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City of London Law Society Financial Law Committee response to the Insolvency Service's consultation on Reforms to the Regulation of insolvency practitioners

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. The CLLS Financial Law Committee, which is made up of solicitors who are experts in the field of banking and finance law, including secured lending, have prepared this is a submission, limited to question 26 of the consultation on the proposal to increase the "prescribed part" by an unspecified percentage/capped amount.

The Committee strongly opposes the proposal to increase the prescribed part, which they consider would **not** contribute to achieving better control of the fees of insolvency practitioners; and, more importantly,

1. Would have potentially severe and adverse consequences on the cost and availability of working capital loans to business, especially SMEs and increase the burdens on the proprietors of these businesses. It may also affect willingness to lend to UK incorporated borrowers on best terms and/or make it more difficult to attract inward investment through UK incorporated subsidiaries.

2. Potentially have serious adverse effects in relation to financial collateral requirements in wholesale markets and on the attractiveness of the UK as a location by such market activity.

3. Affect the legitimate expectations of current proprietors of floating changes in an expropriatory manner.

4. Generally create additional uncertainty about the UK regulatory regime for financial institutions, by making lending on the most commonly used form of security more risky.

This proposal having been put forward apparently without an appreciation of its significance in relation to the current economic situation and it's conflict with the established policy of HMG to promote bank lending, while ensuring that bank lending is carried out on a prudent basis, we urge that, in order to avoid market uncertainty, an early announcement is made either:

- that there will be no change to the prescribed part; or, at least,
- that any changes to the prescribed part will not affect pre-existing charges and that no changes will be made to the prescribed part that would have adverse effects on the availability or cost of borrowing for companies or which would adversely affect the operation of the financial markets. This seems to us the minimum essential to avoid adverse consequences arising from the review itself.

THE OFT STUDY

We note that this proposal does not arise from the OFT Study. We have no doubt that the OFT would have recognized that the proposal would have effects, not in the relatively small market for the services of insolvency practitioners, but in the much larger and much more economically significant markets for corporate lending, in which secured lending plays a key part, and in the operation of the financial markets, which are underpinned by the taking of security in the form of floating charges, so that any increase in the prescribed part increases risk, eg for system operators, and would result in increased collateral requirements for market participants. As other neighbouring jurisdictions generally do not have such requirements, it would have the potential to place UK borrowers at a disadvantage.

We do not consider that it was appropriate to put forward a proposal of such gravity as an adjunct to the this consultation in relation to the services of insolvency practitioners. In fact, this positioning may result in it being missed by parties who could be adversely affected by the proposal.

THE ECONOMIC IMPACT STUDY

We note that the proposed increase of the prescribed part by an undefined amount is dealt with briefly in the economic impact assessment and is assessed as having no cost:

"As the proposal involves a transfer of resources from the floating charge holder to the body of unsecured creditors, this would be a £0 net cost to business change." (para 1.116).

This assessment completely fails to see the economic effect of increasing the prescribed part is also to transfer additional risk of non-recovery of debt from unsecured creditors to those relying on floating charges and thus to affect the cost/benefit analysis for the lender or other party incurring financial risk on the security of a floating charge. This in turn affects the willingness of the charge taker to take risk and the charge holder will require one or more of the following:

- A higher rate of return, such as a higher interest rate: secured lending would normally be cheaper than riskier unsecured lending;
- A greater amount or value of collateral from the chargor to ensure that the exposure to the increased risk is mitigated: this would either tie up assets the chargor could use more profitably (or to raise additional finance for growth) or, if it does not have free assets to add to the collateral, limit the amount that can be borrowed;
- Other additional collateral, such as personal guarantees or charges over personal assets of a company owner or owners, this collateral being unaffected by the rules on the prescribed part. Business owners and their families, when asked for such collateral, have a difficult decision whether to risk core family assets (such as their home) or to keep borrowings down and miss opportunities for growth. Some would undoubtedly decide against giving such collateral and forego business expansion or possibly take their entrepreneurial talents elsewhere.

Reduced availability of finance

Failing one of the above, the amount that can be loaned will be reduced. It will be an absolute reduction where the lender cannot conclude that it would be prudent for it to lend on unsecured terms, including, according to the current law, exclusion from participation in the distribution of the prescribed part. This may also be the case, where additional collateral would have to come from outside the chargor company, and, as described in the preceding paragraph, the company owners are unwilling to take this risk.

Adverse effects in the financial markets

In relation to financial markets, the effect of case law is that charges over changing pools of assets will usually be, or be at risk of being characterised, as floating charges. These do not normally relate to all the assets of the chargor, but nevertheless are subject to the prescribed part rules. These charges, taken as security for the liquidity and credit arrangements that support clearing and/or settlement through UK financial market infrastructure, (including recognized clearing houses such as Crest), are an essential underpinning to the operation of the markets. The effect of an increase in the prescribed part would be to increase the risk that the charged assets would be inadequate to meet the obligations of a failed market participant with the consequent risks to market stability. To avoid that consequence, greater collateral requirements would be placed on UK chargors, or, where additional collateral could not be provided, their activities in the market would have to be reduced. Another alternative would be that they would move their main operations from the UK to some other market where the prescribed part was not applicable and collateral requirements were lower.

Serious financial consequences

None of these consequences could be regarded as having a value of £0! Indeed it seems likely that their cost in relation to markets of many £bn, would far outweigh the benefits of the containment of the fees of insolvency practitioners under the other proposals dealt with in the consultation document, while contributing little or nothing to that containment.

Effect on Containment of Insolvency Practioners Fees

We believe that an increase in the prescribed part would be likely to have no beneficial effect on the containment of insolvency practitioner fees.

In the cases where there is a floating charge over substantially all the assets of the company, the floating charge holder will usually have been instrumental in the appointment of the administrator and will be well motivated to exercise control over his or her fees. If the value of the assets exceeds the amount secured by the floating charge by a significant amount, then unsecured creditors will share that motivation and larger creditors are likely to be active through the Creditor's Committee in any event; if there is only the prescribed part or little more for unsecured creditors, they are likely to show no interest and rely on the controls of the secured creditor to achieve the best outcome in relation to the prescribed part.

A minor increase in the prescribed part (percentages and/or caps) would not change that position.

It could only possibly make a difference if the amount of the prescribed part were increased to a figure which was a significant part of the total net property – and even then only where the amount of the net property is itself a large enough value to make it worthwhile for larger unsecured creditors to take an interest where they would not have otherwise (and in the cases where net assets significantly exceed the amount secured by the floating charge they have that incentive anyway). However, the secured creditor would be, if anything, less incentivised to contain fees in all cases, not just those (which would be relatively limited in number) where the circumstances gave unsecured creditors an incentive they did not previously have.

For floating charges, such as those in the financial markets, which do not cover all the assets of a company, the removal of access to substantial parts of the security, would mean that there was a move to other types of collateral taking (possibly in another jurisdiction, so as to avoid any recharacterisation risk) to avoid the impact of the floating charge and that would remove a powerful secured creditor with an incentive to control the insolvency practitioners' fees from the picture altogether and probably lead to a worse position than currently.

While we conclude that increasing the prescribed part would not assist in containment of insolvency practitioners fees and therefore falls outside of the remit of the proposed changes, the proposal has such adverse other consequences, that we consider it should be explicitly abandoned. If continued in any form at all, it should be in a separate consultation where the policy considerations outlined below can be properly taken into account and appropriate assurances given to the markets, so as to avoid damage.

Policy considerations

History of the Prescribed Part

The prescribed part was introduced in 2002 at the time when the Government agreed to give up Crown preference. Before that time the Crown had been entitled to tax and various other claims ahead of both floating charge and unsecured creditors. In extreme cases this resulted in the Crown obtaining all the realisations of an insolvency and the impact was highly variable and capricious in individual cases, not allowing for effective risk assessment by unsecured and floating charge holder creditors. In giving up Crown preference, the aim of Government was to leave the position of floating charge holders on average neutral (though the standard formula for the prescribed part removed the possibility of extreme results) and to pass the average benefit through to unsecured creditors.

In order to avoid any expropriatory effects, the new law was only applied prospectively.

This is all clearly recorded in Parliamentary records on the passage of the Enterprise Act 2002 and, at the time, it was made clear that the working of the prescribed part would be reviewed only to ensure that it was at the right level to ensure that the value of Crown preference passed to the unsecured creditors: see letter of 10th February 2003 from Victoria Prime of the Insolvency Service to Geoffrey Yeowart (Deputy Chairman of the CLLS Financial Law Committee) attached.

It was also the intention of Government that the floating charge holder would be itself entitled to share in the ring-fenced fund in respect of its shortfall: see attached note of meeting with DTI on 4th November 2002. However, as noted in the Consultation Paper, the Courts, notably in *re Airbase (UK) Limited [2008] EWHC 124*, have decided that the language of the legislation, excludes the floating charge holder from sharing in the prescribed part. This means that floating charge holders are in effect deferred creditors to that extent.

Changing the Prescribed Part

It would be possible to now carry out the review, according to the Consultation Paper, not ever carried out, to determine whether the prescribed part in practice delivers overall to unsecured creditors the value of the Crown preference. Any changes to match the prescribed part better to Crown preference foregone (whether an increase or a decrease) would be justified by the terms of the legislation and the surrounding assurances given to stakeholders.

However, an increase for any other purpose would not be in accord with either the purpose of the legislation or the assurances given at the time.

Policy Considerations

Apart from the statement that the Government believes that increasing the prescribed part is an "interesting idea", there is no indication of any policy reason for doing so. Unless a clear policy can be articulated that there is a respectable case that would bring some wider benefits to the economy, we suggest that now is not the time to create uncertainty about the risks of lending to UK corporates on the basis of a floating charge.

The economy is in a fragile state and bank lenders have been both castigated for imprudent lending and urged to increase lending to corporate borrowers. As increasing the prescribed part increases risk for lenders, to have uncertain proposals to take this step runs counter to Government policy to encourage lending to corporates (especially SMEs), while uncertainty as to the extent and impact of any increase makes prudent planning for that risk impossible.

Need not to affect existing charges

The effect of an increase (save to reflect Crown preference foregone more accurately) would be expropriatory of the rights which holders of existing floating charges would legitimately expect, removing their priority and reducing them to a deferred status to the extent of the increase. Without financial compensation this would be illegal.

Therefore, if there is to be any question of additional changes increasing the prescribed part, it is essential that the Government clarifies that existing floating charges will not be affected. This is also consistent with the approach adopted by the Government when introducing curbs on the rights of existing floating charge holders under the Enterprise Act 2002 (the chief of these was the restriction on appointing an administrative receiver).

Impact Assessment for New Lending to SMEs and larger corporates

In deciding whether there is any policy reason to consider any other change to the prescribed part, the effects would need to be considered in relation to their impact on the availability and cost of finance for businesses borrowing on the security of floating charges. One common type of borrower is an SME borrowing working capital from their principal lender. Another, though less common in modern conditions, is a larger business issuing quoted debentures secured with a floating charge.

In each case, the terms of lending may be more onerous, or the amount that can be borrowed curtailed, having regard to the increased risk for the floating charge holder that its security will prove to be inadequate, not because of a shortfall of charged assets, but because the charge holder has been prohibited from utilising a substantial proportion of those assets on an insolvency in order to obtain repayment. In the case of SMEs the prospect that lenders will require additional security from outside the borrowing company and its subsidiaries will be increased, with consequent increased risk or dampening of entrepreneurship for the proprietors of these businesses and their families (with resulting implications on job creation).

It would be appropriate in that context, if any significant change were considered justified, also to review whether case law should be reversed and the charge-holder entitled to share in the prescribed part, so as to reduce the impact of deferment.

Impact Assessment for Floating Charges in support of Financial Market Operations

Floating charges and charges expressed to be fixed (but at risk of recharacterisation as floating) are commonly taken as security for the liquidity and credit arrangements that support clearing and/or settlement through UK financial market infrastructure, (including recognized clearing houses such as Crest). These charges, are an essential underpinning to the operation of the financial markets. Charges will be taken over defined but changing asset pools, typically securities or a bank account with a minimum balance requirement). As a result of case law, most recently *Gray & Ors v G-T-P Group Limited Re F2G Realisations Ltd (in Liquidation) [2010] EWHC 1772 (Ch)* but building on the House of Lords decision in *National Westminster Bank plc v Spectrum Plus Limited [2005] UKHL 41,* it is impracticable in many (probably most) cases to achieve a charge which will be recognised as fixed and these charges have to be treated as floating charges. They are also unlikely to benefit from the UK implementation of the Financial Collateral Directive in its present form and therefore, although used for precisely the purposes which are recognised as requiring immediate and full enforcement rights in the event of failure of the chargor/collateral giver, suffer from all the disabilities and restrictions that apply to floating charges of the type described above, including the application of the prescribed part.

While Regulation 14(5) and (6) of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (as amended) will protect "collateral security charges" (which may be floating charges) which support central bank operations and charges given in connection with the operation of systemically important "designated systems", these would also be affected by the proposals as section 176A of the Insolvency Act 1986 (as amended) is not itself disapplied in relation to such charges.

Any increase in the prescribed part would increase the problems described above and result in charge holders requiring substantial over-collateralisation from UK borrowers and/or reconsidering whether the UK markets offer the security arrangements required for the operation of these markets. In the highly competitive world in which we operate and with the example of delays and difficulties occasioned in relation to the Lehman Bros insolvency before us, there is no case for creating such uncertainty in relation to these charges. These markets are huge contributors to the EU and UK economies and have an annual value of many billions of pounds.

The need for change to effectively include such charges in the protection intended to be afforded them by the Financial Collateral Directive (as we have repeatedly urged on the Treasury) and to remove them from the scope of prescribed part rules altogether is made all the more urgent by the uncertainty surrounding the prescribed part which the current consultation has produced.

Concluding Note

The Committee finds it shocking that this proposal has emerged for consultation in a paper directed of insolvency practitioners, without any assessment or consideration of its impact on much larger and fragile markets of great importance to the economy.

THE CITY OF LONDON LAW SOCIETY
FINANCIAL LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

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