

Title: A review of the corporate insolvency framework IA No: BISINSS15005 Lead department or agency: Insolvency Service (Exec Agency of BIS) Other departments or agencies:	Impact Assessment (IA)
	Date: 01/03/16
	Stage: Consultation
	Source of intervention: Domestic
	Type of measure: Primary legislation
	Contact for enquiries: David Miller 0207 637 6445 Nicholas Blaney 0207 291 6879
Summary: Intervention and Options	RPC Opinion: Fit for purpose

Cost of Preferred (or more likely) Option			
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2014 prices)	In scope of One-In, Measure qualifies as One-Out?
£66.44m	£36.14m	£-4.1m	Yes OUT
What is the problem under consideration? Why is government intervention necessary? Corporate insolvency has a significant financial impact on creditors and the debtor involved. The effects of insolvency often go beyond the immediate supply chain, the trade association representing the insolvency industry R3, estimate 1 in 6 corporate insolvencies are the result of knock on effects from other insolvencies. Government intervention is necessary to mitigate this network externality from business failures and reduce the impacts on employment and productivity. The intention is to enable more corporate rescues of viable businesses when they are in insolvency, achieving greater returns to creditors.			

What are the policy objectives and the intended effects? There are several policy objectives: Firstly, to ensure that the insolvency framework supports business rescue where possible, maximising returns to creditors where possible. A moratorium will provide businesses with an opportunity to identify new finance or to develop a rescue plan. Secondly, to encourage and facilitate rescue through introducing a new restructuring plan option. The existing rescue option, the Company Voluntary Arrangements, is considered to be underused, is limited in its functioning as it does not bind secured creditors, and when used often does not succeed. The proposals seek to address the perceived weaknesses of the regime by introducing the option of proposing a new restructuring plan which would include secured creditors and enable a fair and equitable plan to be sanctioned by a court even where some creditors do not approve the plan, making the process of proposing and implementing a resolution plan quicker and cheaper. Finally, to ensure that any changes provide for cost effective alternative for SMEs and that conditions are in place to enable rescue finance to be raised for viable businesses.

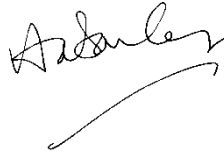
What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base) Do nothing: The UKs corporate insolvency framework will continue to provide a range of rescue and liquidation options, but will increasingly lose pace relative to other leading regimes ranked highly by the World Bank Doing Business Rankings for speed of resolution of corporate insolvencies and the amount of monies returned to creditors. This will impact on the attractiveness of the UK business environment: Option 1: Contains a number of proposals, the consultation is seeking views on which, if any, should be implemented: <ul style="list-style-type: none"> • Introducing a new moratorium, alongside that which is currently only available to small companies considering a Company Voluntary Arrangement, to cover all sizes of companies in financial difficulty requiring some kind of rescue or restructuring to survive. The moratorium will last for at least 3 months. • Widening the definition of an essential supplier prevented from altering or terminating a supply, subject to safeguards, during the moratorium and any subsequent formal insolvency procedure. • Introducing a new restructuring plan which would bind secured creditors and which could be imposed ('cramped down') onto creditors subject to meeting a fair and equitable test • Reforming legislation to encourage greater use of rescue finance. A non regulatory option is not a feasible option to achieve the policy objectives as all the insolvency procedures require amendments to regulation to improve outcomes.

Will the policy be reviewed? Yes	If applicable, set review date: 04/17
Does implementation go beyond minimum EU requirements?	N/A

Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	Micro Yes	< 20 Yes	Small Yes	Medium Yes	Large Yes
What is the CO₂ equivalent change in greenhouse gas emissions? (Million tonnes CO₂ equivalent)			Traded: N/A	Non-traded: N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

**Signed by the responsible
SELECT SIGNATORY:**

.....  **Date:** 24/05/2016

Summary: Analysis & Evidence

Description: A review of the corporate insolvency framework

FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2015	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: - 414.35	High: 542.66	Best Estimate: 66.14

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.5	2.6	23.0
High	1.1	51.7	445.9
Best Estimate	0.8	27.1	234.1

Description and scale of key monetised costs by 'main affected groups'

Familiarisation costs to the insolvency industry and creditors of between £0.55 and £1.15m.
 Cost of preparing reports, monitoring compliance and receiving agreement from the court for a moratorium – ongoing cost of between £2.4 and £45m.
 Cost of suppliers raising a dispute in court after being designated an essential supplier – ongoing cost of £0.7m
 Cost of suppliers purchasing additional insurance to cover insolvency risk and having to maintain supply – ongoing cost between £0.1m and £5.4m.

Other key non-monetised costs by 'main affected groups'

There are no other non monetised costs associated with these proposals.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	4.1	35.3
High	0	65.7	565.7
Best Estimate	0	34.9	300.5

Description and scale of key monetised benefits by 'main affected groups'

A moratorium on debt collection for viable businesses in distress should enable businesses to restructure more easily and deliver improved business rescue outcomes, it is estimated that this will deliver benefit to creditors of between £2m and £60m, with a best estimate of £31m per year.
 Introducing a restructuring plan, widening the definition of essential services and improving access to rescue finance should enable improvements to outcomes from existing CVAs around £0.3m, new CVAs of £2.6m and better outcomes from administration of £0.9m
 Analysis of data from Companies House estimates that around 90 percent of these benefits accrue to business.

Other key non-monetised benefits by 'main affected groups'

Increasing the likelihood of business rescue will help maintain employment, skills and productivity. Preventing failure of otherwise viable businesses will also retain valuable business know how.

Key assumptions/sensitivities/risks

A relatively low number of cases have been assumed to make use of the new procedures. If more cases use them then the costs and benefits will change.
 The proposed regulations make a number of changes to the financing and supplier relationships between distressed businesses and creditors. This may result in some businesses being riskier to supply or finance, evidence on the extent of this problem will be gathered in the consultation.

Discount rate (%)

3.5

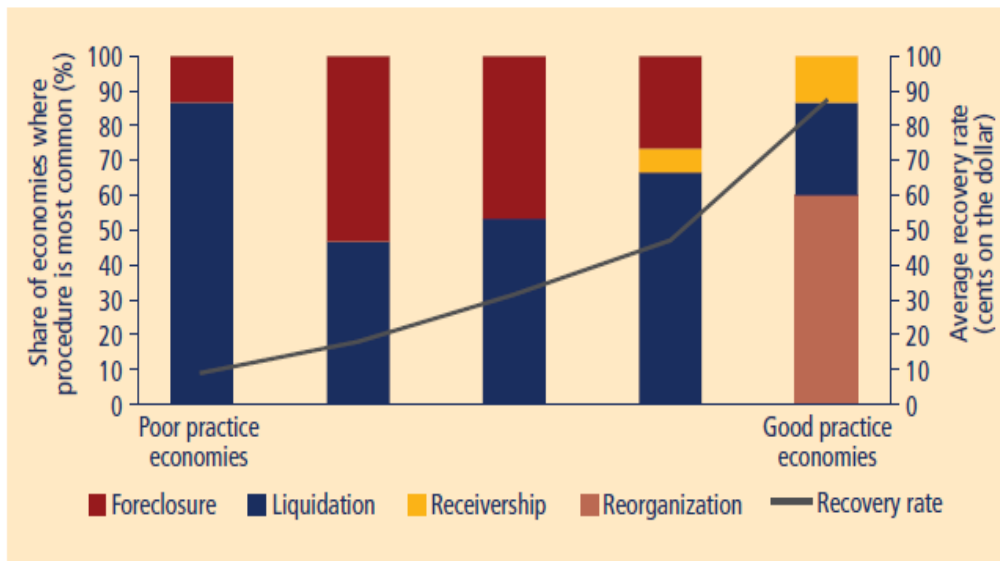
BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 26.8	Benefits: 30.9	Net: 4.13	Yes	OUT

Background and problem under consideration

- 1.1 The Government is committed to ensuring that the insolvency regime is able to rescue viable but distressed businesses and so minimise the need for liquidation. A recent survey from the Association of Business Recovery Professionals (R3) found that 1 in 6 corporate failures were the result of the knock on effects from other corporate failures. Achieving better rescue outcomes that maximise returns to creditors will reduce the impact of business failure on other businesses.
- 1.2 A successful business rescue regime can be expected to lead to improved returns to creditors by preserving value that may otherwise be lost for example through the inability to maintain the business as a going concern. Instead the business can be broken up losing value, know how and jobs. A good rescue regime can lead to enhanced job/skill preservation, improved competitiveness and productivity, and ultimately greater economic growth.
- 1.3 According to the World Bank, the highest recovery rates for creditors are recorded in economies where restructuring is the most common insolvency proceeding¹. For instance, 45 percent of OECD economies use reorganization as the most common insolvency proceeding to save viable firms and have an average recovery rate of 83 cents on the dollar, as opposed to 57 cents on the dollar with liquidation².

Figure 1: Higher recovery rates are more likely in economies where reorganisation is the most common insolvency proceeding



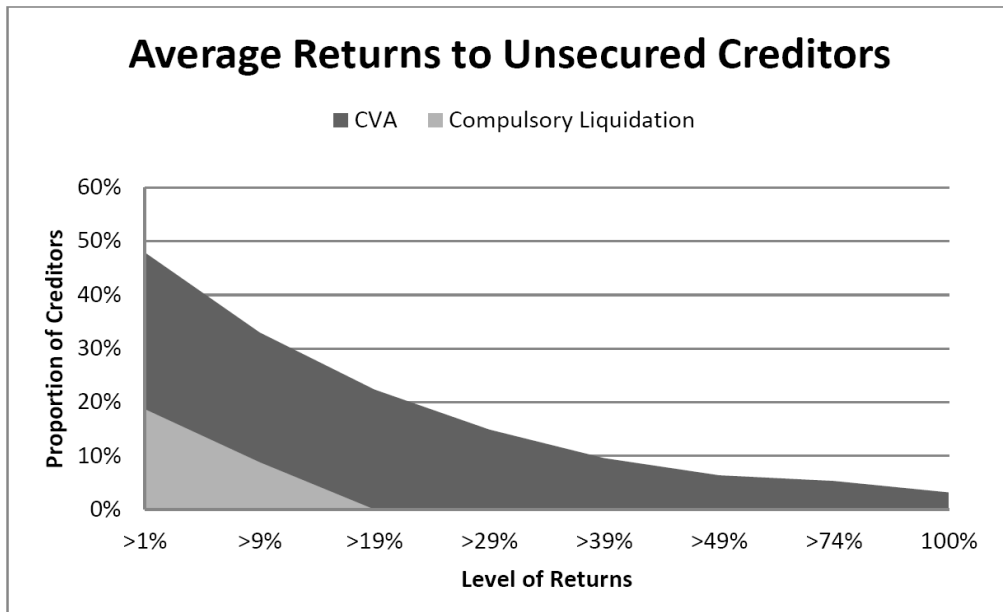
Source: Doing Business 2014 report. Resolving Insolvency, p. 115

¹http://www.doingbusiness.org/reports/globalreports/~/_/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB14-Chapters/DB14-Resolving-insolvency.pdf

² Doing business, smart lessons – real experiences, real development, 2013
<https://openknowledge.worldbank.org/bitstream/handle/10986/17042/752400BRI0SMAR0urable0ResuIts0FIXED.pdf?sequence=1>

- 1.4 The rescue of a company should preserve the value of its technical know-how and business goodwill whereas liquidation is limited to the value of the company's physical assets³. For example, the announcement of a corporate insolvency is associated with a loss in shareholder value of up to 56%. In contrast, following the announcement of a restructuring or workout, firm value appreciates by up to 11%.⁴ The graph below shows the superiority of returns from a CVA over liquidation returns⁵. Where such rescue procedures do not exist or are inefficient, those assets are lost.

Figure 2: The average returns to unsecured creditors from CVA and compulsory liquidations



Source: The law and economics of orderly and effective insolvency, Keith Crawford, doctoral thesis, 2012

³ A Second Chance for Entrepreneurs, Prevention of Bankruptcy, Simplification of Bankruptcy Procedures and Support for a Fresh Start', Final Report of the Expert Group (January 2011), DG Enterprise and Industry, p. 7, available at http://ec.europa.eu/enterprise/policies/sme/businessenvironment/files/second_chance_final_report_en.pdf

⁴ Out-of-court restructuring versus formal Bankruptcy in a Non-Interventionist Bankruptcy setting, Jostarndt, Sautner, 2009, p.664

⁵ The law and economics of orderly and effective insolvency, Keith Crawford, doctoral thesis, 2012 http://etheses.nottingham.ac.uk/3372/1/Keith_Crawford_Doctoral_Thesis_Submitted_Final_Draft.pdf

- 1.5 A successful business rescue is dependent upon a number of factors irrespective of the underlying viability of the business. The literature⁶ argues a successful business rescue is dependent upon the efficiency of the insolvency process. Systems that enable businesses to continue to operate as normal while restructuring tend to lead to better outcomes for creditors, owners and employees.
- 1.6 The Government's Manifesto⁷ contained a commitment to make the UK the best place to do business in Europe and among the top 5 places to do business in the world by 2020, according to the World Bank's Doing Business rankings. Resolving insolvency is one of the measures that contribute to the UK's overall ranking. In the most recent report the UK was ranked 13 in the world for 'resolving insolvency' and to improve on this there are a number of reforms that could be made to the UK insolvency framework. This impact assessment outlines the possible policy changes that could be made to improve business rescue options in the UK and contribute to the cross government pledge to improve the UK position in the Doing Business rankings.
- 1.7 Furthermore, there is also an increased interest at a European level in promoting business recovery, and ensuring that there are the appropriate tools in place to achieve this.
- 1.8 Domestically, there have not been any significant changes made to the corporate landscape since the Enterprise Act 2002. In the aftermath of the global financial crisis, and recent large corporate failures⁸, this is an ideal time to explore options that would improve the UK's existing corporate insolvency framework, to see whether it still delivers for business.
- 1.9 The World Bank recently revised the Principles of Effective Insolvency and Creditor/Debtor rights systems⁹. The research brings together the international best practice in company rescue proceedings. Many of these already exist within the UK insolvency system and this is reflected in the UK's high standing in the World Bank resolving insolvency ranking. However based on these principles there are a number of changes that could be made to improve the outcomes for UK businesses in distress which this consultation aims to address.
- 1.10 The intention is to enable more corporate rescues of viable businesses when they are in insolvency, and ensure that the existing framework delivers the best outcomes, whilst ensuring the correct balance is maintained between the rights and responsibilities of debtors and creditors.
- 1.11 This IA will describe several proposed reforms to the UK Insolvency Framework many of which will focus on providing improved outcomes for business rescue beyond what could be achieved from existing insolvency business rescue procedures, Company Voluntary Arrangements (CVA) and Administration.

⁶ Djankov, Hart, McLiesh and Schleifer (2008) Debt Enforcement Round the World, Journal of Political Economy, vol 116, no 6.

⁷ <https://www.conservatives.com/manifesto>

⁸ Corporate failures such as Comet and Nortel raised issues over the outcomes from insolvency. <http://news.bbc.co.uk/1/hi/business/7830970.stm>, <http://www.bbc.co.uk/news/business-20164228>.

⁹ World Bank (2015) Principles for Effective Insolvency and Creditor/Debtor Rights Systems - [http://siteresources.worldbank.org/EXTGILD/Resources/5807554-1357753926066/2015_Revised_ICR_Principles\(3\).pdf](http://siteresources.worldbank.org/EXTGILD/Resources/5807554-1357753926066/2015_Revised_ICR_Principles(3).pdf)

- 1.12 A **company voluntary arrangement** is a procedure whereby a plan of reorganisation or composition in satisfaction of its debts is put forward to the company's creditors and shareholders who vote whether or not to approve it. This is a 'debtor in possession' process where the company's management continues to run the day to day business. There is limited involvement by the court and the arrangement, once approved, is supervised by a licensed insolvency practitioner.
- 1.13 **Administration** is a process which places a company under the control of a licensed insolvency practitioner and the protection of the court to achieve a specified statutory purpose. The purpose of administration is to save the company, or if that is not possible, to achieve a better result for creditors than in a liquidation, or if neither of those is possible, to realise property to enable funds to be distributed to secured or preferential creditors. In an administration, the directors are effectively replaced by the insolvency practitioner, who will take control over the running of the business.
- 1.14 The UK lacks the established rescue finance market evident in some other jurisdictions, most notably the United States. The current framework does not prohibit rescue finance but there are limited options for creating the conditions which might attract new funding to companies in financial distress. The proposals therefore seek to create such conditions.

Policy Objective

- 1.15 There are four policy objectives of the review. Firstly, to ensure that the insolvency framework promotes recovery where possible. The options under consideration are designed to remove uncertainty and encourage business rescue as default, thereby helping to ensure the best outcome can be achieved resulting in better returns for creditors. This can be through providing a moratorium allowing a business to consider its best option for recovery, or to seek rescue finance.
- 1.16 Secondly, to encourage more debtor in possession rescue through the introduction of a new restructuring plan. Presently, as a rescue tool, CVAs are underused, provide limited scope for proposing a rescue plan and when they are used most do not achieve a successful outcome. The consultation will seek to understand fully the reasons behind this. The proposals are trying to address the perceived weaknesses of the existing regime by providing the option to propose a restructuring plan which incorporates secured creditors into the framework, and which can be imposed, subject to meeting a fair and equitable test, onto classes of creditors who do not approve the plan.
- 1.17 Thirdly, to ensure that any changes provide for cost-effective rescue options for SMEs. Whilst there is an existing moratorium for small companies in CVAs, it is underused¹⁰ and it is well known that SMEs find it very difficult to access finance¹¹ and these difficulties would be exacerbated when trying to seek rescue finance.

¹⁰ An internal analysis of records held at Companies House showed less than 10 per cent of small companies used the moratorium.

¹¹ A recent SME survey found thirty-nine per cent of those that applied for finance had some level of difficulty in getting the money they wanted from the first source they approached, including 30 per cent which were wholly refused.

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/414963/bis-15-151-small-business-survey-2014-sme-employers_v1.pdf

- 1.18 The fourth policy objective is to create the conditions for encouraging rescue finance. A company suffering financial distress but which has a viable underlying business may therefore be able to avoid formal insolvency through the injection of new funding, enabling it to continue as a going concern and pay its creditors.

Economic Rationale for Intervention

- 1.19 Corporate insolvency has a significant financial impact on creditors and the debtor involved. The impacts are likely to be felt beyond the immediate parties involved and can spill over to other parts of a business supply chain from delayed payments and/or defaults by other businesses. R3 have estimated 1 in 6 corporate failures are the result of knock on effects from other corporate failures. This form of **negative externality** can be mitigated by the market to some degree via insolvency insurance protection.
- 1.20 Two of the biggest issues in business rescue where government intervention may improve the overall outcome are transaction costs and coordination problems.
- 1.21 **Coordination problems including rent seeking**¹² - the ability of a minority of creditors to destabilise a negotiation process in the hope of extracting some commercial advantage (even where this is a worse outcome for creditors as a whole) for example by forcing early recovery of their debt, or by delaying response to compromise offers in the hope that others will compromise instead. The second potential difficulty is where smaller creditors, having less financial interest in the outcome, may stall negotiations as there is little incentive to participate. Creditors will act individually and be unaware of the broader impact that their actions will have on businesses, causing business rescue to become more difficult and therefore worsening the position for creditors as a whole.
- 1.22 **Transaction costs** - delays and difficulties in initiating and concluding negotiations (particularly in complex multi-creditor scenarios) can increase the costs associated with restructuring a business. Administrative costs, opportunity costs and the costs of any professionals employed to assist with restructurings all increase over time and contribute to the erosion of business value. Reducing these transaction costs will reduce the cost of restructuring business.
- 1.23 Government intervention in insolvency proceedings can minimise these effects by removing barriers, streamlining processes and regulating structures that promote successful business rescue and reduce liquidations of other wise viable businesses.

Description of Options Considered and Dismissed (including do nothing option)

Do nothing

¹² seeking to extract value through manipulation as opposed to seeking to add value through economic transactions

- 1.24 The UKs corporate insolvency framework will continue to compare favourably with those of other countries, and will continue to be ranked highly by the World Bank Doing Business Rankings¹³ for speed of resolution of corporate insolvencies and the amount of monies returned to creditors in the short term. However the UK would likely lose ground over time as others reform and modernise towards best practice models.
- 1.25 In addition the UK would fail to improve upon the framework and would not realise the benefits of more successful business rescues with higher returns to creditors.

Options under consideration

- 1.26 A number of options are being consulted on that could improve the framework. The four proposals being considered can be applied piecemeal individually or collectively.

- a) **Introducing a new moratorium** that currently only applies to SMEs considering entering into a CVA to cover all businesses in difficulty. The main purpose of the moratorium will be to provide a protected grace period for companies in which a restructuring agreement can be negotiated with creditors. When a company enters the moratorium, the arrears owed to creditors will be frozen, but the business will be obliged to meet ongoing trading costs and debt obligations during the moratorium. This will provide businesses with a 'breathing space' that will allow them to consider the best option for the business. The key proposal being that the moratorium will last for three months, with the possibility of an extension.

The intention is that the moratorium will be a breathing space in which the directors will seek to find the best solution for the distressed business. This may mean a consensual agreement with creditors or a formal insolvency procedure such as a CVA, administration, scheme of arrangement or restructuring plan.

In order to be eligible for a restructuring moratorium the company must satisfy the court that it is already or imminently will be in financial difficulty, but is not yet insolvent.

- b) The Government is proposing to introduce a **statutory, multi-class restructuring procedure to aid company rescue. This will include the use of a cram-down mechanism, which would give companies the ability to bind secured creditors into a restructuring plan**, on the basis that dissenting creditors will not receive less than they would in a liquidation. By introducing a new mechanism for developing restructuring plans, the Government wants to address the scenario where a relatively junior secured creditor can block a company rescue, despite the proposals being supported by more than 75% of senior secured creditors.

To prevent abuse of the cram down mechanism, the new procedure will have in place a number of safeguards for creditors to make sure that their rights and interests are duly considered at all stages of the process.

- c) **Provide a formal structure and process for rescue finance.** Currently, rescue financing is permitted as a cost of the administration and can be agreed by creditors in a CVA, but the Government is proposing to enhance the current provisions to promote greater availability of such finance.

¹³ <http://www.doingbusiness.org/rankings>

The government proposes that rescue finance, where required to effect the rehabilitation of the company, should be registered as a cost and should rank in front of all other categories of administration expenses, including the administrator's own fees. This would require an amendment to the current legislative provisions regarding expenses.

This will give debtor companies, either through the existing management or through an administrator, the ability to override negative pledge clauses¹⁴ in existing security arrangements over company property and grant new security in priority to existing security, and may therefore encourage new lenders to advance rescue finance. This will likely only occur where there is sufficient equity in that property to discharge the indebtedness owed to both the existing and the new lender.

This should encourage additional finance to be made available to distressed businesses, increasing the chances of successful rehabilitation and ultimately benefit all creditors.

- d) When a business enters an insolvency procedure, it can trigger the use of a termination clause by a supplier, which can severely impede any chance of business rescue, even if their invoices are being paid on time and in full. With the power to withdraw supplies, suppliers are also able to negotiate higher payments from the distressed business. These actions can put greater pressure on the finances of an insolvent business at a critical time, damaging the chances of survival by diverting funds that could otherwise be used to facilitate a rescue. On 1st October 2015, an amendment to the Insolvency Act 1986 commenced, which ensures continuity of essential supply of utilities and IT goods or services to insolvent businesses. This proposal is to **widen the definition of what constitutes an essential contract** to make it easier for businesses to maintain contracts that are essential for the continuation of the business. This would make it less likely for businesses, particularly SMEs, to be held 'hostage' by key suppliers.

A nominated individual will be able to apply to the court to prevent nominated essential suppliers from using termination clauses at the point of insolvency.

- 1.27 Option a), b), c) and d) will impact on all distressed companies where there is a possibility of rescue and could potentially enter any form of business rescue insolvency.
- 1.28 Other changes include providing creditors with a generic 'right' to request information from the office holder.
- 1.29 To achieve the required policy objectives a non regulatory option is not feasible in this instance. To provide confidence to business and investors insolvency procedures are highly prescriptive. Introducing guidance material alone would not enable nominees or insolvency practitioners to improve business outcomes as almost all insolvency processes are regulatory and require legislation to change them.

Cost and benefits of proposed options

¹⁴ A negative pledge clause is a provision in a loan agreement preventing a debtor from creating new security or otherwise encumbering charged assets without the prior consent of the lender

Familiarisation costs

- 1.30 Insolvency practitioners will have to spend some time familiarising themselves with the changes to ensure they can carry out their duties in accordance with the law. Some of the changes are relatively minor and will involve relatively little familiarisation time while others will require more formal time and training.
- 1.31 The trade body R3 runs regular training sessions for IPs and it is likely that these changes would be incorporated in to those programs. The costs of these programs vary according to the type of membership, venue and subject but a half day course typically costs around £180 and a full day course around £400. As we are unaware at this stage of the degree of training that will be required we will use these two estimates as upper and lower boundaries.
- 1.32 **As of 1 January 2015 there were 1,359 appointment taking IPs; we assume that each of these will complete the training course to learn about the new requirements. This gives a range for the cost of familiarisation of £0.24m to £0.54m with a best estimate of £0.39m.**
- 1.33 In addition to Insolvency Practitioners it is proposed that other professionals specialising in helping distressed businesses would be able to act as the nominee for a moratorium. At this stage of the policy development it is difficult to estimate the number of nominees that will need to familiarise with the changes so initially we assume a **similar level of costs to those of insolvency practitioners, and additional evidence will be sought during the consultation.**

Secured creditors familiarisation

- 1.34 Lenders who provide secured finance to business will need to familiarise themselves with the changes. The proposals will enable a part of their security to be superseded, enabling the rescue finance to receive a return on investment ahead of other secured lenders. It is difficult to estimate with any certainty the number of businesses involved in secured lending to business but the 2015 Business Population statistics¹⁵ estimates that around 465 employers were involved in monetary intermediation and this is our best available estimate of the number of businesses impacted. Each of these businesses is likely to have a regulatory compliance manager who will be required to understand the changes in law. Using the Annual Survey of Hours and Earnings we estimate the average total hourly labour cost for these employees to be £31.¹⁶
- 1.35 As many parts of the changes are largely clarifications of existing law we assume that the maximum effort required for familiarisation will be around half a day's work, meaning a total familiarisation cost of £0.058m.

Restructuring Moratorium

¹⁵ Table 7 UK groups - Monetary intermediation <https://www.gov.uk/government/statistics/business-population-estimates-2015>

¹⁶ 2015 Annual Survey of Hours and Earnings, Table 2.5a mean hourly rate for corporate managers and directors - £26.10, this estimate was increased by 19.8% to account for non wage labour costs using Eurostat estimates available here. http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Labour_costs_per_hour_in_EUR,_2004-2014_whole_economy_excluding_agriculture_and_public_administration.png

- 1.36 Consultations conducted in 2009 and 2010 proposed similar changes to enable creditors to reach an agreement on business restructuring to be reached. The 2010 consultation¹⁷ is the most recent source of evidence on the costs and benefits of the proposed changes. Evidence provided by respondents identified 4 areas of monetised costs and benefits from the changes that would be similar to the moratorium proposed.
- 1.37 Broadly the 4 areas were:
- Benefits of enabling the restructuring of distressed business to be completed at a lower cost and in a faster time
 - Costs associated with preparing a report on eligibility for a breathing space by a nominated person
 - Costs of monitoring compliance with the terms of the breathing space for the period it is in force
 - Costs of preparing legal material to authorise the breathing space
- 1.38 Creating a breathing space to enable negotiation and implementation of a restructuring plan should enable directors and insolvency practitioners to find a solution more efficiently. This will particularly benefit large businesses with complex financing structures that are likely to have significant costs from restructuring and refinancing. Stakeholder evidence provided for the 2010 consultation estimated that the costs of restructuring varied significantly based on the size and complexity of the business but costs of between £2m and £15m were not uncommon responses.
- 1.39 The degree of cost saving that the breathing space could provide is difficult to estimate but benefits in the order of 10 – 20 per cent of costs were consulted on in 2010 and respondents broadly agreed with this. This equates to a cost saving per case of between £0.2m and £3m. These savings are primarily derived from reduced time spent co-ordinating divergent creditors' interests, including lower costs on legal fees and other professional services to reach agreement in large complex restructurings.
- 1.40 This cost saving will be passed on directly to creditors in the form of higher returns. This is the best available estimated benefit at this time and opinions on the continual validity of this analysis will be sought from stakeholders during the consultation.
- 1.41 There will also be better outcomes for the businesses and their respective creditors resulting from the additional time spent on restructuring and establishing the best structure.
- 1.42 Respondents to the 2010 consultation felt that very few businesses would make use of a breathing space as alternative options were available. Some respondents felt that alternative tools were available to achieve the objectives of quicker resolutions at lower cost. Therefore we estimate only a small number of businesses are likely to use breathing space, perhaps 10 – 20 cases a year.
- 1.43 Combining the saving per case with the estimated number of cases that will make use of the breathing space gives an **estimated range of benefits to creditors of between £2m and £60m and we use the mid point (£31m) as the best estimate.**

¹⁷ Copies of the 2010 consultation stage impact assessment are available at the National Archives <http://webarchive.nationalarchives.gov.uk/20120407112234/http://www.bis.gov.uk/insolvency/Consultations/Restructuring?cat=closedwithresponse>

- 1.44 A variety of creditors will gain from these improved returns including government, employees and businesses. The benefits received by business creditors will be within scope of the business impact target. To estimate this proportion an analysis of a random un weighted sample of 125 records filed at Companies House over a 3 year period and a OFT market study¹⁸ of insolvency practitioners estimated that non-businesses such as HMRC accounted for around 10 per cent of the returns to creditors.
- 1.45 **This means that the benefits to business from the introduction of breathing space will be between £1.8m and £54m. As direct benefits from the change in legislation they are in scope of the business impact target.**
- 1.46 The introduction of a new procedure into the insolvency process will impose costs on the users of this process. The breathing space will require a nominated person to produce a report on the proposed restructuring plan. The time and cost of producing the plan will again vary according to the complexity of the cases and the ease of getting agreement from creditors. Some respondents to the 2010 consultation felt that the estimated cost of producing a report would be higher than the originally stated £0.006 to £0.05m range.
- 1.47 Taking on board this feedback would lead us to increase the range of costs and propose that the estimated range of cost for producing the initial report will be **from £0.04m to £0.15m per case. With the best estimate taken as the mid point of this range, £0.095m.**
- 1.48 After completion of the report, a nominated individual will be required to monitor compliance until the completion of the breathing space period, which is expected to be 90 days with the possibility of an extension. Their monitoring function should not require the creation of additional information other than what is already used during insolvency proceedings such as monitoring compliance with a CVA.
- 1.49 The consultation respondents in 2010 suggested the cost of monitoring compliance would range from £0.1m to £1.8m per case depending on the length of the breathing space and the number of people assisting the representative monitor. This remains the best available estimate of the monitoring cost per case. **The mid point of £0.975m is taken as the best estimate.**
- 1.50 The final cost to be monetised relates to the legal agreement to enter in to the breathing space. This will be granted by a court and so legal costs will be incurred in preparing the case. Cases that are disputed by creditors will incur additional hearing costs. The size of the costs will depend on the level of dispute and as such the length of time it takes to reach agreement.
- 1.51 On the whole stakeholder respondents to the 2010 consultation felt that the estimated range of £0.05 to £0.3m was a good assessment of the possible cost per case. Therefore this will be used as a working assumption of the costs of the legal agreement and additional information will be gathered from stakeholders during the consultation.
- 1.52 After accounting for the estimated number of cases that we initially believe will need to prepare the legal materials for the moratorium. We estimate the total cost to business will be between £0.5m and £3m.

¹⁸http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/shared_of/reports/Insolvency/oft1245

1.53 Collectively the costs of producing a report, monitoring compliance for the period of the breathing space and getting legal agreement for the breathing space will cost between £0.24 and £2.245m per case. **We previously estimated that between 10 and 20 cases might make use of the breathing space meaning the total cost to business would be between £2.4m to £45m, with a mid point best estimate of £23.7m.** This ongoing cost to business from this new regulatory procedure is in scope of the business impact target.

Introduction of a restructuring plan, widening the definition of essential suppliers and providing a formal structure and process for rescue finance

1.54 The prior consultation on the introduction of a moratorium gave us excellent evidence on the possible impacts. The remaining proposals lack anything similar on which to draw upon. However, it is fair to say that the outcomes from the remaining proposals are likely to interact with each other; for example the number of new businesses applying for a moratorium will depend on whether they could also cram down debts and also nominate several of their suppliers to be essential. Disaggregating the benefits from each of the remaining proposals has therefore proven to be quite difficult. Instead, at this stage of the policy development we will describe the type of impacts we would expect from improving business rescue outcome and our initial estimate of possible levels of demand.

1.55 The consultation will seek views from stakeholders on the likely scale and effect of each of the policy proposal but initially we can look at the benefits from improvements within the existing insolvency framework to estimate the possible impacts, such as:

- Improving the success rate of existing company voluntary arrangements, improving returns to creditors
- Switching some businesses (likely to be larger businesses) that currently enter in to administration or a CVA into a restructuring plan again achieving greater returns to creditors
- Preventing some businesses entering liquidation and instead entering into a rescue procedure that delivers greater benefits to creditors

1.56 The IA will describe each in turn.

Improving the success rate of existing company voluntary arrangements

1.57 A CVA can fail for a number of reasons such as unforeseen changes in business environment, changes of opinion by directors and/or shareholders or obstructive or unengaged creditors. CVAs that fail may attempt to enter a new arrangement or use an alternative insolvency proceeding such as administration of liquidation.

1.58 In 2015 there were 357 CVAs in England and Wales and based on an internal analysis of records filed at Companies House the failure rate for CVAs is around 60 per cent (214). Many CVAs fail because of a failure to maintain agreed payment; these proposals may mitigate a small amount of this so we estimate that there will be small reduction in the number of CVAs that fail of around 10 cases a year.

- 1.59 After analysing receipts and payments accounts of CVAs commenced in 2012/13, we estimate that successful CVAs achieved a return to unsecured creditors of 9.8 per cent while CVAs that failed achieved a return of 2.2 per cent. It wouldn't be fair to directly compare the two to get a measure of the improvement from the reforms, as after a CVA has failed, creditors would likely gain a small amount of additional return from the resulting administration or liquidation. Based on further analysis of Companies House records on administration and liquidation cases we estimate an additional 0.6% return to the creditors of a failed CVA. Thus, after the introduction of these proposals those businesses that previously would have had a failed CVA would now receive on average 7 per cent more.
- 1.60 The average unsecured creditor debt in a failed CVA case was estimated to be around £0.4m, meaning each CVA case that succeeds due to the proposed reforms should enable an additional £0.03m¹⁹ in benefits to creditors. Multiplying this benefit per case by the estimated number of CVAs that will now succeed we get an estimated annual benefit from improving the success rate of CVAs from the reforms of £0.3m.
- 1.61 **As with the other business impacts 90 per cent of benefits are likely to be received by business creditors. This means that the annual benefit to business from the improved success rate of CVAs will be around £0.27m.**

Switching some businesses from administration or CVA in to a restructuring plan

- 1.62 The proposed reforms will give businesses that make use of administration or CVAs as a means of achieving a possible rescue an additional option via the restructuring plan. The new powers will encourage some businesses that use other forms of insolvency procedure to switch to the restructuring plan.
- 1.63 The new options will be available to all businesses but we believe larger businesses with more complex ownership structures and financing arrangements are more likely to make use of them. Therefore we believe the new powers will encourage some large businesses that would previously have entered administration to switch. As we don't know the outcome that will be achieved via the restructuring plan we will assume it is at least as good as would occur if the business was able to enter a successful CVA.
- 1.64 In 2015 there were 1,406 administrations in England and Wales. This is low by historic levels and usually a number around 2,500 to 3,000 is more commonplace. It is very difficult to estimate the numbers of cases that would switch because it will depend on the individual circumstances of the cases but for the purposes of this impact assessment we are assuming that it will lead to very few cases switching to a CVA. This is based on the observation that the majority of administrations are small businesses who are likely to be less affected by the change but the consultation is looking for ways to encourage SMEs to use the new procedures.
- 1.65 Therefore we estimate that around 1 per cent of administrations (10 – 20 cases) may switch from administration to a CVA.

¹⁹ Estimated by taking 7 per cent of £0.4m.

- 1.66 Those cases that do switch are likely to see a greater return to unsecured creditors; a recent analysis of filings at Companies House of CVAs and administrations that commenced in 2012/13 estimated that unsecured creditors received 6.75 per cent more from a CVA than an administration. Using the same analysis the average unsecured debt from an administration was estimated to be £2.6m, meaning each case that switched would be better off by around £0.18m²⁰.
- 1.67 With the initial estimates of 10-20 cases a year possible benefiting from the policy options, this equals a benefit to creditors of between £1.8 and £3.6m, with the mid point of this range £2.7m being the best available estimate. As with other benefits to creditors around 90 per cent of the total, **£2.4m annual benefit to business is within scope of the business impact target.**

Businesses entering administration instead of voluntary liquidations

- 1.68 One of the key criteria for being eligible for a moratorium will be an assessment of the viability of the business. This should mean that one of the outcomes from the moratorium should be to reduce the number of businesses that would enter in to a voluntary liquidation. Any increase in the ratio of businesses rescued to those entering liquidation will lead to an improved outcome for creditors.
- 1.69 Returns paid to unsecured creditors in liquidation are extremely low as the value of assets available for distribution is low. An analysis of dividends paid out of the Insolvency Services Account during 2012 in relation to creditors voluntary and compulsory liquidation cases indicates that the average dividend paid to unsecured creditors is effectively zero. Returns paid to creditors in administration are higher due to enhanced asset value preservation (e.g. goodwill preserved through a business rescue). Recent analysis of administration filings at Companies House indicates that the average recovery rate for creditors in administration is around 6%.
- 1.70 Using the same source and analysing voluntary liquidations we estimate the average debt of all creditors in a voluntary liquidations was £0.575m, meaning each case that transferred to an administration would be better off by £0.036m. Estimating how many cases will transfer is very difficult because at one extreme if the moratorium is successful and only viable business will be able to qualify then no businesses should be transferring from voluntary liquidation in to administrations. However, the additional tools provided to an IP, such as the nomination of essential supplies should enable some cases that would previously have gone in to liquidation becoming administrations instead and achieving higher returns to creditors.
- 1.71 The Insolvency Service has provisionally estimated that this could impact up to 50 cases, which will be used as the upper bound estimate. The best estimate will be the mid point of zero and 50 cases. **Combining the number of cases with the benefits per case gives a range of benefits between zero and £1.8m with a best estimate of £0.9m. This benefit will be directly beneficial to creditors with 90 per cent of the benefit going to business creditors, meaning a benefit to business that is within scope of the business impact target of £0.8m per year.**

Cost to suppliers of maintaining essential supplies to insolvent businesses

²⁰ £2.6m multiplied by 6.75% equals £0.18m per case

- 1.72 There is a significant increase in risk to a supplier once a business has been declared insolvent. The business has effectively defaulted on existing debts some of which may have been to the business supplier. To avoid exposing themselves to future losses many businesses include termination clauses in contracts to enable them to cease or renegotiate their terms of supply at the point of insolvency.
- 1.73 A nominated individual's decision to specify that the contract was essential and so must not be changed in a way that penalises the insolvent business is an added cost to the business supplier. Businesses that are faced with this possibility would seek to mitigate these losses. One way of doing this would be to make greater use of insurance products that compensate firms for the losses incurred from insolvency. The cost of this insurance varies considerable with estimates from 0.01 per cent to 0.1 per cent of business turnover. Using these as a range of estimate we can use 2015 Business Population statistics to estimate the average turnover of the businesses involved to be £0.67m.²¹ Meaning the average cost per supplier is estimated to be between £670 and £6,700.
- 1.74 Estimating the number of suppliers that might be affected by this additional cost is very difficult as some businesses would require very few essential contracts to be maintained in order to continue business. The businesses may already have most of their necessary supplies covered by existing legislation which prevents IT suppliers and utilities from terminating supply at the point of insolvency²². However, other firms may require a significant number of contracts to be designated essential in order to maintain their business as a going concern. The nominated individual will determine which contracts are essential and we believe that the average company may ask for 5 – 10 suppliers to be assigned as essential.
- 1.75 As with the other impacts we believe that a small number of insolvency cases will ask the court for additional contracts to be designated as essential and initial analysis estimates that between 30 to 80 cases a year could use this procedure. Multiplying each of these cases by the number of possible businesses that will have to maintain supply means that between 150 and 800 businesses could be impacted. These businesses will be directly affected by the changes to the regulations.
- 1.76 Using the previously estimated cost per business of purchasing insolvency insurance we estimate the cost to suppliers of being made an essential supplier will be between £0.1m and £5.4m. **The best estimate is the mid point of this range, £2.7m. All of these costs are within scope of the business impact target as an ongoing cost of the insolvency procedure for business suppliers.**

Cost of dispute in court of being an essential supplier

- 1.77 The proposal is to enable the supervisor to support the business through their restructuring by nominating certain suppliers as essential. After leaving the moratorium business would be required to maintain this supply contract if they enter into a formal insolvency procedure such as a CVA or administration.

²¹ Table 26: 2014 Business Population estimates. Total Turnover of Business/Number of Businesses <https://www.gov.uk/government/statistics/business-population-estimates-2014>

²² On 1st October 2015, an amendment to the Insolvency Act 1986 commenced, which ensures continuity of essential supply of utilities and IT goods or services to insolvent businesses

- 1.78 The supplier may not wish to continue to provide goods and services to the business on the previous terms and conditions and would rather end their relationship. This may be because the supplier now believes there is a greater risk of not receiving payment or that they have alternative customers. The supplier will be able to dispute the designation of the contract as essential in court.
- 1.79 There will be a cost of preparing legal materials to dispute the nomination. Some of this cost will be recoverable from the losing party. This cost is a direct cost to business of the new regulations on suppliers. The existence of the court process is likely to act as a deterrent on businesses, so they will likely only apply when the costs of the case are less than the benefits they would receive from halting supply. We previously estimated that between 30 to 80 cases, each with between 5 to 10 suppliers could be impacted, meaning an upper estimate of 150 to 800 suppliers who could raise a dispute. The existence of a legal procedure with associated cost we believe means that relatively few suppliers would bring a dispute and our initial estimates are that between 10 – 20 per cent of suppliers or 15 to 160 businesses could bring forward a case.
- 1.80 At this stage of the policy development it is difficult to know the legal costs of raising a dispute but similar insolvency court procedures have been estimated to cost business around £4,000 per case. If a claim is disputed the nominee will need to defend the action and incur costs, and as a provisional estimate we assume that the same level of cost will be payable by the business. **This means an ongoing cost to business that is within scope of the business impact target of between £0.12m and £1.24m, with the mid point £0.70m being the best available estimate.**

Cost of disputing the provision of a restructuring plan imposed on a secured creditor – crammed down

- 1.81 A secured creditor that is bound in to a restructuring plan may not wish to be included in the restructuring plan, even with the requirement that the dissenting creditor not be made worse off from being included. The creditor will have recourse to the court if they wish to be removed from the restructuring plan. The Government believes very few creditors will seek to dispute the decision and seek recourse via the courts. This is likely to be the case because we've previously estimated very few cases would use cram down to aid in restructuring. Also the provision that the plan must be fair and equitable to all parties and the added cost of making the application to court, previously estimated to be around £4,000 per case, collectively we believe means that there are likely to be almost no cases which will be disputed in court. However, the consultation will seek views on this from stakeholders.

Cost of challenge where an existing secured creditor's negative pledge clause is overridden

- 1.82 The proposal is to enable negative pledge clauses in existing security arrangements covering company property to be overridden to allow new security to be given to providers of rescue finance that may rank subordinately, equally or in priority to existing secured creditor's charges.
- 1.83 This will be permitted where the granting of new security is: necessary to obtain the rescue finance; in the best interests of creditors as a whole; and the existing secured creditor is adequately protected. Where the existing secured creditor disputes these conditions have been met, they may apply to court to challenge the rescue finance proposal.

- 1.84 There will be a cost of preparing legal materials to dispute the assertions made by the company. It is likely that challenges will be made on the grounds that the existing secured creditor is not adequately protected and this will often involve a dispute over the valuation of charged property. Costs will therefore be incurred to establish accurate values of company property. The cost of preparing these reports can vary significantly, with some assets being very easy to value whilst others may take considerably longer. Based on initial conversations with Official Receivers, who often require valuations of assets in their roles as trustees. A cost of around £5,000 has been assumed to cover the average cost of producing a report.
- 1.85 Again, we believe very few creditors will challenge the removal of their negative pledge clause in court because it is likely to effect very few creditors and those affected would prefer the outcome that rescue finance could provide rather than the alternative.

Non monetised benefits

- 1.86 Businesses that make use of the moratorium and exit without resorting to formalised insolvency or rescue package are likely to be the biggest beneficiaries of the changes. At this stage in the policy development it is uncertain of the number of businesses and how much they will likely gain from the changes and more evidence will need to be gathered during the consultation.
- 1.87 In addition to the monetised benefits arising from the expected increase in the proportion of business rescues, there are also expected to be indirect economic benefits. The extent of these benefits are difficult to quantify, but a successful business rescue will generally result in the preservation of the whole, or a part, of the insolvent business, meaning that more jobs will be preserved in comparison to a liquidation where businesses will be closed and jobs lost. The retention of employment will also contribute to retaining skills. This not only benefits individual employees, but means that they are less likely to experience a period of temporary or permanent unemployment with the associated negative effects on labour productivity that this would bring.

Risks

- 1.88 There have been a number of assumptions made about how many distressed businesses will use these policy options. If more businesses take up the new procedure than believed then the overall benefits are likely to be higher. The reverse is also true and benefits maybe lower if fewer businesses use these new areas of insolvency law. Further evidence will be gathered during the consultation stage to mitigate this risk.
- 1.89 The options make a number of changes to the financing and supplier relationships between distressed businesses and creditors. The intention is to improve the chances of successful business rehabilitation and improve returns to all creditors. However, the inclusion of these provisions may make some businesses riskier to finance or supply which may result in their having difficulties acquiring finance or suppliers. Effects on business financing and supply chain will be analysed as part of the consultation.

- 1.90 The expenses of the insolvency proceeding have the first call on any assets realised. The policy proposal on rescue financing will put these costs ahead of insolvency practitioner remuneration in the statutory order of payment in insolvency. There is a risk that this may discourage IPs from taking on some cases. This may result in worse outcomes for distressed businesses and the scale of this risk will be assessed during the consultation.
- 1.91 Negative pledge clauses give secured lenders certainty that no further security can be granted over company property without their consent. Whilst the policy proposal on overriding negative pledge clauses and existing charges builds in strong safeguards to protect existing lenders, the ability to override negative pledges may affect the way in which lenders assess risk and therefore price credit.
- 1.92 The consultation will consider how to construct the safeguards so that existing secured lenders are adequately protected and do not receive lower returns from the sale of charged property than they would otherwise do. This should prevent any increase in the price of secured credit and prevent credit being withdrawn from businesses that need it.

Direct costs and benefits to business calculations (following OITO methodology)

- 1.93 The policy proposals include a number of new regulations for the insolvency framework. Across the package of reforms the benefits to business should exceed the costs making it a net beneficial regulation on business and an OUT under the better regulation framework. The intention of the policies is to provide for a better outcome for creditors and improved chances of business rescue.
- 1.94 Below is a list of the impacts on business that are within scope of the business impact target.
- Familiarisation cost to insolvency practitioners, nominees and creditors – one off cost between £0.5m and £1.15m
 - Cost of preparing reports, monitoring compliance and receiving agreement from the court for a the moratorium – ongoing cost between £2.4 and £45m, mid point estimate £23.7m
 - Cost of suppliers raising a dispute in court after being made an essential supplier – ongoing cost of £0.7m
 - Cost of suppliers purchasing additional insurance to cover insolvency risk and having to maintain supply – ongoing cost between £0.1m and £5.4m, mid point estimate of £2.7m
 - Benefit to business from better outcomes from the moratorium – ongoing benefit of between £1.8 and £54m
 - Benefit to business from an improved success rate for CVAs – ongoing benefit of around £0.27m
 - Benefit to business from insolvency cases switching from administrations to CVAs – ongoing benefit of around £2.4m
 - Benefit to business from insolvency cases switching liquidations to administrations – ongoing benefit of around £0.82m
- 1.95 Overall the changes deliver greater benefits than the costs to business, with an EANCB of £-4.1m (2014 prices).

Other impacts

- 1.96 There is likely to be an impact on the judiciary from having to approve the business restructuring plan and moratorium. As well as providing judgement on disputes regarding the designation of essential supplies and overriding negative pledge clauses. The scale of the impact will be investigated as part of the consultation and a justice impact test completed.
- 1.97 We do not expect any impacts on families, competition or equalities but this will require confirmation from evidence gathered during the consultation.