regulator's single code of governance is expected to be implemented in Q2 of 2022. The new code on DB funding is expected late 2022, with pensions dashboards around the same time. In the meantime, the notifiable events regime and associated criminal sanctions of the Pension Schemes Act 2021 came into effect on 1 October just as trustees of certain types of scheme fell within the scope of the requirements of the TCFD.

With this level of change afoot, it's unsurprising that surveys show regulatory burden as the most pressing concern for pension scheme trustees. But ESG still features. EY's February 2021 report showed 94% of UK trustees surveyed agree that addressing ESG factors is consistent with their fiduciary duty to act in members' best interests. Yet, the report shows only 12% factor climate change into their investment management processes and fewer than 19% account for ESG in the assessment of their sponsor's covenant. There is work to be done.

On the other side of the table, sponsor representatives are trying to predict the speed of recovery, return to profitability and future cash flow generation. They are alive to the benefits that positive ESG-focused policies and sustainable value creation can have on their balance sheets. Every strand of ESG resonates as a business imperative, businesses are adapting to calls for less business travel; smarter and more local supply chains, lower emissions and changing working patterns. Environmental regulation and government policy on climate is expected to force operational change, consumer-end employee preference is demanding a quicker pace, government stimulus packages tied to environmentally focused results require action and financing documents are starting to incorporate metrics to reward ESG performance.

Trustees' future approach to ESG

Climate reporting on TCFD is underway for schemes with AUM over £5bn. Trustees will have to try to measure and report on how aligned their investment portfolios are with the Paris Agreement and, importantly for covenant purposes, consider the effects of climate-related risk on scheme funding. It's this that brings ESG squarely into the remit of the covenant assessment report and funding discussions.

As investors seek to manage ESG and climate change risk more actively, companies must factor ESG into business plans if their reputation and underlying business are to survive. The case brought by several NGOs in relation to Royal Dutch Shell illustrates the potential significance of these moves. In that case, the District Court of the Hague ordered the oil company to reduce its CO_2 emissions by 45% by 2030 (compared with 2019 levels). Activist shareholder groups and hedge funds on the other side of the Atlantic have had similar success with their vote to appoint two new directors to the board of ExxonMobil in a move to ensure the transition to a lower carbon strategy, a vote driven by Engine No 1 and supported by two Californian pension schemes.

Granted, covenant-related ESG issues will be less relevant to some schemes, eg those that have reduced reliance on the sponsor because they have de-risked, are close to buy out or have enforceable security to bridge a funding gap. Conversely, for those sponsors that operate in the green economy, the covenant may be strengthened.

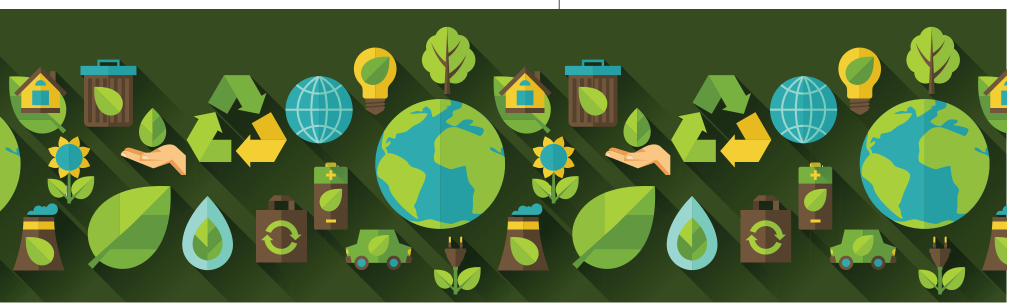
Recognising the role covenant plays in determining member outcomes, trustees and covenant advisers need to engage now with sponsors to identify the data they need to understand the risks and opportunities

> **“Every strand of ESG resonates as a business imperative, businesses are adapting to calls for less business travel; smarter and more local supply chains, lower emissions and changing working patterns.”**

created by ESG considerations. Pension trustees are a unique creditor, whose focus has always been on the long-term sustainability of the employer. They will want to work alongside sponsors on this journey to gather the information they need to make and evidence their informed decision-making processes, not only for their own governance and regulatory purposes, but in response to increasing member engagement in this area. Information will be far-reaching, taking into account production methods, geographic weather-based risks, supply chain exposure and changing consumer expectations etc. This is a complex area and information may not be immediately or readily accessible.

ESG will also drive M&A activity as groups roll out their sustainable strategies. Take the food sector: global groups are moving away from legacy animal-based food businesses, focused more on nutritional bioscience, development of meat alternatives and sustainable food sources. The early engagement that is now required under the Pension Schemes Act 2021 gives the opportunity for sponsors and trustees to discuss these strategies at an early stage and understand the sustainable long-term business model.

Over the coming year trustees will look to their covenant advisers and organisations such as the Covenant Adviser Association and R3 to help them to understand the particular challenges. Covenant advisers who can explain any climate or ESG implications on covenant, with scenario analysis to support the decisions trustees make will be in demand. Support in more nuanced funding discussions will be key. TPR has long expected trustees to use their leverage and significant potential liabilities to act like banks. The financial markets are playing their part in driving change: Klöckner Pentaplast, a German plastics company, refinanced and issued a term loan that included a ratchet mechanism designed to reduce the margin by 2.5% if three sustainable goals are achieved by 2023 (tied to the use of recycled materials for production; emission reductions; and gender diversity within the management team). The covenant adviser that can demonstrate good understanding and work collaboratively with sponsors to weave ESG factors into funding discussions, for the long-term benefit of sponsor, scheme and members is the covenant adviser that trustees will look to. □



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Social care – the CQC and market oversight

Stuart Dean discusses the role of the Care Quality Commission's market oversight function in light of current developments within the adult social care sector.

The past two years have brought the role of the adult social care sector sharply into the public consciousness. Residential and non-residential services alike have been impacted to an unprecedented extent by Covid-19, with many accounts of providers and their staff going above and beyond expectations to deliver safe and compassionate care but also, sadly, high levels of deaths within these same services. Among many other challenges, Covid-19 has impacted the financial performance of providers.

In addition to regulating the quality of health and care services, the Care Quality Commission (CQC) also monitors the finances of potentially difficult to replace adult social care providers. It does this by its market oversight scheme.

The market oversight scheme

The market oversight function was created in 2015 and was in part the government's response to the failure of the Southern Cross care home group. While ultimately any disruption experienced by residents in Southern Cross homes was contained, there was a recognition that people using adult social care services would be better served by a more planned approach in instances of large-scale provider failure.

The purpose of market oversight is to provide impacted local authorities with a notification in the event that CQC considers that there could be likely service cessation owing to business failure. This then assists local authorities to discharge their Care Act 2014 legal duty to ensure continuity of care for all people using services if one or more of these services stops due to business failure. To date, two such notifications have been made.

The scheme applies to England only and covers providers who meet certain statutory criteria regarding their overall size, market concentration or specialism of provision. Inclusion is not a reflection of risk, rather that the provider's size, activity or market concentration may mean that local authorities might find them difficult to replace should they fail. Circa 60 residential and non-residential providers covering approximately 30% of the English adult social care market are currently captured by market oversight.

> **"Circa 60 residential and non-residential providers are currently captured by market oversight."**

The names of those in the scheme are published at **www.cqc.org.uk/guidance-providers/market-oversight-corporate-providers/market-oversight-adult-social-care**.

Operating model

The market oversight operating model is based on regular monitoring, with further analysis and engagement undertaken where potential concerns are identified. Where significant risks to financial sustainability are evident, the scheme has the power to require providers to complete a risk mitigation plan and/or arrange for an independent business review to be undertaken. The hope is that the increased scrutiny supports management to improve the financial sustainability of their organisation, thus negating the need to issue a local authority notification. Indeed, it is a measure of market oversight's success that only two such notifications have been issued since its launch in 2015.

Current challenges

Elderly residential care providers have been hardest hit by Covid-19. Substantial increases in mortality rates significantly reduced occupancy and turnover at a time when costs increased. Government support (including enhanced local authority payments, infection control funding grants and the free provision of PPE) has provided a lifeline to the sector and helped to mitigate the worst of the financial impact.

Other important support was provided by landlords allowing rent deferments and providing PPE, financiers rescheduling capital and interest payments, the provision of CBILS loans, and HMRC granting more time to pay.

While social care remains at the forefront of the Covid-19 response, the severe and ongoing staff shortages are restricting the recovery of the entire sector which in turn is likely to place more pressure on the NHS. This issue was highlighted in CQC's recent 'State of care' report.

Adult social care reform

The government has recently announced plans to:

- raise further funds for both the NHS and social care sector by introducing a 1.25 percentage point increase in employee and employer national insurance contributions from April 2022 (to be replaced by a designated levy from April 2023);
- invest £5.4bn in social care over the next three years;
- introduce a lifetime cap of £86,000 on an individual's expenditure on their personal care costs;
- amend the eligibility criteria so more people can receive means-tested support;
- professionalise the image of social care, with an associated £500m of funding over three years (a separate £162.5m fund has also been announced to help care home and home care providers with recruitment and retention challenges through to March 2022); and
- enact legislation under s18(3) of the Care Act 2014 to enable local authorities to arrange care on behalf of those who fund their own care needs.

At the time of writing, further detail is awaited on how these reforms will work in practice. However, there is concern throughout the sector as to how much residual money will be left once the lifetime care cap has been funded and whether, beyond the initial three-year period, the additional money gets absorbed by the NHS. Providers are also worried about the more immediate financial impact of higher national insurance contributions on staff costs.

Furthermore, if local authorities arrange care for self-funders, depending on the rate that they pay, then this could further destabilise the sector by reducing or eliminating the existing level of cross subsidisation. It will therefore be important for these points to be clarified quickly if the sector's response to them is to be contained.

Ultimately, it is hoped that the workforce initiatives lead to even better care while the proposed reform protects the public from the most catastrophic care costs. Further details should be provided over the coming months. □

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The hidden risks around litigation funding

Mark Beaumont debunks some of the stereotypes about litigation funding.

If you were told that the largest asset in an insolvency was sold with no regard for due process, would you have any concerns? If the asset was only offered to one buyer, despite there being many potential buyers out in the market, would those alarm bells get louder? What if the asset could easily be shown to have been sold at undervalue, by anyone with any degree of knowledge of the market?

Given how you'd likely react to the above statements, it may raise eyebrows that some IPs only approach one litigation funder or insurer, or even leave it to the solicitors to approach their own preferred funder. Creditors often pay the price for this, and it will come as no surprise that more creditors are raising concerns in this area. The ultimate price may be paid in professional negligence claims or similar.

They are all the same – it doesn't matter[1]

The difference in costs from funder to funder can be enormous, as can the premiums from one after-the-event (ATE) insurer to the next. The sums involved can be small (ATE policies of £100k or funding of £20k) or very large (multi-million pound ATE premiums and litigation funder investments of many millions) but the fact is, the difference between the best and the worst deals will always be very large as a percentage of recoveries.

To put this into context, a significant litigation asset in an insolvency could be reduced in value by over 50% for no other reason than the IP did not explore the market properly. Should the word 'litigation' in that sentence make everything OK? Without that word, it reads: a significant asset in an insolvency could be reduced in value by over 50% for no other reason than the IP did not explore the market properly. IPs need to consider the consequences of bringing this risk into their practice, especially given that it is an easily avoidable and unnecessary risk.

The role of the lawyers

IPs typically have good relationships with their preferred litigation solicitors, given the 'swings and roundabouts' nature of financial recoveries from insolvency disputes. The same is often true of the solicitors and the barristers they are close to. Their costs should be recoverable as part of the litigation (in theory!) and are therefore somewhat controlled by *inter partes* recoverable costs and general market pressures.

It would be wrong to say that the same controls exist in the opaque world of litigation insurance and finance, where pricing can fluctuate wildly between providers or within the same provider on a different day!

The deals done with litigation funders and ATE insurers directly relate to the returns to creditors: how does the IP show that what they've agreed with the funders or insurers is reasonable? Is it possible to do so without exploring the wider market?

"Claims vary, and so do funders – their appetites shift based on recent successes and failures, the balance of the existing caseload in the portfolio, new fundraising, timing within their financial year, changing staff and countless other factors."

What is reasonable?

There are dozens of funders and insurers, and the market for litigation financing has never been more competitive.

I hear the argument that, just as with their solicitors, it makes sense to have a 'rough with the smooth' relationship with one funder. The argument here would seem to be that the funder would make up for any losses by recovering in other cases. I wouldn't like to try and justify this to a creditor committee that is paying over the odds to a funder on the basis that they are paying for losses in another funded claim!

The reality is that if a claim is potentially worth funding, then there will be multiple parties interested in doing so. If it's a poor claim, then no one will be interested in it – including your 'friendly funder'. I am yet to see a compelling argument in favour of creditors over paying for funding and insurance.

'I have a good relationship with ABC'

There is nothing wrong with cultivating relationships, and these can be useful. We also build relationships, and we are working with the market day in and day out – we know what the best deals are and how to secure them: we wouldn't be working with dozens of funders and insurers if just one was perfect for every single type of case.

Claims vary, and so do funders – their appetites shift based on recent successes and failures, the balance of the existing caseload in the portfolio, new fundraising, timing within their financial year, changing staff and countless other factors. It's also good to keep even the best of relationships on their toes with a little competition from time to time!

Managing risk

As a sector we hold a responsibility to maximise value to creditors. There is no reason to let this slip when it comes to litigation funding and ATE insurance – overpaying here hits creditors just as hard as selling an asset under value.

By exploring the full market, or even using a decent broker to do so for you, you ensure you are meeting your obligations to creditors, but you may also find that there are far more interesting, useful and economic options out there than you'd been led to believe. □

[1] The statement 'all funders are the same anyway' is not true. They are not. Nor are all IPs (or brokers for that matter!).

MARK BEAUMONT is co-founder of Annecto Legal Ltd, a national broker of after-the-event (ATE) legal expenses insurance and various forms of funding for litigation and arbitration claims. He is happy to assist with smaller claims under £100k as well as mid-market, large-scale and complex claims. Contact Annecto Legal on 0800 612 6587 or Mark Beaumont on **mark.beaumont@annectolegal.co.uk** or 07730 217 643.

What R3 has done for you in 2021

R3 Association of Business Recovery Professionals
Rescue Recovery Renewal

Supporting the profession

GUIDES PUBLISHED:

- Dealing with money worries: A guide to your options
- Get Back to Business: A guide to dealing with corporate financial distress

27 TECHNICAL ALERTS & BULLETINS

MONTHLY TECHNICAL ROUND-UPS

12 ISSUES RECOVERY NEWS

4 ISSUES OF RECOVERY MAGAZINE

ACCESS TO:

- The Insolvency Service
- HMRC
- British Business Bank
- Industry Stakeholders

Campaigning for the profession

Through our Back to Business UK campaign, we've promoted the profession as a source of advice to tens of thousands of directors and business owners, and highlighted the profession's role in supporting business rescue post-pandemic.

Secured a commitment from Government to change HMRC's approach to restructuring proposals.

Gave the profession a voice in the policy making process on the future of Companies House, regulation, and director disqualifications.

Promoted and defended the profession's work through our Value of the Profession research.

Defended the reputation of the profession directly in Parliament.

Engaging the profession

6 DEDICATED VIRTUAL CONFERENCES

- Restructuring Week
- New Professionals Forum
- SPG Forum
- Fraud Conference
- The Scottish Forum
- R3 Annual Conference

10 TRAINING COURSES

25 FREE-TO-MEMBER WEBINARS

140 EXPERT SPEAKERS

110 CPD HOURS OFFERED

100% OF DELEGATES RATE OUR COURSES GOOD OR EXCELLENT

3624 MEMBERS ATTENDING

Connecting the profession

60% INCREASE IN CORPORATE MEMBERSHIP

621 NEW MEMBERS

9000+ SEARCHES ON OUR ONLINE MEMBER SEARCH

Document-sharing dilemmas

Alex Jay and **Ryan Hooton** examine document sharing between insolvent estates in the light of clarity provided by recent judgments.

It is common for insolvency office-holders to be appointed over related estates, and indeed it is of course the case that IPs have a large number of appointments at any one time. In such circumstances, documentation is arguably 'shared' across estates by default.

We operate in a world where information (and so documentation) is a prized commodity, hence the growth of data protection legislation and indeed related enforcement agencies. Moreover, in any litigation context, the question of how information has come into the hands of a claimant (or indeed defendant) may well attract significant scrutiny from a well-advised opponent.

As a consequence, the issue of document sharing is one that is increasingly raised by office-holders, particularly where the same office-holder is appointed over multiple estates. Arguably, it is more efficient (and in creditors' interests) to have the one practitioner investigating what is essentially one transaction or issue between interrelated estates, than two practitioners investigating independently.

What, however, are the principles that should be adhered to when sharing documents between estates? What is allowed, and what should practitioners be wary of?

Following the recent decisions arising in, and out of, the *Avonwick* v. *Shlosberg* litigation a number of principles can be identified. The relevant cases for this article are the first instance decision in *Shlosberg* v. *Avonwick Holdings Ltd & Ors* [2016] EWHC 1001 (Ch) (the first instance privilege decision); the Court of Appeal decision in *Avonwick Holdings Ltd* v. *Shlosberg* [2016] EWCA Civ 1138 (the Court of Appeal privilege decision); and the related first instance decision in *Willmont & Anor* v. *Shlosberg* [2017] EWHC 2446 (Ch) (the Shlosberg documents decision).

Shlosberg documents decision

The use of common office-holders had been considered and approved in *Capital Finance Ltd* v. *Food Holdings Ltd* [2008] UKPC 23, [2008] BCC 371, where Lord Hoffmann delivering the judgment of the Judicial Committee of the Privy Council said at [23]:

'*... It is not unusual for the same liquidators to be appointed to related companies, even though the dealings between them may throw up a conflict of interest. It avoids the expense of having different liquidators investigate the same transactions. The attitude of the court has been that any conflicts of interest can be dealt with by the court (on the application of the liquidators) when they arise: see Re Arrows Ltd [1992] BCC 12; Re Maxwell Communications Corp plc [1992] BCC 372.*'

However, one of the questions that this throws up is in the context of document sharing between related (or indeed non-related) estates, where there is a common office-holder between the sharing and receiving estates. The point has arisen in previous cases, for example *Re Esal (Commodities) Limited* [1988] 4 BCC 475 – where the Court of Appeal indicated that it was permissible for office-holders appointed over a parent company to share material with its subsidiaries, but did not consider disclosure of compulsion material by those subsidiaries to sister companies or the parent, or the inevitable sharing that results from common office-holders). However, it had not been directly addressed until the *Avonwick* proceedings.

In the Shlosberg documents decision (also known as *Re Webinvest Limited (in liquidation)*), one of the joint trustees in the bankruptcy of Mr Mikhail Shlosberg also acted as joint administrator in the liquidation of Webinvest Limited, a company previously owned and controlled by Mr Shlosberg. The office-holder was also advised by the same lawyers across the estates. Noting that the legal position concerning the proper use of documents across the two estates was unclear, the office-holder quite properly applied to the court for directions in relation to three categories of documents, namely (a) documents and information obtained under compulsion; (b) disclosure documents; and (c) privileged documents.

First, and following *Parmalat*, Arnold J saw no issue with the duality of the office-holder's instruction, stating (at 83):

'I should make it clear that I do not consider that any problem arises in this regard out of [the officeholder's] position as both Trustee and Liquidator. If it is not lawful for the Trustees to disclose any Compulsion Material to the Liquidators, then it will not be lawful for the Liqui-

dators to use that Compulsion Material for the purposes of the liquidation, such as by deploying the Material in the Conspiracy Claim and/or the Possession Proceedings.'

Compulsion documents

Looking at the first category of documents referred to by Arnold J, those obtained under compulsion (ie through deployment or threat of deployment of document gathering powers available to office-holders under ss235, 236 and 366 of the Insolvency Act 1986), the court determined that such documents can be shared between the estates, provided that the basis for doing so is either to benefit the winding up (in a corporate context) or the bankruptcy estate (in a personal context) or that it is likely to assist in the investigations being conducted into suspected dishonest transactions.

For the first basis, what amounts to a qualifying benefit? Following the reasoning in the Shlosberg documents decision, sharing material that *may* assist a potential dividend being received into the sharing estate would be sufficient. That remains the case even if the prospect of receiving a dividend is 'unlikely', as long as it is not 'merely fanciful' – a relatively low bar. To add context to that, in the Shlosberg documents decision the sharing bankruptcy estate might have received a dividend from the receiving liquidation estate, but only if the liquidation estate made sufficient recoveries to pay off all creditors and leave a surplus that would be due to the bankrupt and thus the bankruptcy estate. Arnold J's view was that this met the threshold here, as the prospects of recovery through a liquidation are often 'uncertain' and indeed 'it is not unknown for apparently insolvent estates to turn out to be solvent after all.'

However, where the 'benefit' to the sharing estate is more tangential, extra care must be given. Sir Terence Etherton in the related Court of Appeal privilege decision noted that deployment of documentation in such a way as to reduce or even eliminate a creditor's claim in the estate was not a proper exercise of a trustee in bankruptcy's powers. That is because the statutory function of a trustee in bankruptcy is to 'get in, realise and distribute the bankrupt's estate' (s305(2) Insolvency Act 1986). Reducing a creditor's claim does not fall within that ambit. In a corporate context, a liquidator's function is arguably more varied but in a broad sense includes collecting the company's assets, realising and distributing them. The same logic would appear to apply, in the obvious absence of a specific power or obligation actively to reduce the level of creditor claims in a liquidation, such that it would also appear to preclude reduction of a creditor's claim as a valid basis on which a liquidator could share documents.

While the above principles apply ostensibly to compulsion documents, careful thought would also need to be given about deployment of non-compulsion material (eg such as a company's books and records) for a purpose not considered in line with the office-holder's duties. Given the Court of Appeal's concern that an office-holder must act in accordance with their statutory function and duties, it is hard to see why that same logic would not apply to all material in the possession of a trustee or liquidator though their office.

Arnold J did however consider it appropriate for documentation to be shared between estates where the purpose of doing so was to assist in unearthing fraudulent transactions in order to bring proceedings for the benefit of their own estate. Further, disclosure to public authorities for the purposes of criminal investigations and directors' disqualification proceedings was also permitted. While not expressly referred to in the judgment, by analogy the same principle may apply to regulatory proceedings but this would need careful thought.

However, Arnold J concluded that it did not follow that office-holders might share such material with any other third parties without the leave of the court, simply because they raise issues of dishonesty or malpractice. Again, this type of proposed document sharing would need to be carefully considered.

"In any litigation context, the question of how information has come into the hands of a claimant (or indeed defendant) may well attract significant scrutiny from a well-advised opponent."

Disclosure documents

Another point considered in the Shlosberg document decision was the issue of material obtained by an office-holder as part of any litigation proceedings. Such material is usually subject to an implied undertaking that it will only be used for the purposes of the proceedings it was disclosed in, unless the document has been read or referred to at a public hearing, or the court gives permission (CPR 31.22).

There is no exception to that rule for insolvency office-holders, and this is an issue that is sometimes (wrongly) overlooked. Arnold J did observe that there is no real issue in the context of common office-holders, as experienced practitioners and lawyers would not use disclosure material improperly (see also below, re common office-holders). However, some caution should be exercised here, as even viewing material subject to the implied undertaking can amount to 'use' (see *IG Index Ltd* v. *Cloete* [2014] EWCA Civ 1128).

Privileged documents

The third category was material over which Mr Shlosberg had a claim to privilege which was not joint with Webinvest. In the Court of Appeal privilege decision, the court held that, save for the documents classified in the compulsion documents section above, the benefit of Mr Shlosberg's privilege had not been transferred to the trustees, but was retained by Mr Shlosberg – as 'privilege' is not property that vests in a trustee in bankruptcy. Therefore any privileged documents cannot be shared between estates without the bankrupt's consent.

The position is different in a corporate context: a liquidator takes control of a company, and could (subject to it being appropriate to do so) deploy a company's privileged material including by waiving that privilege. A bankruptcy trustee of course does not 'control' the bankrupt per se, unlike a liquidator appointed over a company – hence the different approach.

Conclusions

The court has adopted a pragmatic approach to the issue of document sharing between insolvent estates, and office-holders should mirror that approach in their conduct of insolvencies. Where office-holders are appointed over any number of related estates, careful thought should be given to how they approach documentation at the earliest opportunity.

To ensure transparency, consider a document-sharing protocol that clearly sets out the office-holder's approach. Such a protocol should set out the basis and reasons for sharing documents and provide some protection over any potentially privileged material. In particularly sensitive circumstances, the advice of conflict counsel should be sought.

Where documentation is obtained under powers of compulsion, an easy solution is for the requests to be made on behalf of all interrelated estates in order to avoid arguments about subsequent sharing. If there remains any doubt then applications should be made under the office-holder's powers under ss236 and 366 of the Insolvency Act 1986 for determination by the courts. ◻

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The bankruptcy Pegasus: stalking horse agreements in aviation

Anton Chambers and **Marc Trottier** look at a commonplace US bankruptcy phenomenon and consider its use in the aviation industry.

The Covid-19 pandemic has had a significant impact on the aviation industry, with regular international travel being halted for prolonged periods since March 2020. This has led to payment defaults and insolvencies for airlines and other market participants who have struggled to continue operations and meet their debt and rental obligations. However, the market turmoil has piqued the interest of savvy investors who see an opportunity to exploit depressed aircraft values and demand in the secondary market.

In particular, investing in assets that have become available as a result of the insolvency of a lessor or airline could prove to be fertile ground for both existing aviation market players and new entrants alike. This article will briefly discuss one interesting mechanism through which investors have already sought to take advantage of the current market environment: stalking horse agreements.

Stalking horse agreements

While relatively uncommon in the context of European restructurings and distressed sales, stalking horse agreements are relatively commonplace in the context of Chapter 11 bankruptcies in the US. They are often filed in order to facilitate so-called '363 sales' of a business's assets, in accordance with section 363 of the Bankruptcy Code, in the quest to recover money owed to the creditors of the bankrupt company. The debtor and the bankruptcy court will consider stalking bid proposals from third parties willing to purchase all or part of the debtor's assets. A stalking horse bid will act as a reserve bid, setting a minimum bid level for any competing bidders. Given the distressed nature of 363 sales in the US, the stalking bid will usually value the assets below current market value, but the court and the debtor will be mindful of the fact that a stalking horse bid may represent a competitive price in the current market circumstances and the fact that a stalking horse bid and subsequent auction process guarantees that the assets will be sold and may instigate interest from other bidders. In these circumstances, a stalking horse will negotiate with the debtor-in bankruptcy the conditions of its stalking horse bid and the parameters of an auction process, which could result in other bidders defeating that stalking horse bid. The benefits of such a 363 sale for the stalking horse bidder/eventual buyer include:

- the assets are sold to the eventual buyer free and clear of any liens;
- the costs incurred during the due diligence and asset purchase negotiations are often recoverable by the stalking horse bidder, through an expense reimbursement or payment of a break-up fee; and
- the stalking horse bidder is often heavily involved in structuring the auction process, meaning that the rules and procedures are often beneficial to the stalking horse bidder who can influence auction timeframes and rules, such as minimum overbid requirements for competing bids, increasing the likelihood that the stalking horse bidder will prevail in the auction process.

> **"A stalking horse bid will act as a reserve bid, setting a minimum bid level for any competing bidders."**

Stalking horse agreements in aviation

Since early 2020, we have seen many aviation businesses endure tough times and undergo various insolvency or restructuring arrangements, which has led to lessors defaulting on debt repayments and airlines defaulting on rent payments and/or rejecting aircraft leases altogether. In such scenarios, unless new debt or lease terms can be agreed between the defaulting party and its creditors, aircraft assets need to be remarketed and disposed of, in order for creditors to retrieve some value for their initial investment. The extent of the market downturn means that aircraft values are currently depressed and demand for them is low compared with pre-pandemic levels, which means that the proceeds from any disposal of aircraft assets are less likely to be high enough to cover the outstanding debt amounts owed to creditors of the aircraft-owning entities in question. In an attempt to stimulate market interest in purchasing their aircraft assets and to guarantee that the aircraft assets will be sold at a pre-agreed minimum price, certain debtors have been entering into stalking horse agreements with potential buyers (the stalking horse bidders), where such buyer agrees to purchase the aircraft assets at an agreed price if they are not sold at a subsequent auction. The stalking horse bidder will have conditions attached to its stalking horse bid, such as a minimum threshold for any bid which defeats the stalking horse bid and some kind of financial compensation in the event that the stalking horse bidder is ultimately unsuccessful in purchasing the aircraft assets.

Two high profile examples of this type of stalking horse bid agreement in the aviation industry can be found in VMO Aircraft Leasing's (VMO) stalking horse arrangement for the ten Boeing 737-800s owned by Norwegian Air Shuttle's (NAS) enhanced equipment trust certificates

(EETC) issuance and the 17 aircraft associated with LATAM's EETC issuance. In both scenarios, investors reportedly utilised the standard EETC terms in order to take control of the process for disposing of the aircraft collateral and initiate an auction process in which such investors were the stalking horse bidders.

Based on reports, the stalking horse agreements we have seen in the aviation industry since the onset of the Covid-19 pandemic include:

- significant 'break-up fees', in the tens of millions of US dollars, payable to the stalking horse bidder if it is outbid in the eventual auction;
- stalking horse bids for entire aircraft portfolios, typically sufficient to repay at least the majority of principal and interest owed to the senior noteholders/lenders, reimburse the costs incurred by and fees due to the administrative agents and to repay amounts owed to the liquidity facility providers. However, the stalking bids typically have not been sufficient to repay amounts owed to subordinated noteholders/lenders;
- requirements that competing bidders in the eventual auction process meet certain conditions such as: signing a confidentiality agreement; providing evidence of their ability to execute the transaction; and a minimum overbid increment in the case of more than one qualified bidder;
- in one particular EETC deal, a stalking horse bid (made by a controlling class A majority creditor) which values the aircraft at least 30% below certain third-party appraisers' current market values of the portfolio aircraft; and
- in another case, a stipulation that any competing bid must be for all of the aircraft in the portfolio and that qualifying bids must be at least $60m (£45m) higher than the stalking horse bid, inclusive of a break-up fee.

While unusual for UK and European restructurings and distressed aircraft disposals, this type of mechanism for acquiring distressed company assets is quite common in US '363 sale' scenarios.

Private equity and other alternative credit providers may be tempted to exploit the downturn in the aviation industry to acquire assets at discounted prices using stalking horse arrangements, which have been successfully utilised by them in other sectors.

Consequences for creditors

It has been reported that in both the NAS EETC and LATAM EETC stalking horse arrangements the stalking horse bids were sufficient to discharge at least the majority of the senior outstanding debt but not the outstanding subordinated debt. This has led some observers to question the propriety of such a mechanism, given that the stalking horse bidders introduced a relatively novel and aggressive set of rules and

> **"The stalking horse bidder will have conditions attached to its stalking horse bid, such as a minimum threshold for any bid which defeats the stalking horse bid and some kind of financial compensation in the event that the stalking horse bidder is ultimately unsuccessful."**

procedures compared with usual commercial aircraft auction processes.

Some observers have speculated that potential investors from the aviation finance community have been deterred from bidding in these types of auctions, which they see as being designed to ensure that the stalking horse bid would ultimately succeed, due to the minimum bid and break-up fee requirements, as well as the tight timeframe during a depressed market where potential bidders would have been less confident about placing the aircraft with operators. Hudson Structured Capital Management and other subordinated B noteholders under the NAS EETC issuance have launched legal proceedings in the New York courts against Wilmington Trust and Ares Management. The principal complaint in that lawsuit is that auction process was a 'sham' process designed to ensure that VMO's (an affiliate of Ares' parent company) stalking horse bid was successful. It is claimed that VMO's purchase of the aircraft at a discount resulted in losses for the subordinated noteholders, whose outstanding debts were reportedly not discharged by the sale proceeds.

The counter argument to complaints about these stalking horse agreements is that subordinated debt is by its nature a riskier investment and is priced accordingly, with subordinated debt investors being well aware that they will potentially suffer losses in the event of a debtor insolvency and distressed collateral sale. One could also point to the fact that in the context of these EETC transactions, the stalking horse bidder simply availed itself of the standard EETC provisions which facilitate trading of subordinated certificates on the secondary market and entitle majority subordinated certificate holders to buy out the senior certificate holders.

It is too early to say whether or not these examples foreshadow a genuine emerging trend in the aviation industry when it comes to airline insolvencies and distressed asset sales, but it is an intriguing prospect. Investors in subordinated debt instruments in particular would be well advised to keep a keen eye on how this develops and whether they believe any such emerging trend will have any impact on how they analyse the concomitant risks going forward, given that stalking horse bids on the lower side and auction processes which deter competing bids could result in substantial or even total losses on subordinated outstanding debt recoveries. What is for sure is that the stalking horse mechanism and depressed aircraft asset values provide an intriguing opportunity for alternative credit providers to gain entry into an industry that usually garners solid returns for its investors and which many hope will return to normal health in the not-too-distant future. ◻

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The fightback against zombie companies

Frank Tschentscher writes on the opportunities for working together in the wake of the new wave of zombie companies.

I assume that everyone is sufficiently tired by now of hearing how 'strange', 'challenging' or 'unprecedented' the past two years have been but it is true that the Covid-19 pandemic continues to have an immediate and extreme effect on all of us and on our economies. That being so, and given that Halloween is just behind us, what could be more natural but to turn our attention towards the dreaded zombie and, more specifically, the corporate undead?

World war Z?

When the pandemic struck, governments around the world imposed lockdowns and severe restrictions to contain the spread of Covid-19. Most governments responded, as is well known, with supporting measures and financial injections to boost their respective economies, spending billions on job-retention schemes, bounce back loans to struggling companies and bailouts for big firms threatened with insolvency.

However, these massive public interventions designed to prevent viable businesses being driven out of the market may have kept non-viable firms alive as well, raising fears of the emergence of 'zombie companies' and a 'zombification of economies'. These corporates are economically unviable and manage to survive only by tapping banks and capital markets or, in recent times, government funds. The number of such 'living dead' firms has progressively increased since the 1980s and again risen strongly in the decade after the financial crisis. Now, economists fear, the problem is being exacerbated by the policy response to the pandemic and the million-dollar question is whether it will lead to a wave of insolvencies and restructurings in 2022, once all injections by governments have run their course.

The zombie strike team

All of this is worrying but it can also present opportunity. With a large membership in the UK and across Europe, R3 and INSOL Europe are best placed to deal with the inevitable fallout from the pandemic. As professionals within the crisis management and restructuring community, we are accustomed to approaching each new hardship as a challenge and the ongoing pandemic is no different. Our industry performs a valuable role for the economy, rescuing struggling businesses where possible and providing an orderly way to deal with individuals and businesses where insolvency is the best option. The wealth of expertise available in both our organisations is expansive and cannot be done justice here in one small paragraph but if I had to, I would refer you to INSOL Europe's initiatives over the past year or so.

We are known for providing the opportunity to bring together peers and colleagues from across Europe and around the globe, to build cross-border relationships and assist in the development of best practices for insolvency and restructuring systems. Our events programme has been an instrumental part of achieving this objective and although we had to cancel our Annual Congress due to be held in Sorrento in October 2020, we continued to hold successful online conferences and published regular technical papers during the past year. With R3, we hosted the Joint Virtual Fraud Conference on 2 and 3 February 2021. INSOL Europe's Spring Conference on 4 March and 18 March 2021 saw a hand-picked selection of international experts speaking on a range of highly relevant and important topics including the EU Directive. With INSOL International, we presented an online seminar on 15 April 2021 featuring a keynote address from professor Ignacio Tirado, secretary-general of UNIDROIT. On 20 May 2021, we held an online lecture by professor N Bermejo on the topic of 'public creditors in preventive restructuring frameworks: considerations in the light of the pandemic crisis'. Plus, we held a series of very enjoyable speed networking events in June 2021 and September 2021.

This is exactly what we want to do more of – support local initiatives, to make more people aware of what our organisation does and how it can help but also to ensure we are close to the key insolvency and restructuring issues and debates that go on in every country every day. We will continue to be creative about online learning, find ways to connect with our colleagues across Europe and around the world and pull together to help rebuild the global economy.

The next opportunity to do so in real life will be at INSOL Europe's Annual Congress in Dublin between 3 and 6 March 2022. Registrations are open (**www.insol-europe.org/events/**) and we encourage you to join us. I am proud to be part of a community which looks forward and concentrates on positive change instead of dwelling on things outside of our control and I know that, together, we will get through these monumental times.

FRANK TSCHENTSCHER is the new president of INSOL Europe and a partner at Deloitte in Germany.

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Briefing peers and bringing the UK back to business

James Jeffreys outlines the work R3's Press, Policy and Public Affairs (PPP) team has carried out on the profession's behalf since the last issue of *RECOVERY*.

Over the summer and autumn, the insolvency and restructuring element of the parliamentary and policy agenda has been dominated by a debate on regulation, the ending of a number of the government's temporary insolvency measures and legislation to tackle director misconduct.

We've been busy briefing parliamentarians, journalists and stakeholders on the profession's stance on these issues, as well as continuing our work to educate directors about the profession and the benefits of early engagement, as well as carrying on our work with the Insolvency Service on diversity and inclusion.

A voice in the regulation debate

When the all-party parliamentary group (APPG) on fair business banking published its report on insolvency regulation, R3 was front and centre defending the profession, its work and its current regulatory framework.

We were quoted in an article in *The Times* about the launch of the report, and R3's CEO Caroline Sumner spoke at a parliamentary roundtable to mark its launch. She met members of the APPG and other parliamentarians, along with industry stakeholders at the launch event at the House of Commons.

We've continued to engage with the APPG as the debate on the future of regulation continues and, at the end of October, had a letter published in the *Financial Times* highlighting the strength of our current regulatory regime and the areas of it we believe could be evolved, based on members' feedback.

A voice in Westminster

Since the summer recess, two key pieces of legislation have had their turns in the parliamentary spotlight.

The rating (Coronavirus) and directors disqualification (dissolved companies) bill began its passage through the House of Lords, and we briefed the peers who were due to speak in the debate on the second reading of the bill ahead of it taking place.

As a result, R3 was mentioned by the Liberal Democrat peer Baroness Pinnock, who quoted directly from our briefing and stated that investigations into dissolved companies should not come at the expense of investigations into insolvent ones.

Other peers also raised our concerns that the legislation might be targeted at bounce back loan fraud, to the benefit of the exchequer, rather than being used to tackle this type of fraud more widely.

In the Commons, R3 was mentioned by the shadow insolvency minister Seema Malhotra MP during the debate on a statutory instrument that brought the temporary restrictions on winding-up petitions and statutory demands to an end and introduced a new temporary debt limit for winding-up petitions.

During the debate, the shadow minister mentioned R3 and our point on the importance of businesses seeking early advice, and stated that she agreed that businesses who seek advice often have the best options and the best information to take a decision about their next steps.

> **"R3 was mentioned by the Liberal Democrat peer Baroness Pinnock, who quoted directly from our briefing and stated that investigations into dissolved companies should not come at the expense of investigations into insolvent ones."**

Back to Business UK: an update

Work on our Back to Business UK campaign continues. We've reached out to all 650 MPs a number of times, urging them to use our directors' guide to encourage business owners in their constituencies to seek advice at the first sign their business may be financially distressed.

We ran a media campaign at the start of September calling for company directors to be alert to the signs of financial distress as furlough came to an end, which generated around 50 cuttings in national, regional and small business media.

And, as this column was going to press, we had contacted more than 19,000 councillors across England and Wales to urge them to do the same.

Diversity and inclusion

At the start of October, we partnered with the Insolvency Service to promote the work of our joint steering group on diversity and inclusion during National Inclusion Week.

Mercury Corporate Recovery Solutions managing director and steering group member Francesca Tackie was interviewed for R3's blog about her career and her work as part of the group and we published a blogpost outlining some of the headline results from our recent members' survey.

Following the completion of the survey, the steering group is now finalising an action plan to achieve its aim of addressing potential barriers to entry and progression – and we hope to be able to share more about this in the next issue of *RECOVERY*.

R3 in the media

Over the last few months, our communications team has been busy briefing journalists and responding to breaking news stories on insolvency trends and policy announcements.

R3's response to the new temporary insolvency measures featured in articles in *The Times* and *The Daily Telegraph*, while our comments on the monthly and quarterly insolvency statistics have appeared in pieces in Reuters, Bloomberg, *The Herald*, *Scottish Financial News* and *The Guardian*, as well as in a range of regional and specialist media outlets.

In addition to this, R3 spokespeople have given interviews and briefings to journalists from a range of outlets that include Bloomberg, *The Times* and the *Financial Times*, as well as *Accountancy Age*, *The Herald* and *EuroMoney* on issues that include the end of furlough, football administrations and zombie companies.

JAMES JEFFREYS is head of Press, Policy and Public Affairs at R3.

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An interview with... Louise Durkan, chair of the R3 new professionals steering committee

Louise Durkan talks about her work with R3 and how the association is setting itself up for the future.

Louise Durkan biography

- Louise was what she calls a 'classic fell-into-it person' when it came to the insolvency profession. After undertaking some A level work experience with a local accountancy firm, she decided to write to every practice in the Cardiff area asking for a job and was invited to be interviewed by Ernst & Young (now EY). The manager couldn't offer a trainee accountant role but did have a posting open in the insolvency department. Louise now found herself working for one of the Big 4, in a small insolvency team during a recession, learning a lot very quickly over the next seven or eight years.

- Not long after the birth of her daughter, Louise returned to work for a boutique accountancy firm. Finding that she was better suited to a larger firm with greater corporate work, she applied to KPMG. After just a couple of years in the role, and with a need to relocate, she moved to Grant Thornton in Bristol for seven years before joining Deloitte, where she stayed until 2020.

- In 2020 she became a partner at Quantuma, progressing to the managing director role in the same year. Louise now heads up the financial advisory practice for Quantuma and has advised businesses and supported their stakeholders in a very wide range of industry sectors including retail, manufacturing and engineering, leisure, residential care, agricultural, commercial/residential property management, transportation, commercial/agricultural vehicle dealerships, financial services, distribution, education, aviation and construction.

Q How did you come to be involved in R3?

A I was part of R3 before it was even called R3. The partner who I worked for in my first job when I was 19 was a regional chairman of the Society of Practitioners of Insolvency, as it was then called. I initially went along to regional meetings to help out, pass around the register and help with back-office admin for meetings. The partner would always make a point of introducing me to people at these meetings, which was probably the best introduction into the networking side that regional meetings offer. I could immediately see the benefits of the community that was there.

At that time, we had a great cross-section of our community in the meetings – bankers, lawyers, agents and IPs used to attend. We heard from different voices and gained different perspectives as well as the interesting updates that we still get today. It was a great environment in which to appreciate the profession that you're in in the wider sense.

Q Why is R3 valuable to the profession (both for new members and veteran professionals)?

A The great thing about R3 is that you could potentially make a connection, an introduction or have a conversation with somebody that might, at some point in your career, be hugely beneficial to you on a personal level, on a business level or as an opportunity in terms of work. There are so many things you could get out of just one regional meeting, a technical or networking event.

I've met people who I've ended up working with on a project, sometimes acting for the other side, even someone that you might interview for a job in future (or be interviewed by!). We're not always there on parade but if you really want to get the most out of your membership, there is more that you can access beyond the formal technical and soft skills training. There is a community and an environment that can give you opportunities to build your personal brand, your organisation's brand and even that of the profession as a whole.

"The great thing about R3 is that you could potentially make a connection, an introduction or have a conversation with somebody that might, at some point in your career, be hugely beneficial to you on a personal level, on a business level or as an opportunity in terms of work."

Q We understand that you've been working closely with R3's new professionals' group. Could you tell us a little about what they do?

A A lot of activity has been virtual over the last year, which means the range of the events have been somewhat limited. I sit as chair of the new professionals steering committee, which means I'm interacting directly with the regional chairs of the new professionals' groups and committees across the country. The discussions we are having are around the challenges they have within their region around membership engagement – ensuring they have the right content and focus for the membership, and some more practical issues such as having enough members on each committee and the constant need for succession planning. The chairs are the voice of the new professionals in our community and an important point of contact to hear their views and concerns – for me they help to identify any common themes around what the membership wants. The new professionals' groups have existed for some

> We know we've got to change the hearts and minds of some of our senior professionals, as much as we have got to encourage the new professionals.

time, but we must re-energise those groups and refocus them with some new structure and leadership.

There was always a seat on a regional committee for a new professional, which was traditionally given to a student member of R3 (prior to sitting the JIEB exams and becoming a full member). I think the role itself was probably a bit vague and lacked some clarity and structure. There's a recognition from R3 that the committees needed more investment and support and there is a genuine commitment to doing this. The creation of the steering committee is only part of this but it is a great way to improve communication, direct support, share ideas and provide feedback between the R3 central team and individual members.

Q What sort of topics are you talking about in relation to the new professionals within R3?

A It's not purely networking and professional fulfilment that they're looking for from R3, although there is a focus on that. It's also looking at technical content, and access to technical content that is relevant to them and 'hits the right spot' from a more junior perspective. So, we are looking at how we adapt what we're delivering, both on a national basis and at regional level. More and more I think there is a genuinely interest to get more involved in R3, shape R3's initiatives, learn about what the organisation does and play a role. They offer lots of energy and enthusiasm – they just need the opportunity.

Q It sounds like you've taken on a bit of a mentoring role with the new professionals. Would that be fair to say?

A R3 has gone through a period of reflection culminating with its strategic review and has identified some key initiatives. A fundamental part of that has been talking to membership and getting membership views on what they want. It would be wrong for me to sit as the chair of the steering committee and tell new professionals what I think they need. My role is more of a facilitator role and yes, sometimes mentoring does play a part, but my role is a temporary one – I'm there to get things up and running and get the structure in place. My first order of business is to work out who's my successor, who's next and who wants to play a part in shaping the future. It's helpful to have me lay some groundwork for them and give them some strategic direction, but it's equally as important to encourage, mentor and support them to be confident to take on my role in future and to have a key role in R3.

Q Do you think it's harder with modern life to find time to participate in something like R3? Are there higher demands on professionals' time now that compete for attention?

A I don't think it is necessarily different. I became involved because a senior person at my firm was a regional chair and we had a very pro-R3 workplace. You didn't have to justify or explain the value of an event because the senior leaders already recognised it and were bought in – I think that's the real key to it. We're all going to be busy and there are going to be times when client work and client commitments mean you simply can't give up your time, but if you have to ask for permission to leave early or incur some costs to attend an event and the decision makers don't see it has any value to them or your firm then is a difficult position to be in. I think that's where the new professionals can help to identify some of those challenges and issues that they're facing day to day.

Maybe there are some quick wins: more breakfast events rather than end-of-day events, or free-to-attend events or a hybrid of online and face to face. Half the battle for R3 is getting new professionals engaged and delivering something of value to them, but it's also making sure that their senior leaders, bill payers and marketing spend controllers see the value in it too. We know we've got to change the hearts and minds of some of our senior professionals, as much as we have got to encourage the new professionals.

Q Why is it important to reach people that are just starting out in the profession?

A There are a couple of different reasons. Firstly, to show people that you can have a long-term career in what we do in our profession and in the world that we inhabit. At the moment people can have several jobs and do several different things at different points in their life, but we need to show that there is a very valuable and rewarding career here for you for however long you want it. Secondly, if we want our community to have a voice, whether it's the lobbying side of what R3 does or the training and support, some of us have got to play a part in delivering that – it doesn't happen by magic. I've always been happy to give back through R3 because I got a lot out of it. It's a great profession, you'll meet some really interesting people who will share their knowledge with others – you will get to work on some really unusual cases and situations that will stretch and challenge you. Most importantly you will be playing you part in maintaining the lifecycle of our profession.

Q What would you have told your earlier-career self if you'd joined the new professionals' group?

A I was, and still am, a very shy individual. I started my first job as a teenager straight from school. At times I was afraid to pick up and answer a telephone in the office and speak in front of people. I didn't like the sound of my own voice; I didn't like standing up in front of people and found the whole thing absolutely terrifying. I would probably tell myself to face some of those fears and to get more involved. You just never know what opportunity or door is going to open for you. You may pick up snippets of technical information that you can use at some point in time, you may make a connection with somebody who could be a future employer, future employee or provide you with a great opportunity. I'd say go into it with an open mind, but also be prepared to put some effort into it. That's what I've always tried to do and it gave me a great stepping stone for my career. I've been associated with R3 for such a long time and have met so many people and had so many opportunities since I was that 19-year-old who went along to their very first regional committee and stood at the back taking the register. Roll forward many years later, I'm stood on a stage in front of an entire room hosting a black-tie dinner for 400-plus people. I would never have believed where R3 was going to take me then but I know there is still more it can offer me today. □

> If we want our community to have a voice, whether it's the lobbying side of what R3 does or the training and support, some of us have got to play a part in delivering that – it doesn't happen by magic.

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