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BRIEFING PAPER

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Insolvency Practitioners' fees

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Summary

New rules requiring Insolvency Practitioners (IPs) to provide upfront estimates of what they will charge for their work came into force on 1 October 2015.

The *Insolvency (amendment) Rules 2015* ('the Rules') require IPs to provide upfront a summary of estimated costs , the work to be undertaken and, where an hourly rate is proposed, an estimate of the time they expect to be working on that case. These estimates will act as a cap on fees as, once agreed, they can only be changed by agreement between the IPs and those that are owed money by the insolvent firm ('the creditors').

The new Rules apply to England and Wales only. In Scotland, the court reporter system is a check on remuneration, as a result the issue of lack of fee control by unsecured creditors does not exist.

In a nutshell, IPs act as office-holders in insolvency procedures and are given extensive powers by legislation. They take decisions that can have a significant impact on the funds available to creditors; their fees are paid out of the assets in cases. Under the new rules Insolvency Practitioners are required to provide a summary of estimated costs, the work to be undertaken and, where an hourly rate is proposed, an estimate of the expected time. These estimates act as a cap on fees as, once agreed, they can only be changed by agreement between the insolvency practitioners and the creditors (i.e. those that are owed money). The new rules apply to the following insolvency procedures:

- administration;
- creditors' voluntary liquidation;
- compulsory liquidation (unless the Official Receiver acts as liquidator); and
- bankruptcy (unless the Official Receiver acts as trustee in bankruptcy)

It is hoped that the new rules will increase transparency for creditors as they will have a much clearer indication of what the likely fees and costs of dealing with an insolvency will be. Creditors should be better equipped to challenge fees when they appear unreasonable. Additionally, Insolvency Practitioners will be given the opportunity to demonstrate to creditors what they do and the value they deliver in return for their fees.

The new rules follow the Office of Fair Trading's 2010 market study into corporate insolvency and Professor Elaine Kempson's 2013 review of insolvency practitioner fees. The Kempson Report identified that, where fees were controlled by unsecured creditors collectively, control mechanisms did not work as intended. In 2014, the Government published a consultation document on proposals aimed at tackling these issues.

This briefing paper provides information on the background to, and the main provisions of, the *Insolvency (amendment) Rules 2015.*

1. Introduction

The relevant legislation is the Insolvency Act 1986 (as amended), the Enterprise Act 2002, and the Insolvency (Amendment) Rules 2015 ('the Rules').

In a nutshell, Insolvency Practitioners (IPs) act as office-holders in insolvency procedures which include administration, administrative receivership, liquidation, bankruptcy and voluntary arrangements. To be qualified to act as an IP, the Insolvency Act 1986 requires a person to be authorised as a member of a professional body which has been recognised for this purpose by the Secretary of State.

Box 1: Professional bodies recognised to authorise IPs

- There are currently 7 recognised professional bodies (RPBs), operating largely in the accountancy and legal professions, overseen by the Insolvency Service.
- Once authorised, IPs are subject to a system of self-regulation by their RPB.
- Each RPB has its own set of rules and regulations to ensure that those individuals they authorise to act as IPs are 'fit and proper' persons with the necessary experience, qualifications and insurance in place.

Various reports (see section 2 below) show that secured creditors (such as banks) and some other larger creditors exercise close control over IP fees when they are involved in an insolvency (and larger corporate insolvencies in particular). In addition, IPs confirmed that the pressure to reduce fees was far greater in corporate insolvencies than in personal bankruptcy cases.[1] Where there are either no secured creditors or all secured creditors have been paid in full, oversight of the IP falls to unsecured creditors.

IP fees are always subject to creditor approval where they relate to insolvent individuals (bankruptcies), partnerships and companies (liquidations). Fees are often charged on a time cost basis, or alternatively as a percentage of realisations and distributions or, since 2010, on a fixed fee basis. In reality, in the vast majority of insolvency cases, fees have historically been approved on a time costs basis.

Insolvency Practitioner fees are subject to creditor approval.

[1] The Department for Business Innovation and Skills, 'Strengthening the regulatory regime and fee structure for Insolvency Practitioners – Consultation', 17 February 2014, online (accessed 15 April 2015)

2. Background

2.1 OFT Report

In November 2009 the Office of Fair Trading (OFT) launched a market study into corporate IPs. This review was initiated following concerns raised by, amongst others, the Government and industry about the market place for corporate IPs, and the regulatory framework under which they practice and charge fees. In June 2010, the OFT published its report, "The market for corporate IPs – A market study".[2]

Box 2: OFT report: Market for corporate Insolvency Practitioners

- The OFT report published in 2010, found that in just over a third of insolvency cases where unsecured creditors received a pay-out, fees were estimated to be 9% higher in like-for-like cases than where secured creditors 'control' an IP's fees.[3]
- The OFT estimated that in administration cases only, this amounted to £15m per year that unsecured creditors were paying in higher fees to IPs.
- According to the Insolvency Service, despite numerous discussions with the profession and the regulators little has changed to correct this market failure.

2.2 The Kempson Report

To address these concerns the Government announced in December 2012 a review, led by Professor Elaine Kempson into IP fees, to make recommendations for change to ensure that creditors are being charged fairly, as well as to increase confidence in the insolvency regime. The review was intended to build on the work conducted by the OFT.

In July 2013, Professor Kempson published her report, supporting the OFT's findings. [4] The report found that the system of controls on IP remuneration works where a secured creditor plays an active part in an insolvency. In this situation there is a degree of competition, as banks are repeat customers and IPs want to join and remain on bank panels. In contrast, where control lies in the hands of unsecured creditors collectively, there is little effective oversight by unsecured creditors of the work undertaken by IPs and that costs are higher as a result.[5]

[2] Office of Fair Trading, "The Market for Corporate Insolvency Practitioners – A market study", (OFT 1245), June 2010, [online] (accessed 25 November 2015)

[3] Ibid

[4] Department for Business, Innovation and Skills, 'Review of Insolvency Practitioner Fees', Elaine Kempson, July 2013, [online] (accessed 15 April 2014).

[5] Ibid

Box 3: Key findings of the Kempson Report

According to the Kempson Report, unsecured creditors seem to exercise (and to be able to exercise) very little control at all over IP fees, particularly in corporate insolvencies.

The reasons for this are complex, but the following factors all play a role:

- creditors' apathy;
- creditors' lack of knowledge and understanding of the insolvency process and of their rights;
- a lack of transparency on IP fees;
- opportunity cost; and
- an inability to exert influence (coupled with a feeling of disenfranchisement)

In general control is greatest when a single creditor is in a position to drive the insolvency process. This is both a failing in the regulatory system and a clear market failure when unsecured creditors are in control of an IP's remuneration.[6]

The Kempson Report identified weaknesses in the regulatory regime and clear market failure when unsecured creditors were in control of an IP's remuneration. Specifically, the report highlighted four main areas of concern amongst unsecured creditors, those being:

the actual hourly charge-out rates and what they include:

- inefficient staff management;
- time recording; and
- cost-ineffective working[7]

Whilst complaints about an IP's fees could be made to the court, because of the costs involved, few challenges were made.[8] As a result, there was no single solution to address the market failure for unsecured creditors.

The *Insolvency Rules 2010* had aimed to improve the position for unsecured creditors. Specifically, it made the following changes:

- lowered the threshold of creditor value required to challenge an IP's remuneration from 25% to 10%, or as the court allows;
- gave creditors (5% or more as court allows) the right to requisition further information on receipt of an IP report; and
- opened up the possibility of an IP having more than one basis for remuneration (in practice, this option was seldom used)

However, the Kempson Report concluded that further reform was necessary. Creditor engagement was crucial for effective fee-setting. It set out a number of recommendations, which fell into three main categories:

[6] Department for Business, Innovation and Skills, 'Review of Insolvency Practitioner Fees', Elaine Kempson, July 2013, [online] (accessed 15 April 2014).

[7] Department for Business, Innovation and Skills, 'Review of Insolvency Practitioner Fees', Elaine Kempson, July 2013, paragraph 5.2, [online] (accessed 15 April 2015)

[8] Ibid., para.5.2

- Transparency measures – to increase the availability of information to encourage greater engagement by unsecured creditors.
- Simplifying the fee structure – by replacing the current presumed basis for remuneration (which is time and rate in almost all cases) with either percentage of realisations as the presumed basis or using different bases for different aspects of a case.

- Enhanced monitoring and oversight of fees by regulators (Recognised Professional Bodies). The report raised the issue of whether a single regulator would be beneficial in this sector.

To tackle the issues identified in the Kempson Report, the Government published in 2014 a consultation document on proposals aimed at, entitled 'Strengthening the regulatory regime and fee structure for insolvency practitioners'.[9] Responses to the consultation indicated that creditors wanted meaningful information at the beginning of the process to increase transparency, and to address shortcomings in the current regime.

A **preferential creditor** (in some jurisdictions called a **preferred creditor**) is a **creditor** receiving a **preferential** right to payment upon the debtor's bankruptcy under applicable insolvency laws.

2.3 The basis of the Government's decision

Box 4: Why intervene in the IP market?

It is the Government's view that intervention in the IP market is necessary for two reasons:

- market failure and
- Fairness to unsecured creditors (i.e. a creditor, other than a preferential creditor[10], that does not have the benefit of any security interests in the assets of the debtor).

As identified by the OFT and the Kempson Report, market failure resulted from unsecured creditors being unable to exercise effective control over IPs. This in turn increased costs and/or reduced the quality of work (with IPs taking longer to do the same job) for unsecured creditors. In economic terms, this was am 'inefficiency in the market'. The Government explained its position as follows:

Inefficiency in the market.

> IPs are obtaining fees above the market rate; the transfer of returns from IPs to unsecured creditors has the potential to deliver a more efficient dynamic economic allocation of resources as these creditors are more likely to reinvest these resources in growth driving activities. Indeed, increased insolvency recovery rates to this class of investor could well increase the absolute amounts of credit made available, to the benefit of the wider economy. Reduction of the current profit margin in servicing

[9] The Department for Business Innovation and Skills, 'Strengthening the regulatory regime and fee structure for Insolvency Practitioners – Consultation', 17 February 2014, online (accessed 15 April 2015)

[10] A preferential creditor is a creditor receiving a preferential

> unsecured creditors will also incentivise cost effectiveness/minimisation by IPs.[11]

A question of fairness

In addition, the Government argued that purely out of 'fairness' it should intervene. The evidence showed unsecured creditors seemingly facing higher fees than secured creditors for the same service.[12]

New rules, the *Insolvency (amendment) Rules 2015* ('the Rules'), were laid in Parliament on 3 March 2015 and came into force on 1 October 2015. In introducing new rules, the Government has stated that its overall policy objective is to increase returns to unsecured creditors and at the same time increase confidence in the work of IPs.[13]

Commenting on the new Rules, Jo Swinson, then Business Minister, said that the introduction of initial fee estimates was a "sensible and practical" way of giving creditors more certainty over fees:

> Insolvency practitioners do important and specialist work realising the assets of failed companies for distribution to suppliers and others owed money. Initial fee estimates, which can only be changed by agreement, will strengthen the position of those owed money to ensure that fees are fair and reasonable.
>
> Increased transparency is a sensible and practical way to strengthen the hands of those owed money in an insolvency and will give insolvency practitioners the opportunity to demonstrate how their services provide value for money.[14]

[11] Department for Business Innovation and Skills, Impact Assessment on Insolvency Practitioner Fees Regime, IA. No. RPC 13-BIS-1979, 4 December 2013

[12] Ibid

[13] Ibid

[14] "More transparency for fees charged in insolvency", Gov.UK, 3 March 2015, [online] (accessed 25 November 2015)

3. The Insolvency (Amendment) Rules 2015

Box 5: The nature of Insolvency Practitioner (IP) Fees

- IP fees are always subject to creditor approval where they relate to insolvent individuals, partnerships and companies.
- Fees are often charged on a time costs basis, or alternatively as a percentage of realisations and distributions or, since 2010, on a fixed fee basis.
- In reality, in the vast majority of insolvency cases, fees have historically been approved on a time costs basis.

The *Insolvency (Amendment) Rules 2015* came into force on **1 October 2015**.[15] With effect from this date, where an IP is seeking approval of his fees on a time costs basis, he will be required to provide an estimate of his fees and expenses at the outset of the procedure. If the IP subsequently wishes to charge more than his original estimate, he must seek further approval from the creditors. The rules apply to the following insolvency procedures:

- administration;
- creditors' voluntary liquidation;
- compulsory liquidation (unless the Official Receiver acts as liquidator); and
- bankruptcy (unless the Official Receiver acts as trustee in bankruptcy)

The new Rules do not apply to the fees charged by the Official Receiver as they are already set out by regulations. Nor do they apply in the case of an Individual Voluntary Arrangement (IVA) or a Company Voluntary Arrangement (CVA), where IP fees are closely controlled by creditors. For obvious reasons, the new Rules do not apply in the case of Members Voluntary Liquidation, where the company is solvent and all creditors are paid in full.

Box 6: Key features of the *Insolvency (Amendment) Rules 2015*

- Introduces a requirement to provide a 'fees estimate' where an IP wishes to take remuneration on a 'time and rate' basis.
- IPs will not be permitted to draw fees in excess of the approved estimate unless creditors give further approval. This will therefore act as a cap on fees.
- Regardless of the basis of remuneration, IPs are required to provide clear information, setting out what work will be done and what it will cost to undertake that work (including anticipated expenses). This is for information only – creditor approval is not required.

  This estimate of work and expenses can be given up to completion of a case, or if not possible, up to a particular milestone or for a designated period.

It is hoped that these measures will increase transparency for creditors as they will have a much clearer indication of what the likely fees and

[15] SI 2015 No.443

costs of dealing with an insolvency will be. Creditors should be better equipped to challenge fees where they appear unreasonable. The new measures should also give IPs the opportunity to demonstrate to creditors what they do and the value they deliver in return for their fees.

These new rules should be seen in conjunction with the insolvency measures contained in the *Small Business, Enterprise and Employment Act 2015,* which are designed to strengthen the oversight regulation of IPs.

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