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Comment

Down the rabbit hole

Heather Greig-Smith **Editor**

Corporate insolvency has attracted a lot of the headlines in the last year – from pre-packs to high profile retail administrations and even accusations of the UK becoming a "bankruptcy brothel". There are still a number of issues for the sector, many of which are covered in this supplement. However, there is also structural change afoot in the personal insolvency world.

In many ways personal insolvency has had a quieter time since the upheaval of the individual voluntary arrangement protocol, with companies that based their business models on expensive television advertising either changing their ways or shutting up shop since the banks put down a collective foot. But the system is inherently controversial and the government has added further layers of complexity over time, debt relief orders being one recent example.

The latest layer that could be added is a statutory debt management plan, borne out of good intentions in terms of monitoring and standardising a more fluid and less controlled area of personal insolvency. However, you have to wonder if all this is getting a bit much for an indebted person to navigate? Could even the most savvy decide between all these options when faced with the emotional turmoil and inevitable barrage of calls from creditors and collectors that accompany such levels of financial distress?

Of course the government is also doing its best to write up menus of options and explain the difference, but it seems that control of the quality of personal insolvency practitioners is more crucial than ever as they need to act as the translators and guides for Alice the debtor down the rabbit hole of insolvency.

And there lies a further problem – squabbling between the different providers of debt solutions, with the free sector staunchly refusing to acknowledge the private sector's right to exist and the paid-for providers defending their skills and ability to respond more quickly.

It's a shame that the two can't get along a bit better. While the free sector may argue that it's wrong for a debtor to have to pay the fee of an insolvency practitioner, isn't that the choice of the individual debtor as long as their creditors are willing to accept the proposed payback? Some may be prepared to pay for quick private sector advice when seeking immediate relief and faced with waiting time for the free option.

And is free advice really free? Someone somewhere has to pay for it – if the contributions come from the creditors then other customers have to pay, if it comes from government then the taxpayer is footing the bill.

Instead they should unite against the real rogues in the system, such as those writing to debtors under official-sounding names suggesting they have been mis-sold their solutions. This deceptive and cruel practice should end.

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Debt solutions: the game plan

Amid growing concerns over a lack of regulation in the booming debt management industry, opinions differ as to how to deal with the issue, writes Ashley Armstrong

Since the global recession raged its way through the credit markets, leading to a spike in the number of people facing financial worries, the debt management market has enjoyed a booming trade.

In the first week of this year debt management plan (DMP) providers were reporting a 30 per cent uplift on normal seasonal trading as more people were left in dire financial conditions – a combination of bloated Christmas spending and income shocks following redundancies.

To combat the financial turmoil, a number of credit providers and brokers have side stepped into debt management provision to offset their declining trade, and as the number of new entrants soars, reports of foul play have also jumped.

Growing concerns that providers looking after their own interests could lead to people in debt ending up in a worse, rather than better, financial position have prompted the Office of Fair Trading (OFT) to launch a review of practices, and the Ministry of Justice (MoJ) to hold a consultation into the regulation of debt management plans.

Unlike individual voluntary arrangements (IVAs) or bankruptcy options, debt management plans are not regulated by law. Therefore it is up to firms to sign up to trade bodies which champion good practice, such as the Debt Management Standards Association (DEMSA) or the Debt Resolution Forum (DRF). And as they are not recorded, the number of DMPs currently in action is unknown, as is the number of firms which provide them.

Confusion over providers

Mark Sands, head of the national bankruptcy team at insolvency practitioner Tenon Recovery, says: "There are rough estimates, but no one knows how many are currently in practice – which means that someone could set a debt management firm up relatively easily, and just start peddling plans."

It has been estimated that there may be around 850 DMP providers in the UK, with debt management plans estimated to be between 100,000 and 150,000 a year. Insolvency trade body R3 recently stuck its neck out in the confusion and hazarded that there were 700,000 DMPs currently operating. To date that figure has not been challenged.

Nick Pearson, director of debt solutions firm Paymex, says: "There are a huge number of new entrants in the market, who obtained debt licences from the old [consumer credit] regime and have little or no experience of running debt management plans."

Mark Sands: Tenon Recovery

Someone could set a debt management firm up relatively easily, and just start peddling plans"

"There's the danger that people look at DMPs as a 'get rich quick scheme', and it's not that straightforward. People would think that because of the current environment it's a great time to go into the debt management business – but it's hugely complex," Pearson adds.

As the number of people seeking debt solutions has jumped, the lack of control and knowledge has meant that unscrupulous providers have continued to operate under the radar.

Concerns regarding current practice in the debt management industry were highlighted by the OFT's decision to review its guidance of debt management. Since April 2008 the OFT has launched 24 formal actions to either refuse or revoke licences held by debt management businesses for misleading advertising and fee charges.

Ray Watson, OFT director of consumer credit, says: "A recent increase in formal OFT enforcement action, rising complaints and new problems emerging in the market suggest that some businesses are still not meeting minimum standards. This review will help us identify those practices that are harming consumers, as well as the reasons for non-compliance, and will help us target our enforcement action."

The OFT is expected to publish a report later this year with issues that have come to light in its review. It is then expected to take the steps to change the current guidance, if needed.

It is the OFT's statutory duty to ensure that only those who are fit and competent are given and retain a licence. But while the OFT is likely to throw some light on the concerns affecting the industry, it is unable to say what resources it will be able to commit specifically to debt management plan providers, including the frequency and nature of inspections.

Government involvement

The MoJ sets out in its consultation that it aims to ensure a working balance between the creditors, debtors and debt management plan providers and provide more transparency for the person in debt. It also aims to ensure that fees charged by debt management scheme providers are reasonable and consistent and end the practice of some creditors adding interest to debts included in a repayment plan. Primarily the MoJ wants to make sure that debtors are aware of the range of options available to them and are advised on the most appropriate and sustainable solutions for their circumstances.

In its consultation the MoJ has proposed three options to remedy the situation. Option one suggests that the OFT should continue examining compliance and essentially suggests improving the status quo. The second option suggests the introduction of a debt management protocol with an emphasis on ensuring standards are monitored and audited. The third option outlines regulation of the industry by introducing statutory debt management schemes.

Most of the industry is not in favour of option one and agrees that change needs to happen to guarantee clarity for all parties involved in the process.

However, the notion of statutory regulation provokes a stark polarisation of opinions.

One main issue of contention centres on a clause within the Tribunals Courts and Enforcement Act which does not allow statutory regulated debt organisations to make a profit.

However, the MoJ told *Credit Today* that if option three was chosen, it would seek a change to the legislation to allow profit and would not bring the schemes in before that.

If option three is chosen, it could also impose a fee-capping clause on debt management providers. The free-advice sector claims that fees are driven into advertising, helping to push market share up against the interests of a person in debt.

John Fairhurst, director of provider Payplan, says: "Currently fees are too high and the majority of the income goes towards marketing – which there needs to be a limit on."

But, naturally, the idea of a cut in income has provoked outrage from commerical providers. Paymex's Pearson says: "We'd have to rule against statutory regulations – simply because if we can't make any money from debt management plans we won't offer them. Fees shouldn't be capped, there should always be competition in the marketplace."

Since the jump in the number of debt management providers, reports have circulated about a growing number of unscrupulous firms that steer people in

Ray Watson: Office of Fair Trading

This review will help us identify those practices that are harming consumers, and will help us target our enforcement action"

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debt towards the most profitable option, rather than the option best for their debt situation.

Commercial operators tend to charge people in debt a set-up charge to negotiate a debt management plan with creditors and on top of this a monthly fee is also charged for ongoing management and reporting.

While quality commercial firms argue they are paid reasonably for excellent service, the free sector continues to criticise their existence. Delroy Corinaldi, Consumer Credit Counselling Service (CCCS) external affairs director, says: "People in debt want all their money going towards paying off debt – not contributing towards debt management firms' marketing proceeds."

The MoJ is concerned that some providers manipulate clients' income to ensure a debt management plan is initially accepted by creditors. This practice is ultimately flawed as a debtor is unlikely to be able to afford inflated outgoings.

When a debt management plan fails the person in debt is often forced to file for bankruptcy. Fairhurst and Corinaldi believe there should be a review into the number of DMP breakages and the reasons behind them.

The MoJ and many industry bodies are recommending the use of the Common Financial Statement as the standard measure in negotiations with creditors. However providers say privately that creditors still challenge this document, and they would like to see it honoured if it is to be used exclusively.

For option three to succeed, the government would have to create or appoint an organisation to take charge of regulation and enforce guidelines.

But many industry figures are concerned that this would be a slow and lengthy process, especially if a new government comes into power in May, which could lead to any debt management proposals being lost in a sea of new policies.

As DEMSA chairman Michael Land says: "I don't think that debt management will be very high on the list of priorities for a new government."

Others disagree. David Mond, chairman of the Debt Resolution Forum, says he believes both Labour and the Conservatives are committed to the change. Bridget Prentice, parliamentary under secretary of state for the Ministry of Justice, says: "If the consultation shows that there are problems with current debt management plans that need to be addressed, we will consider what further action can be taken urgently, recognising that it is likely to take time to implement the measures in options two and three."

The MoJ adds: "The consultation on debt management has now closed. We will consider the responses and respond to them in due course."

MoJ insolvency team leader Phil Kelly says that after analysing all the responses to the consultation, which is likely to take some time, advice will be offered to ministers some time in February.

As a stop-gap the government has recently published guidance to help people facing financial worries better understand their debt management options.

But while the government's guidelines for debtors have been welcomed as a step in ensuring they are well informed, many within the industry believe that statutory regulation of debt management plans would be too heavy handed and over-regulation would turn DMPs into IVAs.

Self regulation

The British Bankers Association believes that for the second option of self-regulation to be accepted a holistic review is needed, focusing on what is best for the person in debt. Eric Leenders, executive director, argues: "We need a consumer-centric overview." His suggestion is that a protocol must take into account that people fall into debt problems due to an 'income shock' and should be allowed a grace period on repayments.

Meanwhile Michael Land believes that the best possible solution could be met by a combination of options one and two. "We believe that the scale of the problem is great and neither the free sector nor the fee charging sector is capable of dealing with this alone," he says.

Land adds: "The overall problem currently is compounded by the fact that government encourages lenders to deal only with the free sector, irrespective of the circumstances. Whilst encouraging use of the free sector has its attractions, it needs to be understood that, for the reasons discussed earlier, many people will suffer huge stress and misery, because they cannot access the free services quickly or effectively."

There are currently two trade bodies acting within the debt management industry – the DRF and DEMSA. DEMSA is approved by the OFT and all firms wishing to become a member must be fully audited and tested to ensure high standards. It has fewer members than the DRF, which represents 70 per cent of the market.

Peter Sargent: R3

It's time for them to sit down in a room together and join up – it would be a lot easier if there was one body which had the responsibility"

Trade body merger

The DRF, while not yet being affiliated with the OFT, has its own code of standards. But a number of players in the industry believe the ultimate solution to regulation would be a tie-up between the two trade bodies.

Paymex director Nick Pearson says: "We are calling on DEMSA and DRF to join up and act as a single trade body to regulate the industry. In this way the body would deal with everything the government wants to do, but with voluntary regulation, rather than statutory regulations. There has to be one trade body – it's painfully obvious – why have two when you can have one? It's more than sufficient."

R3 president Peter Sargent agrees: "It's time for them to sit down in a room together and join up – it would be a lot easier if there was one body which had

the responsibility."

Peter Joyce, director general of the Insolvency Practitioners Association, says that there "would be some logic in the to associations coming together", but adds: "It would be difficult to get the total community signed up to a voluntary code."

And Tenon Recovery's Mark Sands says that while he believes a heavy-handed approach is not necessary, he wants the code to have its foundations in statute to ensure it has enough power behind it to enforce regulation.

DRF chairman Mond says it is logical to have one trade body and DRF is willing to sit down with DEMSA but "politics" are in the way.

DEMSA chairman Michael Land appears not to be in favour of a merger. "We are OFT approved, DRF is not. It would be like getting nurses to join the doctors association: it doesn't make them doctors. Everyone in the debt management industry is welcome to apply for DEMSA membership, and anyone who passes the tests is welcomed. It is a high barrier to cross. But I see no point in simply making a bigger organisation."

The OFT is expected to publish its review later this year, while the MoJ is expected to outline its findings in March. But with a general election just round the corner, observers are sceptical about when the industry will experience the shake-up it urgently needs. CT

IVAs: The regulated option

While DMPs are preferred by many creditors, individual voluntary arrangements (IVAs) are monitored more closely under the IVA protocol and recorded by the Insolvency Service.

The IVA protocol, set up in February 2008, is a voluntary agreement that provides a standard framework for dealing with straightforward consumer IVAs and recommends that specific advice should be given to debtors by insolvency practitioners.

It had been hoped that the protocol would increase the streamlining and transparency of the process for the benefit of debtors and creditors alike.

But a recent review of the protocol by the Insolvency Service showed that an overwhelming 97 per cent of protocol compliant IVAs still have to be modified before creditors accept. It said 13 per cent of protocol compliant IVAs required 15 or more modifications. It is better than non-protocol compliant IVAs, 65 per cent of which required 15 or more modifications, but is still far from simple.

The majority of modifications regarded fee levels. At initial proposal the average projected rate of return to creditors was 35 pence in the pound, but this on average jumped to 41 pence in the pound after modifications. Smaller providers argue that they may be squeezed out of the market as it is no longer economically viable to provide IVAs due to current fee structures, which they say take no account of the amount of work in managing an IVA.

The review suggested that the protocol might include direction for creditors on what are suitable fee levels and recommends creditors could inform providers of their criteria in advance, so they would know whether a proposal was likely to be accepted.

Six per cent of protocol compliant IVAs also failed and 60 per cent of debtors said their IVA had failed because they were unable to maintain their contributions.

The Insolvency Service has recommended a further full-scale review of the protocol within the next two years to allow a complete evaluation of its effectiveness.

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Rewriting the rescue equation

2010 will be the year of innovation in the use of CVAs as a less damaging alternative to administration, says Richard Fleming, UK head of restructuring at KPMG

While company voluntary arrangements (CVAs) have existed as an insolvency tool for more than 20 years, the approval of retailer JJB Sports' CVA in April 2009 marked a turning point in how large companies in distress are restructured; showing that a large, public company could go through a CVA with minimal disruption to operations. Indeed its shares continued to trade throughout.

Since JJB, we have seen a string of high profile retailers go through the CVA process. According to the Insolvency Service, the number of CVAs remains relatively flat, but we are already seeing that the JJB CVA and other large companies such as Blacks and Focus DIY, which followed suit in 2009, have raised the profile of the process. Since JJB we have had an increasing flow of enquiries from companies in similar situations asking us to consider whether a CVA might be a suitable vehicle to alleviate their distress.

To date the largest group of creditors that has been affected by CVAs is the retail landlord community but the CVA of AIM-listed Discover Leisure, a caravan dealer, has shown that the CVA is not just a tool for finding a compromise between retailers and landlords.

Our own pipeline of activity shows that companies outside the retail sector and retailers themselves are exploring how the CVA might be used as a tool for compromising a range of creditor issues, which might otherwise tip them into administration.

Consensual process

A CVA can adopt many forms because it is, at the most basic level, an agreement between a company and its creditors.

The key characteristics of large corporate CVAs so far have been: a consensual process whereby all creditors are involved; existing rent levels being maintained with no renegotiation on assignment to protect investment values; and landlords of closed stores receiving around six months rent, as opposed to receiving nothing in the alternative of administration.

Other characteristics have included the existing company management retaining control, rather than an external team of administrators taking over operations, and the CVA being part of a comprehensive turnaround strategy. CVAs have also included the disposal of non-core businesses and lender negotiations.

Now that these precedents have been set, we are likely to see much more innovation in the use of CVAs. With the retail/landlord relationship tested, it will not be long before other industry sectors and creditors discuss how a CVA might work for them.

While CVAs have not been without their critics, we should not underestimate the serious and damaging consequences of administration and liquidation: the company can quickly lose its value, while job losses and store closures are often an unfortunate inevitability.

From a creditor's perspective, the amount of money that can be recovered from a company in administration or liquidation is always less than can be recovered from a company trading on through a CVA. Critics should not forget that the CVA has to offer a better return to creditors than administration.

Moratorium needed

With their more collaborative approach and less damaging effects, it is understandable that the government is seeking to encourage the use of CVAs. The historic CVA process offers no moratorium against creditor action, unlike an administration order, while it is being negotiated.

A disgruntled or predatory creditor can launch legal proceedings to the disadvantage of other creditors, and to the detriment of attempts to rescue the company, which goes some way to explaining why companies have been reluctant to follow the CVA route in the past.

With regime reform extending the moratorium to CVAs, this should ease the nerves of hesitant management teams.

While it is important that the correct balance is struck between companies and their creditors, we are supportive of the overall intention of increasing the use of CVAs. With the recession expected to have a long tail, an insolvency process that involves the wider creditor group in discussing the best way forward for a struggling business will often be a more constructive alternative to administration.

Counting the cost

Peter Sargent, president of insolvency trade body R3, says the OFT's market study into the cost of insolvency is an opportunity for corporate practitioners to prove their worth

Corporate insolvency is usually portrayed in the media as a money spinner for the big four accountancy firms to generate fees from businesses that have collapsed. Perhaps responding to increases in corporate insolvency during this recession, on 12 November 2009 the Office of Fair Trading (OFT) announced a market study into the costs of insolvency and many might think "about time too". Let's pause here, as this is not an investigation, it is a market study, which is looking not just at insolvency practitioner (IP) fees, but the costs of insolvency overall.

Understanding what insolvency practitioners do to earn their fees gets lost in the complex processes of administration, liquidation, company voluntary arrangements and pre-packs. IPs are left sorting through, and often running, a business that everyone else is running away from and can do so in numerous capacities. The OFT study and the attention it attracts should be seen as a chance for IPs to explain the important work they do.

High-profile examples

Given that the media mainly reports on big cases such as Woolworths, Zavvi and Lehman Brothers, it is not surprising that fees leveraged on massive realisations sound like too much money. But these fees must be seen in context. Looking at Zavvi as an example, the costs amounted to £4.3m, but the administrators were able to realise £105m. Therefore, the costs were four per cent of the amount realised. In this instance, two members of staff had to go to each of Zavvi's 144 stores on the day of administration. Woolworths had 800 stores and many complex property issues to overcome, so it is easy to see how costs add up.

However, more than 70 per cent of insolvency practitioners work within small to medium sized enterprises (SMEs), and their bread and butter is the UK's SME culture. You are unlikely to read about a local father and son business being turned around or going through the insolvency process.

Let us be clear what IPs actually do: they work within a set of highly regulated legal processes to decide if a company can be saved; decide which parts of a business can be saved; work out what assets remain; identify the order in which they are paid out; perhaps run the business themselves in administration; investigate the directors' conduct and generate reports for public scrutiny. This is highly sophisticated and complicated work, and they must comply with regulation, which necessitates cost. The value bought in terms of saving jobs where possible (according to the Centre for Economics and Business Research, this is some 910,000 per year) and bringing about high returns to creditors, is vital for the economy. Without an effective insolvency regime, creditors would not lend.

Creditors priority

Second, let's be clear about who actually pays the fees – the creditors. These creditors, typically banks and asset based lenders, are financially literate organisations and they know the value of what we are paid to do. By definition, in an insolvency situation there are not enough realisations to satisfy all creditor claims and what there is must be allocated in a strict order.

Third, there is literally a handful of countries in the world where the costs of administering an insolvent business estate are lower than in the UK but the amount returned to creditors is more. According to World Bank data, in the UK the costs of insolvency are six per cent of the estate – it is seven per cent in the US, France is nine per cent, Spain 15 per cent and Italy 22 per cent. Attention tends to be focused on the fees generated by the big four, and yet these are large, complex jobs which means the cost of the practitioner's work typically will be around six per cent of the assets realised. IPs should use this 'spotlight' on costs to demonstrate the value they bring when dealing with companies in serious financial difficulty.

This announcement by the OFT came the same day as insolvency minister Ian Lucas set out the government's response to the Insolvency Service consultation on encouraging company rescue. He said: "Despite the challenges faced by business in the current difficult economic conditions, the existing statutory framework for company rescue is performing well, and continues to compare well internationally."

Of course, R3 is making a submission to the OFT study, but as to the need for a complete overhaul, I would agree with the words of Ian Lucas. CT

Sebastian Kokelaar, barrister in real estate disputes at Mills & Reeve explains the boost to landlords in a recent court case on rent in administration

Salvaging the landlord position

In the current economic climate there will be few landlords who have not had to deal with the consequences of a tenant being placed in administration. One of their key concerns is invariably whether the administrators of the tenant are required to pay the rent.

In relation to arrears of rent which pre-date the administration the answer is negative. The landlord is in no better position than any other unsecured creditor and will have to claim for such arrears in any liquidation that may follow.

By contrast, administrators can be required to pay rent which falls due after the onset of administration in priority to other unsecured debts if the rent can be classed as an expense of the administration. Rule 2.67(1) of the Insolvency Rules 1986 lists the expenses which are accorded priority. They include "any necessary disbursements by the administrator in the course of the administration".

The salvage principle

In December the High Court held in the case of Goldacre (Offices) Limited v Nortel Networks Limited (in administration) that in order to determine whether or not rent should be treated as a necessary disbursement, regard should be had to the so-called salvage principle, which was developed in the context of liquidations and is also known as the liquidation expense principle. Applied to leases it means that rent falling due after the tenant has gone into liquidation is payable in priority to other unsecured claims if the liquidator makes use of or retains the property for the benefit of the liquidation.

Perhaps more importantly, however, the court declined to follow the view expressed by the Court of Appeal in another recent case called Innovate Logistics Limited (in administration) v Sunberry Properties Limited that administrators and the court have a discretion as to whether or not to treat rent as an expense of the administration, which is to be exercised by balancing the interests of the creditors as a whole against those of the landlord. Where the salvage principle applies, there is an obligation on the administrator to pay rent as an expense of the administration.

Landlord benefit

Obviously, the salvage principle will apply where the tenant continues to trade from the property whilst in administration. Even if the administrator is only using part of the property, as in the Goldacre case, the full rent will have to be paid as an expense of the administration. Nor will the administrator be able to insist on an apportionment of the rent if he decides to vacate the property part way through a quarter, unless the lease contains an apportionment clause. This is because the administrator can only retain the property for the benefit of the administration on the terms and conditions contained in the lease.

What about a situation in which the administrator allows the purchaser of the assets and business of the tenant to trade from the property, pending a formal assignment of the lease, or to allow the purchaser to satisfy outstanding contracts and collect the book debts?

This is particularly common in the context of pre-pack administrations in which the business of the tenant is sold immediately prior to it being placed in administration. In such a situation the tenant in administration will no longer be trading from the property, but there are nevertheless good grounds for saying that by allowing a third party into occupation as part of a deal to sell the business of the tenant, the administrator is adopting the lease for the benefit of the administration.

Finally, even if post-administration rent is to be treated as an expense of the administration, this does not necessarily mean that the landlord will be entitled to immediate payment as soon as the rent falls due. In the Goldacre case the court made it clear that, if there is doubt over whether the realisable assets of the tenant company will be sufficient to satisfy all the claims which have priority, the landlord may have to wait for his money. However, where the assets of the company are sufficient, there will usually be no justification for not paying the rent as it falls due in accordance with the terms of the lease. CT