

Report on the Operation of Statement of Insolvency Practice 16

1 January to 31 December 2010

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Executive summary

The Insolvency Service has continued to monitor the operation of Statement of Insolvency Practice 16 (SIP 16) following the publication of previous reports during 2009. The background to the introduction of SIP 16 has been discussed in those reports. This report examines the extent of compliance with SIP 16 by insolvency practitioners during 2010.

During the period, we have received SIP 16 information in relation to 769 companies where the business or assets were reported as being sold through a pre-pack transaction. We have reviewed the disclosures relating to 538 companies (see section 2.3) and, of those, information in relation to 402 companies was found to be fully compliant with the SIP, representing 75% of the cases reviewed. Of the 136 cases found to be not fully non-compliant, we have referred 13 cases, involving 15 insolvency practitioners, to the relevant Recognised Professional Body for the matter to be considered from a regulatory and disciplinary perspective.

Overall compliance during 2010 has increased to 75%, from 62% in 2009. Generally, the quality and timeliness of reports we have received during 2010 has been much improved in comparison to those received during 2009. In particular, overall compliance for the latter six months of 2010 increased to 84%.

While there has been a slight increase in the number of pre-pack cases where director misconduct has been reported to The Insolvency Service, there is no reliable evidence to suggest that misconduct by directors is any more prevalent in pre-pack cases than in conventional administrations.

We remain satisfied that SIP 16 provides greater information for creditors at an early stage of administration, and a greater degree of transparency in pre-packs. It is particularly encouraging to note the increased level of overall compliance, and the improved level of information being provided in the majority of cases which we believe has led to a greater understanding of the reasons for particular pre-packs on the part of creditors and others affected by the process.

Notwithstanding the increased transparency of reporting under SIP 16, the use of pre-pack sales continues to attract criticism from creditors and the public which led to the previous Government's consultation on pre-packs being published in March 2010. The responses to that consultation and the Government's response are being published separately. This report solely considers insolvency practitioners' compliance with SIP 16.

Results of the review

The results of the review are divided into two areas: the findings that relate to insolvency practitioners' compliance with SIP 16, and those that relate to an analysis of returns received by insolvency practitioners on the conduct of company directors involved in pre-pack cases.

Regulation of insolvency practitioners

The regulation of insolvency practitioners in Great Britain is one of Government monitored self regulation. The Secretary of State has recognised seven professional bodies as being able to authorise their members to act as insolvency practitioners. There are also a number of insolvency practitioners directly authorised by the Secretary of State. The Insolvency Service exercises these functions on his behalf.

Each of those bodies have been recognised since 1986 and are collectively referred to as the Recognised Professional Bodies (RPBs). Each of the RPBs carries out regular monitoring visits to ensure that its practitioners are conducting their work in accordance with the legislation, guidance and Statements of Insolvency Practice (SIPs). Complaints regarding unprofessional, improper or unethical behaviour by an insolvency practitioner can be addressed to the appropriate RPB, who will decide if sanctions should be imposed.

In October 2009, the Insolvency Service published further guidance for insolvency practitioners to assist them in disclosing details of pre-pack sales. Each of the RPBs have agreed to have regard to that further guidance when considering the conduct of an insolvency practitioner.

Method and scope

The Insolvency Service has reviewed information disclosed by insolvency practitioners pursuant to the requirements of SIP 16 in relation to pre-pack administrations undertaken during 2010. The purpose of SIP 16 is to improve the transparency of the pre-pack process by the provision of timely information to creditors. We have therefore concentrated our review on insolvency practitioners' compliance with the disclosure requirements contained within SIP 16, taking into account further guidance issued by the Insolvency Service in October 2009.

In this period we have only reviewed a proportion of SIP16 statements received, rather than all statements received as in previous reports, though all have been recorded. Where we express a percentage of, for example, compliance with SIP 16, it is given as a percentage of the cases reviewed, not

the total received. The number of statements reviewed on a monthly basis has varied during the course of the year:

- From January to the end of April - 100% of those received;
- From May to the end of August - no less than 35% of those received;
- From September onwards - no less than 30% of those received.

In total, 70% of all statements received in relation to companies entering administration during 2010 were reviewed. The statements to be reviewed were selected on a random basis. When reviewing disclosures relating to the sale of a group of companies, we have also considered the other companies involved in the sale.

Wherever possible, we have sought to consider the nature of the underlying transaction in order to inform our understanding of the drivers for pre-pack administrations and the impact on creditors. In assessing the information provided by insolvency practitioners, we have consequently sought to form a rounded view of the disclosures made in light of the particular circumstances of the insolvency as known to us and by reference to the specific requirements, and spirit, of SIP 16. However, given the nature of this type of information the assessment as to whether or not adequate disclosures have been made by insolvency practitioners in any particular scenario is, to some extent, a subjective test.

Where we have formed the view that the disclosures made by insolvency practitioners are insufficient to give a detailed explanation and justification of the reasons for the pre-pack sale in line with the requirements of SIP 16, or where the disclosure is not sufficiently timely, we have recorded the information as non-compliant.

We have also reported a number of insolvency practitioners to their authorising body where we believe that the disclosures made are such that they could give rise to concerns about the conduct of the practitioner or where the level of non-compliance is substantial. Further information regarding such referrals is given on page 7 of this report, together with examples of regulatory action taken by the RPBs.

Number of pre-pack administrations during the reporting period

During the reporting period the Insolvency Service has received SIP 16 information from insolvency practitioners relating to 769 companies in administration. As this includes companies within a group structure, which may all be sold in a single transaction, the actual number of business sales reflected by this figure will therefore be somewhat lower. A breakdown of the information received by month is indicated in Figure 1 below.

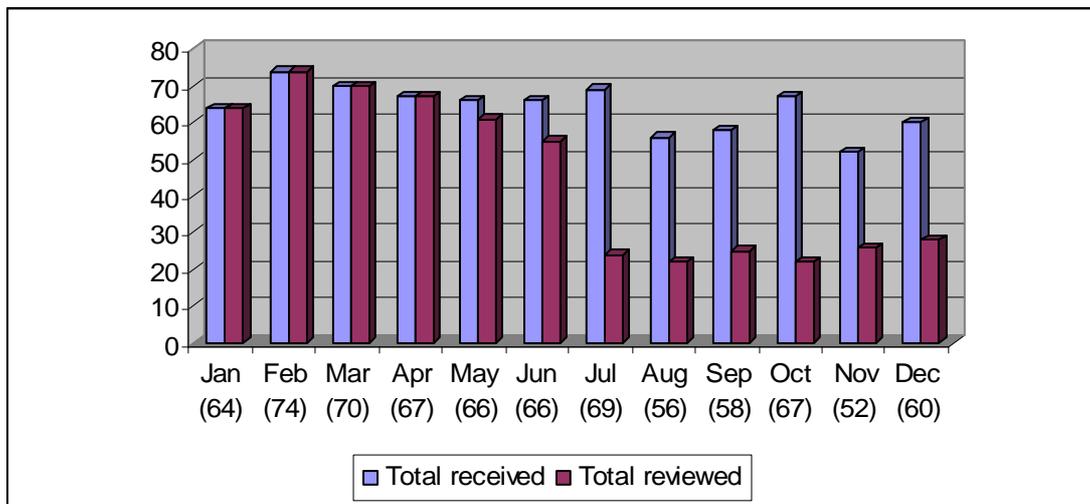
According to the official insolvency statistics, 2,835 companies entered administration during 2010, indicating that approximately 27% involved pre-pack sales during the period. This is presently the most reliable indicator of

the number of pre-packs undertaken, as there is no official statistical record of pre-pack sales.

As highlighted in previous reports, it is possible that the Insolvency Service is not being sent SIP 16 information in all relevant cases, leading to an under-representation of the extent to which pre-pack sales are being undertaken. This may be because there is no statutory definition of what constitutes a pre-pack administration, leading to interpretative differences as to whether or not a business sale has been facilitated in this way

Figure 1 indicates the number of companies for which SIP 16 information has been received by month:

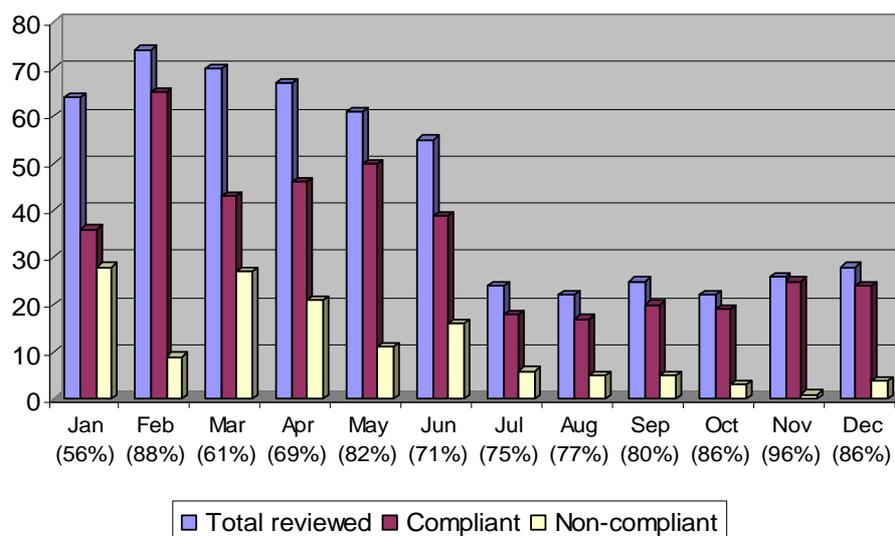
Figure 1 – SIP16 received by month



Insolvency practitioners' compliance with the disclosure requirements of SIP 16

During the period, information reviewed relating to 402 out of a total of 538 companies entering administration was in our view fully compliant with the disclosure requirements of SIP 16, representing 75% of the total. A breakdown of the information analysed by month is indicated at Figure 2 below:

Figure 2 – SIP16 compliance by month



Where we have formed the view that the nature of a deficient SIP 16 disclosure is substantial, the matter has been reported to the relevant authorising body, without prior reference to the relevant insolvency practitioner. We have also considered other issues not confined to information disclosure when reporting matters to authorising bodies, such as the timeliness of the provision of information and any third party information, such as complaints.

During 2010 we have reported 15 insolvency practitioners to their authorising bodies, so that their SIP 16 disclosures may be considered from a regulatory and disciplinary perspective. These disclosures relate to 13 companies in administration and represent around 2% of the cases reviewed.

The number of referrals made to each authorising body in relation to companies entering administration during 2010 is indicated in Figure 3:

Figure 3 – Referrals to Authorising Body

RPB (No. of authorised IPs as at 01/01/10)	No. of referrals during 2010
ICAEW – Institute of Chartered Accountants in England & Wales (678)	6
IPA – Insolvency Practitioners Association (476)	8
ACCA – Association of Chartered Certified Accountants (182)	-

LS – Law Society of England & Wales (155)	-
ICAS – Institute of Chartered Accountants of Scotland (115)	1
SoS – Secretary of State (88)	-
CAI – Chartered Accountants Ireland (38)	-
LSS – Law Society of Scotland (14)	-

The main areas of concern leading to SIP 16 information being marked non-compliant continue to be the issues associated with the timeliness of the disclosure, valuations, marketing and asset details. These aspects were all specifically addressed in the further guidance issued to insolvency practitioners in October 2009, and we are of the view that what should be disclosed, and when, is now clear.

We continue to see cases where insufficient information is provided concerning the valuation and marketing of assets. The nature of the assets and how values have been attributed to them is crucial in forming a proper understanding of the pre-pack transaction. In addition, the basis upon which substantial allocations are made to goodwill is not always explained.

These factors are predominant in contributing to SIP 16 information that, taken as a whole, does not provide the detailed justification and explanation required and therefore is considered non-compliant.

Results of previous referrals to the Authorising Bodies

Our previous reports stated that a number of insolvency practitioners had been referred their authorising bodies in order for potential regulatory breaches to be considered. While a number of those investigations are ongoing, we are aware of the following outcomes from those referrals:

Institute of Chartered Accountants in England & Wales (ICAEW)

- 1 Consent Order issued, £500 fine and £2,167 costs
- 8 Technical breaches – no regulatory action taken as creditors were not significantly misled
- 1 No regulatory action as new processes in place
- 29 No action as considered to be only minor breaches
- 2 Considered to be no breach
- 1 Withdrawn by Insolvency Service

Insolvency Practitioners Association (IPA)

- 2 Consent Orders issued with £250 fines and £250 costs
- 4 Consent Orders offered
- 6 Formal warnings for failure to comply with paragraph 8 of the SIP
- 5 Informal warnings
- 8 Formal reminders of duty to comply with SIP 16 and to focus on paragraph 8 of the SIP

3 Informal reminders of duty to comply with SIP 16 and to focus on paragraph 8 of the SIP

1 Firm's procedures for dealing with pre-packs issued after relevant appointment and appropriate controls now in place

8 Considered to be no breach

1 Withdrawn by Insolvency Service

Association of Certified Chartered Accountants (ACCA)

1 Consent Order offered

2 Formal warnings for failure to comply with paragraph 8 of the SIP

2 Technical breaches – no regulatory action taken as creditors were not significantly misled

2 Considered to be no breach

Secretary of State (SoS)

10 Warning letter issued, which will be taken into account when considering future authorisation.

Institute of Chartered Accountants Scotland (ICAS)

2 Formal reminders of duty to comply with SIP16

There are some differences in outcomes from referrals we have made to the Authorising Bodies and, in conjunction with them, we will be considering whether those differences, and any difference in publicity given to them, are justified by the nature of the breach.

Directors' Conduct

Method and scope

The Conduct and Complaints Directorate of The Insolvency Service's Investigations and Enforcement Services has continued to monitor potential conduct matters relating to directors in pre-pack cases reported under SIP16. This is done through the consideration of reports received by insolvency practitioners reporting under the Company Directors Disqualification Act 1986 and from the receipt of other intelligence.

Insolvency practitioner reporting under the Company Directors Disqualification Act 1986

Under the provisions of the Company Directors Disqualification Act insolvency practitioners acting as administrators have an obligation to report to The Insolvency Service, acting on behalf of the Secretary of State, within six months of the date of the administration order, on the conduct of the company directors. Where potential matters of misconduct have been identified the administrator will report these using a conduct return known as a D1. The Insolvency Service has discretion to investigate the directors of companies in which a D1 return has been submitted.

Alternatively, the administrator may also report that no matters of misconduct have been identified and this conduct return is known as a D2.

In relation to the 915 pre-packs notified to us during the twelve month period 1 July 2009 to 30 June 2010 (for which the corresponding conduct return was, therefore, due in 2010), The Insolvency Service has received 888 corresponding conduct returns from insolvency practitioners. Of these, 315 were D1s (unfitted conduct) and 573 were D2s (fitted conduct), representing 35% and 65% respectively of reports received. The proportion of pre-pack cases in which misconduct is also reported has, therefore, increased slightly (from 29%) when compared to those pre-packs notified during the six months to 30 June 2009. It is also slightly higher than the proportion of unfitted conduct reports received from insolvency practitioners in respect of insolvent companies generally which, in 2010, was 30%.

However, as with the previous periods reported, it remains the case that the misconduct identified by the D1 returns is not, in the great majority of cases, connected directly to the events surrounding the pre-pack itself, but rather is of a nature that is likely to have been evident whether or not a pre-pack had occurred.

This is also borne out by the pre-pack cases where enforcement action, following investigation, has resulted in sanctions against directors. However,

due to the timescales required for insolvency practitioners to collate any evidence of misconduct and present it to The Insolvency Service, and for enforcement investigations to be carried out, the number of unfitted conduct reports, in pre-pack cases during 2010, that have been taken to an enforcement conclusion remains limited.

In respect of all such reports received since July 2009, where there was also a pre-pack, so far 152 have been referred for further investigation of which 89 remain under investigation. Four cases have resulted in completed enforcement action with disqualifications of five directors for 3, 3.5, 4, 7 and 10 years, although in these cases the misconduct which lead to the disqualification was unconnected with the pre-pack sale.

Action relating to live companies

The Insolvency Service's Investigations and Enforcement Service also has responsibility for conducting investigations into companies using the statutory powers of enquiry contained in Part XIV of the Companies Act 1985 (as amended) – specifically under section 447. Such investigations are not publicly announced.

As a result of concerns identified from complaints, insolvency practitioner reporting, and other intelligence regarding directors' conduct in pre-packs, The Insolvency Service is positioned to investigate the affairs of both the old company 'oldco' (i.e. the company now in administration) and the new company 'newco' (being the purchaser of oldco's assets under a pre-pack arrangement).

In this connection so far three such cases have been investigated under the provisions contained in section 447 of the Companies Act although none have identified matters that require further action (in relation to the pre-pack sale or otherwise) which is consistent with the findings from insolvency practitioner reporting.

Summary

The level of misconduct by directors reported as occurring in cases that also feature a pre-pack has increased slightly (by 6%) when compared with the second half of 2009, and is now also slightly higher (by 5%) than the level of misconduct reported by insolvency practitioners generally.

The Insolvency Service will remain vigilant in its monitoring of director conduct in this regard. In respect of the wider potential misconduct identified, The Insolvency Service has an established and robust investigations process to target and disqualify directors who may have otherwise abused the privilege of limited liability.

Further analysis

In order to further inform our understanding of the nature of pre-pack transactions, we have carried out an analysis of the SIP 16 information received in relation to companies entering administration during the reporting period, in respect of:

- Sales to connected parties
- Whether the administrator undertook any marketing
- Whether any element of the sale consideration was obtained on a deferred basis

Below are the percentages for those categories, of the statements reviewed during 2010. Figures shown in brackets relate to 2009. Please note that the 2009 figures may differ from those included in our previous reports – this is due to additional cases for the relevant periods being received after the publication of our reports.

- **72%** of pre-pack sales were to parties connected with the insolvent company (79%)
- Administrators undertook some marketing in **44%*** of cases (38%)
- An element of the sale consideration was deferred in **58%** of cases (61%)

***does not include marketing that may have been undertaken by the company prior to the involvement of the insolvency practitioner**