

Summary: Intervention & Options

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|---|--|---------------------------|
| Department /Agency: INSOLVENCY SERVICE | Title: Impact Assessment of Encouraging Company Rescue - a consultation | |
| Stage: Consultation | Version: 1 | Date: 15 June 2009 |
| Related Publications: Consultation document - "Encouraging Company Rescue" | | |

Available to view or download at:

<http://www.insolvency.gov.uk>

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What is the problem under consideration? Why is government intervention necessary?

The problem is the failure of companies which but for an inability to secure 'new' funding at a vital stage might survive. Such company failures precipitate a systemic risk of 'knock on' failures whereby their creditors fail as a consequence of bad or part paid debts, or reduce their operations: shareholders face a similar risk. The economic cost of systemic risk encompasses reduced economic performance & tax revenues, increased job losses & personal debt, and damage to future economic development potential of the market.

Government intervention is necessary to effect legislative change

What are the policy objectives and the intended effects?

Strategic objectives - in summary to enhance the rescue culture, save jobs and produce greater returns for creditors and shareholders.

What policy options have been considered? Please justify any preferred option.

- i) Making no change.
- ii) Considering whether a non-legislative approach would deliver the desired effects.
- iii) Giving those who lend companies post-administration, or post-CVA funds priority over existing creditors for the return of monies.
- iv) Extending the option of a moratorium to large and medium sized companies giving them a "breathing space" in which they can reach legally binding agreements with their creditors thus increasing the likelihood of rescue.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

Three years after the implementation of any changes

Ministerial Sign-off For consultation stage Impact Assessments:

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 Minister:

..... Date:

Summary: Analysis & Evidence

| | |
|-----------------------|---------------------|
| Policy Option: | Description: |
|-----------------------|---------------------|

| | | |
|---|--|--|
| COSTS | ANNUAL COSTS | Description and scale of key monetised costs by 'main affected groups' companies may incur some costs including court fees. Costs are difficult to quantify and consultees views are welcomed on the treatment of costs and benefits. |
| | One-off (Transition) Yrs | |
| | £ 0 | |
| | Average Annual Cost (excluding one-off) | |
| | £ 125K - 1.25M | Total Cost (PV) £ 125K - 1.25M |
| Other key non-monetised costs by 'main affected groups' Please let us know if you consider there would be costs that cannot be quantified in monetary terms. | | |

| | | |
|--|---|--|
| BENEFITS | ANNUAL BENEFITS | Description and scale of key monetised benefits by 'main affected groups' enhance the rescue culture, safeguarding and securing jobs for employees of companies saved from failure having had the benefit of rescue finance, greater returns for creditors and shareholders. Direct benefits of a shift from administrations to CVAs are estimated as £5M - £86M. Further benefits described in next box. |
| | One-off Yrs | |
| | £ 0 | |
| | Average Annual Benefit (excluding one-off) | |
| | £ 5M - 86M | Total Benefit (PV) £ 5M - 86M |
| Other key non-monetised benefits by 'main affected groups' Something in the region of £450M to £8500M might be preserved for the economy by more companies being rescued with positive 'knock on benefits' arising as a consequence of more companies being rescued. Please tell us if you can think of other non-monetised benefits. | | |

Key Assumptions/Sensitivities/Risks In seeking to establish costs & benefits we have assumed 'starting points' for the quantum of companies that might take advantage of, or be otherwise affected by the proposals . We invite views from consultees on the starting points we have provided.

| | | | |
|-------------------------|-------------------------|--|---|
| Price Base Year 2005 | Time Period Years 10 | Net Benefit Range (NPV) £ ~ 5M - 85M | NET BENEFIT (NPV Best estimate) £ ~ 40M |
|-------------------------|-------------------------|--|---|

| | |
|---|---|
| What is the geographic coverage of the policy/option? | UK |
| On what date will the policy be implemented? | not yet known |
| Which organisation(s) will enforce the policy? | enforcement not req. |
| What is the total annual cost of enforcement for these organisations? | £ N/A |
| Does enforcement comply with Hampton principles? | Yes |
| Will implementation go beyond minimum EU requirements? | N/A |
| What is the value of the proposed offsetting measure per year? | £ N/A |
| What is the value of changes in greenhouse gas emissions? | £ N/A |
| Will the proposal have a significant impact on competition? | No |
| Annual cost (£-£) per organisation (excluding one-off) | Micro Small Medium Large |
| Are any of these organisations exempt? | No No N/A N/A |

| | | |
|---|----------------------|-------------------------|
| Impact on Admin Burdens Baseline (2005 Prices) | | (Increase - Decrease) |
| Increase of £ N/A | Decrease of £ N/A | Net Impact £ N/A |

Key: Annual costs and benefits: Constant Prices (Net) Present Value

[Use this space (with a recommended maximum of 30 pages) to set out the evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Ensure that the information is organised in such a way as to explain clearly the summary information on the preceding pages of this form.]

1. INTRODUCTION

This is a consultation stage Impact Assessment. It accompanies the consultation document on “Encouraging Company Rescue”. Consultees are invited to offer views and comments on the treatment of costs and benefits, and the results will feed into the final Impact Assessment.

It is important to stress at onset some of the quantification of the costs and benefits are indicative figures, and therefore contain some uncertainties. On areas, where it was difficult to quantify the costs and benefits, we have provided, to the extent possible, the qualitative costs and benefits of the proposals. We would welcome comments on the estimates contained in this Impact Assessment. Such comments will enable us to give better information in the final Impact Assessment.

2. OPTIONS

Option : Make specific changes to promote business rescue, namely

(a) Giving those who lend companies post-administration, or post-CVA funds priority over existing creditors for the return of monies.

(b) Extending the option of a moratorium to large and medium sized companies giving them a "breathing space" in which they can reach legally binding agreements with their creditors thus increasing the likelihood of rescue & introducing new court sanctioned moratorium.

Background

Strategic objective

1) The proposals' strategic objective is to enhance the rescue culture, save jobs and produce greater returns for creditors and shareholders. Estimating the likely effects is not easy and we would very much welcome your help in refining our assumptions and estimates.

The proposals' benefits

2) The proposals are intended to make it more likely that viable companies will be rescued. This would benefit both small and large companies and those benefits would flow on to creditors (including employees) and shareholders.

3) Saving viable companies contributes to a strong market in goods and services, both nationally and internationally, and would deliver economic benefits for the country through sustained economic activity, higher levels of employment and tax revenue.

4) It also means a reduction in the damaging knock on effects of companies collapsing – when value is lost as a business is broken up and people are made redundant. Saving viable companies boosts investor confidence and preserving jobs reduces the likelihood of personal debt problems and reliance on the state for financial support. Small businesses in particular should find themselves less at risk of financial difficulty if the other companies they supply are rescued and can continue to pay their bills.

5) Larger companies can save money – for some that can be many thousands of pounds - by achieving a moratorium via the cheaper Company Voluntary Arrangement route rather than the more expensive administration route. This in turn means more money being available to pay back to creditors.

6) Creditor engagement could be improved as a consequence of greater utilisation of the CVA route seeing agreement, cooperation and conciliation between parties leading to greater chances of recovery for ailing companies, strengthening the market.

The proposals' risks

7) A principal risk is that any changes could affect the terms of provision of finance to solvent as well as insolvent companies. Lenders may, in future, be less flexible in providing funds by attaching 'onerous' conditions such as levying higher interest charges than might otherwise have been the case.

8) The proposals would prevent secured creditors from enforcing their security for the period of any moratorium; that security would also be diluted by the fact that the new lending acquired priority. This would be of particular importance for security held subject to negative pledge clauses. These clauses give lenders a degree of certainty, at the time they agree the initial loans to a company, about the extent to which they might eventually rely on that security for repayment of the loan amount. If giving priority to rescue finance involves overriding those clauses, without such protections, existing lenders could find that the security they hold is worth less to them than they had thought.

ESTIMATED BENEFITS ARISING FROM USING PROPOSALS A and B

We have considered how many companies will use the extended Schedule A1 moratorium procedure (A) and the court sanctioned moratorium procedures (B). Our view is that the majority of companies newly using the procedures will be larger companies as small companies already have the option of a moratorium; and the court sanctioned moratorium, which is likely to be more expensive than the Schedule A1 extension, has an initial moratorium period of 42 days specifically to allow larger companies more time to get their affairs to a position where a viable CVA proposal can be drawn up. We submit, as starting points, the ranges set out below for potential take up of the procedures.

Our 'starting points':

Proposal extending Schedule A1

There were 3377 company administrations in 2007/08 and internal data sourced from the Department for Business, Innovation & Skills (BIS) suggests around 85% of administrations would have been amongst small companies. This reflects the size structure of the company population. Of the remaining 15% our view is that approximately half will continue to use administration in preference to CVAs because an insolvency practitioner concludes that a CVA is unlikely to succeed, that creditor support cannot be secured, or there is little prospect of rescue; and of what then remains (7%, approximately 235 companies) we estimate a range of between 10 – 150 might seek to take advantage of the moratorium.

Proposal court sanctioned moratorium

As regards the court sanctioned moratorium the likelihood is that due to the potential greater costs involved it will be used mainly by large companies of which there are relatively few. We do not have data on the number of large companies making use of CVA procedures but suggest a possible range of companies which might take up the new procedure of 5 – 50.

Table 1 : our 'starting points' for companies utilising moratorium procedures

| | our 'starting points' |
|--|--|
| Schedule 1 moratorium (+) | 10 à 150 |
| Court sanctioned moratorium | 5 à 50 |
| Either moratorium | 15 à 200 |
| Estimated 50 - 75% success rate as some will inevitably fail | 8 à 150 successful CVAs ⁽¹⁾ |

⁽¹⁾The lower figure, 8, has been reached by 15 x 50% and 'rounding' up, the upper figure 200 x 75%; we assume these companies will be mainly medium or large companies.

Estimated costs and benefits of proposals

There were 3377 company administrations in 2007/08 the vast majority of which we expect to have been amongst small companies given the size structure of the company population. We estimate that 8 - 150 companies that

might have entered administration will instead successfully use a CVA with a moratorium. We believe the population of 8 -150 will comprise more 'larger' companies than small because small companies already have the option of a moratorium.

Question 1: Do you agree that the ranges we have set out in table 1 are reasonable? If not, what range would you estimate? Please provide evidence to support your view if it is available.

Benefits of Proposed Measures

In the UK as a whole, the average turnover of the 30,500 medium and large companies (defined by employee numbers) is £57M. ¹ Applying this to the lower and upper estimates of potential additional companies successfully saved in England and Wales from Table 1 (8 – 150 companies) suggests that somewhere between £450M to £8,500M of turnover might be preserved through the moratorium proposals.

Similarly, there are on average 380 people in employment in medium and large companies, suggesting that somewhere between 3,000 and 57,000 additional jobs might be retained within companies as going concerns.

¹ Source: Table 3 of "SME Statistics 2007" : <http://stats.berr.gov.uk/ed/sme>

These figures represent the scale of the resources involved. However, the direct benefits accruing to the UK economy from these measures are better represented by the losses to creditors which are avoided or reduced (see table 4), the unemployment and other benefits which would otherwise be paid out by HMG, and the loss of profits which would be inflicted on shareholders. These are not easy benefits to measure and we will be doing further work to assess these benefits over the coming weeks.

In addition to the direct benefits of these proposals we also expect to see significant indirect benefits as a result of the avoidance of those "knock on" effects that often occur with the collapse of large or significant companies. In particular, the losses that are often inflicted on customers, creditors and suppliers when a company fails which can ripple out across a sector or region of the economy. We will be doing further work over the coming weeks to try and gauge the likely scale of these impacts.

Question 2: What do you think are likely to be the ultimate benefits of these measures - both direct and indirect? How significant are the "knock on" effects of company failures?

Table 2 - range of costs per administration/CVA⁽¹⁾

(1) Informal figures sourced from the insolvency profession

| | per Administration (£ 000's) | per CVA (£ 000's) |
|----------------|---------------------------------|----------------------|
| Small company | 5 à 300 | 5 à 25 |
| Medium company | 45 à 500 | 10 à 200 |
| Large company | 2,000 à 4,000 | 500 à 1500 |

Question 3: Do you agree that the ranges identified for average costs (including fees) in administrations and CVAs are reasonable? If not, what ranges would you estimate? Please provide evidence supporting your estimates if you are able to do so.

Creditors (see Background Data: Table 4)

Figures suggest that returns to creditors are roughly twice as high in CVAs as in administration. We invite views on the scale of benefits of enabling more companies to negotiate a CVA without entering administration.

Secured creditors may be more likely to benefit than unsecured creditors although it needs to be noted that amounts received by unsecured creditors when a company goes into administration are low and lower still in a liquidation.

Legal and direct costs

Costs can be broadly categorised as :

Those arising from the cost of administrations and CVAs as set out in Table 2 above where savings for business should be significant as a consequence of utilising CVAs.

Schedule 1 costs – obtaining advice and calling meetings etc. We should be grateful for views on how much these costs might be for each of the proposals.

Costs arising in the court based moratorium. These include professional advice, legal fees, and court application, which we estimate to be £20,000 - £30,000 per application.

Changing priority proposal

Benefits

The key issue is how far these proposals will increase rescue funding for viable companies, and whether there would be a consequence (positive or negative) for cost or availability of funding to companies generally.

It is difficult to estimate how many companies might secure rescue funding as a result of these measures. If only 10 medium or large companies were to receive this increased funding, say, and only 50% of these survived, this would represent an average preservation of £280M of turnover in England & Wales and nearly 2,000 jobs. If this number were 100 (medium and large companies), and 75% of them were to survive, this would represent some £4,300M of turnover and nearly 30,000 jobs retained in going concern companies.¹

¹ Source: Table 3 of “SME Statistics 2007” : <http://stats.berr.gov.uk/ed/sme/>

Costs

We do not believe that there will be any administration costs although we recognise, notwithstanding that any impact should be slight, there may be an impact on cost of borrowing. We expect the overall impact to

be beneficial if more companies are rescued or creditor returns increase. Some creditors might however be adversely affected as a result of change in priority to new lending and this could have consequences for both scale and cost of future lending to companies. We invite your views on these matters.

Impact Tests

Competition Assessment: We do not believe that these proposals will have a significant adverse impact on competition but views are invited on this.

Small Firms Impact Assessment: The development of the proposals has been guided by “Think Small First” principles and has been formulated with small and medium sized enterprises in mind. Proposals have been designed so that wherever possible regulation is proportional to firm size, and is also presented in a more coherent and accessible form. We estimate that there will be substantial benefits to small and medium sized companies generally as a result of more successful business recoveries.

Race Equality, Disability Equality and Gender Equality: We do not believe that there will be an impact on the equality strands as the proposals impacts on companies not on individuals. We have, however, looked at each of the equality impact initial tests individually and are confident that there is no impact.

BACKGROUND DATA

Table 3: Number of active businesses as at 3 May 2009 as sourced from Companies House Register

| | England & Wales | Of which Public Companies | Scotland | Of which Public Companies | Great Britain | Of which Public companies |
|-----------------|----------------------------|---------------------------|-----------------|---------------------------|----------------------|---------------------------|
| Ltd Cos. | 2,147,139 | 9,212 | 130,352 | 337 | 2,277,491 | 9,549 |
| LLPs | 32,442 | | 1,815 | | 34,257 | |

Table 4 : Breakdown of insolvency procedures between October 2003 – September 2008⁽¹⁾

(1) The quarterly figures run from implementation of the Enterprise Act 2000.

| Period (Oct. – Sept) | CVL | Compulsory W.U. | Admin. | CVA | CVA with moratorium |
|--------------------------------------|--------|-----------------|-----------|-----------|---------------------|
| 2003 – 2004 | 7,992 | 4,570 | 1,394 | 679 | Nil filed |
| 2004 – 2005 | 7,564 | 5,095 | 2,138 | 622 | Nil filed |
| 2005 – 2006 | 7,863 | 5,278 | 2,661 | 540 | [to be advised] |
| 2006 – 2007 | 7,331 | 5,413 | 3,413 | 433 | [to be advised] |
| 2007 - 2008 | 8,834 | 5,105 | 3,377 | 529 | [18] |
| Estimated return to creditors : p/£1 | 0 à 5p | 1p à 2p | 10p à 20p | 30p à 40p | [to be advised] |

Question 4: Do you agree with the estimated ranges of returns to creditors for each procedure? If not, what range would you estimate?

Table 5 : legislative definitions of small and medium-sized companies for accounting purposes (figures for "large companies" are not legislative but estimated averages necessary to prepare tables 4 & 5)

| | Turnover (not more than) | Number of employees (not more than) |
|----------------|--------------------------|-------------------------------------|
| Small company | £6.5 million | 50 |
| Medium company | £25.9 million | 250 |

Suggested benefit arising from 'shift' from administration to CVAs

Internal data sourced from the Department for Business, Innovation & Skills (BIS) suggests that companies going into administration do so in the approximate ratio 85%: 11% : 4% small: medium: large, reflecting the size structure of the company population. These figures suggest that medium and large companies enter administration in a ratio of around 3:1.

Table 2 above suggests that, on average, medium companies agreeing a CVA rather than entering administration might expect to save something in the region of £150,000.

Similarly large companies might expect to save something in the region of £2million.

We have identified in Table 1 that 8 – 150 companies might utilise moratorium procedures, in which case:

- at the lower figure, medium companies : large companies, ~ 6:2
- at the higher figure, medium companies: large companies, ~ 113:37

Consequently potential benefit, arising from a shift to CVA from administration, could be calculated as:

Lower end benefit : $6 \times (115,000) + 2 \times (2 \text{million}) = \sim 4.7 \text{ million}$

Higher end benefit : $113 \times (115,000) + 37(2) = \sim 86 \text{ million}$

Total benefit: in the range £5M – £86M

Costs

Schedule 1 costs – obtaining advice and calling meetings etc. We should be grateful for views on how much these costs might be for each of the proposals. For purposes of

Costs arising in the court based moratorium. These include professional advice, legal fees, and court application, which we estimate to be £20,000 - £30,000 per application; averaging £25K per application.

On a basis, then, of 5 – 50 medium & large companies undertaking a court sanctioned moratorium, we suggest court fees in a range of £125K - £1.25M.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

| Type of testing undertaken | <i>Results in Evidence Base?</i> | <i>Results annexed?</i> |
|----------------------------|----------------------------------|-------------------------|
| Competition Assessment | Yes | No |
| Small Firms Impact Test | Yes | No |
| Legal Aid | No | No |
| Sustainable Development | No | No |
| Carbon Assessment | No | No |
| Other Environment | No | No |
| Health Impact Assessment | No | No |
| Race Equality | Yes | No |
| Disability Equality | Yes | No |
| Gender Equality | Yes | No |
| Human Rights | No | No |
| Rural Proofing | No | No |

Annexes

none