Insolvency Service Call for Evidence: Bonding arrangements for insolvency practitioners

Response by the Association of Business Recovery Professionals ('R3') to the call for evidence issued in September 2016

Introduction

1. R3 is the trade body for the UK insolvency and restructuring profession. R3 represents insolvency practitioners working in firms of all sizes, from the global legal and accountancy firms through to smaller, local firms, as well as insolvency lawyers and other professionals working in the insolvency and restructuring profession.
2. R3 has focused this response on those areas where we can provide suitable comment based on the views gathered from our members. R3 represents a wide constituency across the insolvency and restructuring professions and we have therefore sought to provide a balanced summary of views. However, it should be recognised that R3 does not possess empirical evidence which may be required for substantive answers to a number of the questions raised. In such instances, this has been marked accordingly where it is believed that empirical evidence should be sought from third parties.
3. Members' views on the questions contained within the Call for Evidence were sought via meetings and email communication.

Executive Summary

4. R3 welcomes the Call for Evidence from the Insolvency Service. It is hoped that the evidence collected will enable government to undertake a comprehensive review of the current bonding system for insolvency practitioners and to draw substantiated conclusions on any proposals for reform. R3 is aware of the issues raised in relation to the current bonding system from a number of interested parties, including successor insolvency practitioners, the bond providers, and smaller insolvency firms facing increasing bond premiums.
5. R3 notes, however, that the incidence of insolvency cases featuring bond claims appears to be low based upon the Insolvency Service's reference (page 9 of the Call for Evidence) that 92 out of 56,443 cases in 2015 featured bond claims.
6. R3 believes that the introduction of a claims management protocol would be a welcome first step in resolving some of the issues with the current system. While this would not resolve specific fundamental weaknesses in the legislation, R3 believes that an effective protocol would improve communication, transparency, and help to simplify processes for all parties.
7. Whilst a claims management protocol is being developed, further consideration should be given to whether the bonding system needs to be removed entirely, or whether legislative amendments would be capable of resolving the issues which stem from weaknesses in the current legislation. In order for any further changes to be effective in achieving their objectives, a full consultation would need to be issued to provide adequate opportunity for all possible options and perspectives to be discussed and analysed.

Response

<u>Question 1:</u> These are the issues that have been identified as weaknesses of the current bonding system. Do you agree with this assessment? If you have any evidence, which demonstrates the impact of these weaknesses, it would be helpful if you could provide this.

8. As detailed below, some of the weaknesses identified are issues with the current bonding system. However, R3 does not have evidence to support some of the weaknesses identified by the Insolvency Service. It would be necessary for the Insolvency Service to seek this evidence elsewhere in order to support the assertion that the issues identified are weaknesses within the system.

1. Legal framework

a) ***The prescribed statutory requirements for bonds are unclear and expensive.*** *The requirements may be open to interpretation and do not allow for innovation by bonders – requiring submissions of cover schedules irrespective of the insurer's business model. The requirements for monthly cover schedules are burdensome and increase costs for creditors.*

9. The prescribed requirements for bonds are contained within Schedule 2 of the *Insolvency Practitioners Regulations 2005* (the Regulations). The requirements are not overly detailed and, as such, in principle they enable innovation and commercial considerations to be taken into account in the wording of the bonds by the bond providers.
10. R3 agrees in principle that the prescribed statutory requirements for bonds are unclear, in the sense that the majority of the detail for inclusion in the wording of the bond is left to the discretion of the bond provider. There are also no statutory definitions, in the Regulations or elsewhere, for what is meant by the terms "dishonesty", "connivance" or "collusion", which, it has been stated, has created some uncertainty about the circumstances of dishonesty which are covered by the bond and those which are not. In addition, it is not clear how assets held under reservation of title terms, VAT which is additional to an asset's value, or the interest earned by the estate are dealt with by the bond.
11. As noted above, only certain details are specifically prescribed in the Regulations for inclusion in bond wordings. This has meant that there is a wide variety in the wordings for bonds between bond providers, which is covered in more detail at paragraphs 37 and 38. It has also meant that, as a result of only certain details needing to be considered, bond wordings with potentially unintended consequences have been approved by the Insolvency Service. For example, there have been changes to the basis on which a claim can be made from a "claims occurring" to a "claims made" basis, which R3 understands has created issues for successor insolvency practitioners bringing a claim against the bond for an estate where the fraud was discovered outside of the policy period and is therefore not covered by the bond. R3 understands that it has also created difficulties for insolvency practitioners seeking to change bond providers.

12. R3 does not believe that, in a well-run practice, the requirements for monthly cover schedules are burdensome (as the systems for producing monthly schedules are automated) and should not substantially affect costs for creditors. Indeed, the monthly submission of cover schedules has advantages to regulators and practitioners. However, R3 would not disagree that simplifying this process may still be beneficial.
13. The requirement for cover schedules to be submitted on a monthly basis to the RPBs may be expensive for the Recognised Professional Bodies (RPBs) themselves, in terms of the time and resources required to process and review the schedules. Empirical data to support this view would be better sought from the RPBs.
14. It should be noted that the requirements for the cover schedules to be submitted and to advise the bond provider of any changes in the value of the estimated assets in a case on a monthly basis are not specified within the Regulations. These state that these actions must be undertaken *as specified in the bond*, and it would therefore seem to be at the discretion of the bond provider to state the timeframes in which they require submission of cover schedules. The requirement for the insolvency practitioner to submit these cover schedules (where a cover schedule has been submitted to the bond provider in that month) on a monthly basis to their RPB is contained within section 13 of the Regulations.
15. In addition, the Regulations relating to the calculation of bond levels may sometimes not reflect the level of potential losses to creditors. For example, third party contributions to costs, which do not form part of an insolvent estate from which creditors would ever suffer a loss, are still included in the calculation of bond levels. Similarly, excluding secured assets from the bond does not reflect the fact that a successor IP would still be required to pay secured creditors in the statutory order of priority.

b) Statutory cover limits are inadequate and inconsistent. *The monetary limits have not changed since the introduction of bonding requirements some 30 years ago. The GPS amount of £250,000 over all appointments is prescribed as an absolute and may no longer be adequate. Several recent insolvencies would exceed the maximum level set for the SPS.*

16. The statutory cover limit of £250,000 for the general penalty sum (GPS) is inadequate for contemporary insolvency proceedings. In the majority of bond claims and the majority of cases, the specific penalty sum (SPS) limit of £5 million is sufficient. There are, however, a small but distinct number of cases where the SPS limit is also not adequate. A case example has been provided to R3 where the level of assets to be realised in a members' voluntary liquidation (MVL) was £100 million, for which it was not possible to obtain bond cover for more than £5 million. In these instances, the bond provider and insolvency practitioner are barred from having a bond arrangement in place which would adequately cover the level of assets - effectively leaving creditors (and in the MVL example quoted, members) exposed to a higher degree of risk.
17. It should be considered, however, whether any increases to the statutory cover limits may result in an increase in overall bond premiums charged to insolvent estates, as there will be

a corresponding increase in risk for the bond providers. If this only affects the larger asset cases that are able to more easily absorb any increases in premiums, this may be an acceptable solution, but the possibility that premiums for all insolvency practitioners may also be increased needs to be considered. The impact on premiums of any increases to statutory cover limits must therefore be weighed against the benefits that this would bring.

18. Alternative options could include a tiered approach to GPS limits, which may help with ensuring that any rise in the overall limit of the GPS does not disproportionately affect premiums for smaller insolvency practitioners, who may not have sufficient assets in their cases to require an increase to the GPS in their bond cover.
19. Consideration could also be given to a similarly tiered approach to SPS limits, which would enable different levels of SPS cover for different types of cases. This would need to be analysed in detail to determine whether it would have a material effect on the cost of premiums.
20. Finally, the £5 million SPS limit could also be removed entirely. The SPS limit for an individual case could then be determined by the bond provider and the insolvency practitioner/creditors/members (dependent on the circumstances of the case), or an “exceptional” provision could be included which states that the value of the SPS may be increased to the value of a case’s assets, where agreed to by the relevant parties, i.e. the bond provider, insolvency practitioner, and the creditors/members. This would most likely only apply to larger firms with larger cases, and may not have a corresponding effect on the bond premiums for smaller firms, unless they are also undertaking work with high value assets above the £5 million threshold.

c) **Bonds rely on the honesty of a potentially dishonest insolvency practitioner to obtain adequate cover.** *The applicability and amount of the SPS depends on the honesty of the insolvency practitioner to make a correct declaration. If the insolvency practitioner either under-declares the value of the assets, or does not declare at all, then the only available cover would be a pro-rata portion of the GPS, assuming that the insolvency practitioner has that in place.*

21. It should be considered whether the monitoring systems of the RPBs adequately identify at a sufficiently early stage systematic under-bonding or other issues potentially indicative of fraud/dishonesty by an insolvency practitioner. An example was provided to R3 of a case where the successor insolvency practitioner had found that the original office holder had bonded all of their cases for the minimum £5,000 SPS. This had not apparently raised concern for either the relevant bond provider or RPB prior to the fraud/dishonesty being uncovered, despite cover schedules being submitted to both bodies as required.
22. While the RPBs are reliant on the information provided by the insolvency practitioners to determine the level of assets in the cases the insolvency practitioner is administering, it is important that the monitoring systems are sufficiently sensitive to identify where there may be issues in the cover schedules being submitted: this was, presumably, the intention behind

the statutory requirement for insolvency practitioners to submit the cover schedules on a monthly basis to their RPBs. More effective regulatory systems, and increased communication between bond providers and the RPBs, could help to reduce systematic under-bonding and instances of undetected fraud and dishonesty. This may also particularly assist with the situation whereby an insolvency practitioner does not make the necessary bond premium payments to the bond provider and may in effect not be bonded. Increased communication could mean that these situations are more quickly brought to the attention of the relevant RPB by the bond provider, who can then act as necessary in relation to the information.

23. R3 acknowledges that for a bond claim to be brought, it does not need to be proved that there was intent to be fraudulent or dishonest, which means that there may be instances where the actions undertaken by an insolvency practitioner could appear to be fraudulent or dishonest, although this was not the intention behind the actions. Similarly, it should also be noted that an insolvency practitioner may miss a premium payment or under-declare the value of assets for a range of reasons, including simple human error.

d) **The proceeds of a bond claim are not ring fenced.** *Once a claim is made, it is paid into the estate and treated in the same manner as any other asset, and is subject to the usual order of priority of costs and fees of the proceedings. We are told it is often the case that creditors who may have been adversely affected by the fraud will receive no direct financial benefit from a successful bond claim.*

24. R3 does not have access to empirical evidence to support the claim that creditors have not been receiving any direct financial benefit from successful bond claims. This evidence would be better sought elsewhere.
25. R3 believes that it is important from both an economic and moral position that fraud and dishonesty are uncovered and, insofar as is possible, restitution is made to the estate for the benefit of creditors and/or members. This should also be supported by robust regulatory processes that discipline the insolvency practitioner(s) involved.
26. However, it cannot be expected that successor practitioners undertake complex, and potentially lengthy, investigative work for no fee. While successor practitioners' fees should perhaps not be so high as to unfairly reduce the returns to creditors, the wider value of the work undertaken in uncovering instances of fraud needs to be acknowledged. This should, however, be considered in the wider context of a need for transparency and openness about successor insolvency practitioner fees to ensure that bond providers and creditors/members are given an adequate opportunity to understand and, if necessary, challenge fees.

e) **Lack of provision/control over successor insolvency practitioner fees**. *The costs of investigating fraud are provided for by the bond, but the liability of the surety is capped at the value of the SPS. The only control over costs is that they are paid at the discretion of the* *surety which can lead to uncertainty. Successor IP fees are determined in the usual manner with any insolvency, though different rates may be charged for bond claim work. Given the age of cases, it can be difficult to engage creditors on these issues. As a result, successor IP fees may exceed the amount available under a bond claim leaving no money left for distribution to creditors.*

27. R3 is not in a position to provide evidence to support the claim that successor practitioner fees may exceed the amount available under a bond claim leaving no money for distribution to creditors. R3 suggests that this evidence needs to be sought from the bond providers, successor practitioners, relevant creditor bodies, or creditors themselves (who have or may have been affected).
28. There are already controls in place for ensuring that successor insolvency practitioner fees are not excessive. The costs associated with a bond claim need to be agreed with the bond provider/loss adjustor before they are paid out as part of a claim. Further to this, the basis on which a successor practitioner may calculate fees is through either the original fees resolution agreed for the case, or through a subsequent resolution passed by creditors/committee/members as relevant.
29. For those cases subject to the new fees estimates regime, the involved successor insolvency practitioner will also be bound by the original fees resolution, unless they obtain a new approved resolution from creditors. This may have a future effect on the costs charged by a successor practitioner, although it may be some time before this is discernible.
30. R3 considers it important that a balance is struck between the need for investigation of dishonest and/or fraudulent activities in order to seek appropriate restitution for the estate, and the need for transparency and appropriate approval processes for the fees being charged for such work.

f) No statutory requirement for professional indemnity insurance. *There is no statutory requirement for specialised PII, which is instead governed by the rules of the individual RPBs, whose requirements differ.*

31. There is no statutory requirement for insolvency practitioners (or their firms) to hold professional indemnity insurance. This is not, however, a weakness of the legislation, as the RPBs require insolvency practitioners to hold this type of insurance in order to obtain and hold an insolvency licence. In practical terms, there is no material difference between the requirement for an insolvency practitioner to hold professional indemnity insurance being a statutory requirement or a regulatory requirement. Under the current system, if an insolvency practitioner does not hold the requisite professional indemnity insurance, then they are effectively barred from holding a licence and cannot take appointments.
32. There are, however, inconsistencies across the RPBs in terms of the requirements to hold professional indemnity insurance. Greater consistency in this area may be beneficial for the insolvency profession as a whole from a simplicity perspective, although it is not clear what

practical difference the different requirements have from the perspective of the claimant. Given the relatively small size of the profession, it is also not clear why there are different requirements for professional indemnity insurance across the different RPBs. If there is a practical difference, it may not be necessary for greater consistency to be achieved through legislative means, as it could also be achieved through other, less formal, mechanisms, such as the voluntary alignment of the current professional indemnity insurance regulations across the RPBs. Nonetheless, this alignment may still be beneficial

33. This type of alignment could also provide an opportunity to resolve some of the current differences with the professional indemnity insurance regulations. For example, the Insolvency Practitioner Association's regulations require a minimum professional indemnity insurance cover of 2.5 times the gross fee income. While the maximum figure for firms is set at £1.5 million, there is no maximum figure set for partnerships. In contrast, the Institute of Chartered Accountants in England and Wales require a minimum professional indemnity cover of 2.5 times the gross fee income, if the insolvency practitioner's turnover is less than £600,000 (with a minimum cover of £100,000), or a minimum cover of £1.5 million if their turnover is higher than this.
34. A review of the professional indemnity insurance regulations to identify inconsistencies and other issues which need to be resolved would be beneficial for the profession, regardless of any decision regarding the current bonding system.

g) **The bond only covers fraud and dishonesty by or with the collusion of the insolvency practitioner.** *There is no regulatory or statutory requirement for insolvency practitioners or firms to hold fidelity guarantee insurance which would cover fraud or dishonesty of a director or employee without the knowledge or collusion of the insolvency practitioner.*

35. The statutory requirements for bonding only cover instances where there is fraud or dishonesty by an insolvency practitioner, or fraud and dishonesty undertaken by an employee or colleague of the insolvency practitioner with the collusion or connivance of the insolvency practitioner. As noted above, there is no statutory definition for what precisely is covered by these terms. R3 agrees that it is a weakness that there are currently no consistent regulatory or specific statutory requirements which provide protection for creditors from fraud or dishonesty of a director or employee without the knowledge or collusion of the insolvency practitioner.
36. Fraud and dishonesty by an employee or director without the knowledge or collusion of the insolvency practitioner could be more likely to occur in firms with extended hierarchies, which may result in an insolvency practitioner having less direct oversight of their cases than would otherwise be the norm. This, in itself, may create more opportunities for employees to act fraudulently or dishonestly. However, larger firms with extended hierarchies also have more opportunities for third party review of cases, which in turn may reduce the instances of fraud or dishonesty.

37. Any changes in the requirement to hold fidelity guarantee insurance would need to be carefully considered. Such a requirement would likely result in an increase to insurance premiums for insolvency practitioners, which may be disproportionate to the risks involved. It would also need to take into the account the impracticality of requiring all firms to hold fidelity guarantee insurance; for example, there would be little point for a sole insolvency practitioner with no employees to hold this type of insurance.

2. Practical issues

a) Variation in particulars of bond wording causes confusion. *There are wide variations in cover between bond wordings, particularly in terms of deadlines, limits on liability, and maximum indemnity periods. These depend not only on the bond provider but on the date of issue. There are reported issues with successor practitioners obtaining copies of the relevant bonds, and having to submit protective claims in order to ensure that cover will be available.*

38. R3 does not have access to empirical evidence regarding any variations in cover between bond wordings, although anecdotally this appears to be the case. Some members have advised that the differences in wordings between the different bond providers have created difficulties when seeking to change bond providers. However, R3 acknowledges that, in line with the current statutory requirements, the wording of bonds is subject to the commercial considerations of the bond providers.

39. An area which may require greater clarification is that of early notification of claims. There appear to be differing interpretations about what constitutes early notification, who is able to provide this notification, and to whom it should be made. This seems to have created difficulties for successor insolvency practitioners, the RPBS, and the bond providers. Clarifying exactly what is needed for a bond provider to be notified at an early stage that there may be a potential claim may help to alleviate some of the apparent miscommunication and the perceived adversarial nature of some claims processes.

b) Increasing costs of premiums. *In response to perceived risk, we are informed that some bond providers have increased SPS premiums for smaller firms (two or less insolvency practitioners) by up to 200% for 2016. While pricing is a commercial matter for insurers, concerns have been raised that smaller insolvency practices could be priced out of the market, which would reduce competitiveness.*

40. There have been substantial increases in the SPS premiums charged by some bond providers for smaller practices since 2015, which is of particular concern to R3. R3 understands that the same increases have not been applied to larger firms. This is presumably due to a difference in perceived risk as a result of the greater third party scrutiny available to larger firms, and potentially fewer bond claims where a larger firm is able to cover any losses caused by fraudulent activity on an estate without recourse to the bond being required,

which smaller practices may not be resourced to do. Larger firms also often have risk or other oversight committees which provide a greater level of 'independent' oversight within the firm.

41. Smaller practices are extremely valuable to the insolvency profession, the wider UK business community, and the UK economy. Where there are sufficient funds, the costs of the SPS premiums are borne by the insolvent's estate, but any increase could nevertheless affect competitiveness. R3 is concerned that pricing smaller insolvency practices out of the market will reduce the availability of local small practices and will not just reduce competitiveness, but will very likely have a wider range of detrimental effects on the UK economy as a whole.
42. Across the UK, there are currently a large number of smaller firms of insolvency practitioners who are readily accessible to local small or medium enterprise (SME) business owners. These practitioners are uniquely well qualified to give personal, face-to-face advice on how SME businesses can manage and, where possible, recover from their financial difficulties.
43. Where an SME business has run into financial difficulty, the availability of a locally-based insolvency practitioner who understands their needs, the state of the local economy and market, and who can call upon a diverse range of local contacts and professionals to assist the business, can be crucial in finding the best possible solution.
44. It is therefore very important that smaller firms are not inadvertently priced out of the insolvency market. Continuing increases to bond premiums will likely result in smaller practice insolvency practitioners either leaving the profession entirely or merging with or joining larger sized firms, eventually resulting in fewer smaller firms in the profession.
45. Despite the above, R3 is aware that the pricing of bonds will depend on the risk profile of the firms that the bond providers are being asked to provide cover for. R3 acknowledges and respects that this is a commercial decision for the bond providers and that bond providers will make decisions about bond premiums based on the perceived risk to their own business.

c) **Adversarial nature of claims.** *We understand there is little interaction between successor practitioners and sureties, with the insolvency practitioner carrying out their usual statutory duties and any investigation according to their own judgement. There is often no discussion or sanction of investigatory work by the surety, who are presented with costs only at the claims stage. There is no agreement to determine the amount of work to be undertaken, which insurers claim can on occasions be disproportionate to the loss suffered by the estate. This lack of co-operation can lead to delays in settling claims and increase costs to the detriment of creditors.*

46. Some bond claim processes appear to be adversarial in nature, although R3 is aware that there are differing views on where the lack of engagement and adversity stems from. Regardless, anecdotal evidence suggests that there are issues with communication between the parties to a bond claim, which may be affecting the effectiveness of the bond system as a whole. There are requirements in the bond wordings regarding communication and notification, which may need to be clarified to ensure that each party is aware of their

obligations and when they need to become actively engaged in the bond claims process. As noted above, there seem to be particular issues surrounding what constitutes effective notification of a bond claim (including early notification of a bond claim), and it may be beneficial to provide further clarity on this to ensure that this is firmly understood by all parties.

47. R3's comments at paragraphs 27-29 set out R3's views relating to the costs of successor insolvency practitioner work. This has also been commented on further in response to the questions in the Call for Evidence relating to the claims management protocol.
48. Of equal concern appear to be issues with communication and engagement between the bond providers and the RPBs. It would seem prudent that, where RPBs have been notified that an insolvency practitioner has not been paying their bond premium (which may be suggestive of wider issues with the insolvency practitioner's practice), this triggers engagement on the issue. Stronger engagement between the bond providers and the RPBs should be encouraged and facilitated in order to ensure that 'early warning signs' of issues with bond cover or wider issues of misconduct are identified and acted upon.
49. It may also be worthwhile reviewing the matters which have triggered a successful bond claim in the past in the context of how this matter would be treated by an RPB if picked up as part of the regulatory process.

d) Cessation of cover on non-payment. *Some bonds provide that cover is only available when the premiums are paid. While the enabling bond is paid at the outset of cover, the SPS is collected throughout the year as appointments are taken. Where an insolvency practitioner fails to maintain payments, it is reported that in some instances insurers are terminating cover retrospectively which leaves estates without protection.*

50. R3 acknowledes that, from a commercial perspective, it is reasonable that bond cover is only available when premiums are paid (albeit only certain bond providers have this as a term included in the bond itself). It would be unreasonable to expect that bond providers should still pay out on a bond where an insolvency practitioner has committed fraud or acted dishonestly during a period of time when they not paid their bond premiums (although this becomes less clear cut when that premium was deferred/then paid at a later date).
51. However, it appears that there may be inconsistencies between the bond providers in terms of when bond covers remain in place despite a premium not being paid. R3 believes that the non-payment of bond premiums should act as a trigger point for further monitoring or review by the relevant regulator. While there may be innocuous reasons for the non-payment (including simple human error), this should be investigated and determined by the RPB at the earliest opportunity, given the potential ramifications of non-payment of bond premiums on the protection available for creditors.
52. Further clarification and consistency is also needed regarding how non-payment of bond premiums is treated and how this affects the application of bond cover. Clarification is also

required in instances where a new case has been placed on the cover schedule, and so a bond provider has been notified of its existence, but there is a gap of several months before the premium for this new case is invoiced. R3 has been informed that it is not clear, currently, whether the latter case would be covered by the bond at the point of notification or at the point of invoicing. While this is likely a commercial decision for the bond providers, further clarification and consistency on this issue would be beneficial.

e) **Limited number of insolvency practitioners willing to take on successor appointments.** *Currently there are only a small number of insolvency practitioners willing to take on successor appointments, which means that there is little competition and to some extent those undertaking successor appointments can set their price for undertaking this type of work.*

53. R3 is aware that there are only a small number of insolvency practitioners who currently undertake successor insolvency practitioner appointments. There are a variety of reasons for this, including the risks associated with this type of work (which may involve writing off large sums of costs and disbursements where cases, particularly those in a block transfer, are found to have no assets); the need for specific expertise in investigatory work which may take time and expense to acquire; and the time involved in reviewing a large number of cases and then undertaking a detailed analysis where instances of fraud or dishonesty are suspected.
54. R3 understands that a successor insolvency practitioner is rarely able to undertake any due diligence prior to taking an appointment, and will have to review the relevant cases after the appointment takes place. Anecdotal comments indicate that a large number of cases with a successor insolvency practitioner appointment need to be closed at great expense, which is not able to be recovered from the estate, although empirical evidence to support this would need to be sought from successor insolvency practitioners themselves. R3 cannot comment further on whether more insolvency practitioners should be involved in successor work, as this is a commercial decision for the individual insolvency practitioner and/or their firm.
55. It is not clear to what extent the small number of successor insolvency practitioners affects the setting of fees, although basic market theory would indicate that a greater number of successor insolvency practitioners could lead to lower costs.
56. There also appears to be a general lack of clarity and understanding within the wider profession around the processes for being alerted to the opportunity of a successor appointment, the processes for being appointed as a successor, and when an RPB should intervene in this appointment. It is not clear whether the RPBs appoint particular insolvency practitioners as successor insolvency practitioners to the exclusion of others, and, if this is the case, the reasons for doing so. More extensive and clearer information on this could be beneficial in making these appointments more accessible to the wider insolvency profession.
57. There needs to be greater clarity about the differences in the types of appointments and subsequent processes required to be undertaken by the successor insolvency practitioner. It

should be remembered that not all successor practitioners are appointed with bond claims in prospect. For example, cases where successor insolvency practitioners are appointed (usually because they have been named by another insolvency practitioner as their successor) where an insolvency practitioner has retired or is ill are distinct from cases where successor practitioners are appointed where there has been disciplinary action or there are suspicions of wrong-doing. Many insolvency practitioners are willing to act as successor insolvency practitioners in the former instance, but if this is to continue, any measures taken to resolve weaknesses in the bonding system should recognise and distinguish this largely non-contentious role. Clarity on the expectations and duties of the successor insolvency practitioners in each instance is therefore needed.

<u>Question 2</u>: Are you aware of any other weaknesses with the current system that have not been identified? Again, it would be helpful if you could provide any supporting evidence.

58. R3 has identified other weaknesses in the current system, which include:

    a. The lack of transparency and oversight into successor insolvency practitioner work. There appears to be a particular gap in the monitoring of successor insolvency practitioners, especially with regards the investigatory side of their work, where it is not clear that this lies within the ambit and responsibility of the RPBs, as the work undertaken may not be that envisaged by the *Insolvency Act 1986*. This lack of transparency has potentially created issues and misconceptions, as R3 believe that it may not be clear to all the monitoring bodies whether this work is (and should be) regulated in accordance with the insolvency legislation. Greater clarity is required regarding who has the responsibility, and the processes that should be used, for monitoring the work of successor insolvency practitioners with regard to any investigations into fraud and dishonesty, particularly those which may become the subject of a bond claim.

    b. Instances of fraud and dishonesty not being identified during routine monitoring. As mentioned earlier, instances of fraud and dishonesty may not be identified during routine monitoring visits by the RPBs. This might imply that the current monitoring processes may not be robust enough to detect fraud, dishonesty, and potentially other issues at a sufficiently early stage. Further consideration should be given to how the monitoring processes of the RPBs could be improved to increase the likelihood that these issues are being picked up.

    c. The lack of a clear definition for what constitutes dishonesty. As noted above in paragraph nine, there need to be clearer definitions for what constitutes dishonesty for the purposes of the bond. While a successful bond claim for fraud requires a criminal conviction, there is no similar requirement for dishonesty – this not being a criminal offence. Greater clarity around what constitutes dishonesty, particularly to distinguish it from incompetence or a genuine mistake, and what is required to prove its existence in a particular case, would be beneficial for all parties and the bonding system as a whole.

<u>Question 3</u>: Do you think that similar arrangements to those covering fraud and dishonesty in the legal profession would work in the insolvency profession?

59. There would be significant barriers to introducing a similar arrangement (that is, an equivalent of a solicitors' compensation fund) to that used by the legal profession for the insolvency profession. The first barrier would be securing sufficient funding for the fund. Given that there are bond claims up to £5 million, any fund would need to be able to absorb such claims, requiring significant 'upfront' funding at the inception of the fund.
60. There are also currently approximately 176,000 solicitors (136,000 practising) paying into the Solicitors Regulation Authority Compensation Fund, compared to 1,600 insolvency practitioners (of whom around 1,300 take insolvency appointments). The attendant cost of paying into a fund would therefore be spread across a much smaller number of practitioners within the insolvency profession, meaning that the cost for each insolvency practitioner would be much higher than that for each solicitor. This may disproportionally affect smaller insolvency practitioner firms and could be more expensive than the current bond premiums.
61. If a fund was to be introduced, and adequate means to fund it found, it is not clear who would have responsibility for administering the fund. It would need to be considered whether there would be a number of funds (each administered by the relevant RPB for their members) or if there would be a central fund, with the associated difficulties in determining where responsibility for administering this fund would lie.
62. It should also be noted that there is no entitlement to money for claimants to the Solicitors Regulation Authority Compensation Fund as it is entirely discretionary. Unlike in bond claims, where the bond provider is required to pay out the bond money if fraud and/or dishonesty are proven, there is no such requirement for money from the fund to be paid to successful claimants. As such, the concept of a similar fund to replace the bonding system may only offer more limited protection to creditors.

<u>Non-legislative and regulatory changes</u>

a) Claims management protocol

63. A claims management protocol could be an effective means for managing some of the issues identified above. A protocol will not be able to resolve the fundamental issues with the legislation (which would require legislative change or repealing the entire bonding system, as has happened in other jurisdictions), but it may be able to mitigate some of these. It would be essential that any claims management protocol is established with the input of all relevant parties, including the bond providers, successor insolvency practitioners, and the

RPBs. As the trade body representing the insolvency profession, it would be logical for R3 to provide input to this process.

64. For a protocol to be effective, it is essential that it does not seek to cover in explicit detail every possible scenario that could arise as part of a bond claim process. Expectations regarding communication, engagement, and notification need to be clearly stated, and relevant definitions for dishonesty, collusion, and connivance should be included. The basic process for managing a bond claim, and also for undertaking the investigatory side of successor insolvency practitioner work, including around appointment of successor insolvency practitioners, should be outlined. There should be explicit requirements relating to transparency and the approval processes for successor practitioner fees and other associated costs.
65. The protocol should also address the timing of payments to the successor insolvency practitioner. The uncertainty surrounding the funding of work by a successor practitioner appears to be a deterrent to many insolvency practitioners becoming involved in this work. It would be helpful if the protocol was to promote transparency around this area for practitioners who comply with the protocol.
66. The role of the RPBs in monitoring successor insolvency practitioner work should be outlined, as should expectations on engagement between the bond providers and the RPBs where there are concerns around matters such as consistent under-bonding or missed bond premium payments. Clearer monitoring processes and methods to identify and determine instances of fraud and dishonesty at an earlier stage in the regulatory process may also need to be established, although this may be considered a separate issue.

b) Approved panel of successor insolvency practitioners

67. The introduction of an approved panel of successor insolvency practitioners is not necessary to resolve the issues associated with the current bonding system. While the idea of a panel, particularly if panel members are required to abide by the claims management protocol discussed earlier, has some merit, there are practical issues associated with a panel and other methods of resolving the identified issues are likely to be more effective.
68. If a panel were to be introduced, it should provide for the appointment of successor insolvency practitioners only where fraud or dishonesty is suspected (or where an insolvency practitioner has had their licence removed), rather than including the appointment of successor insolvency practitioners in non-contentious cases (that is, those where there is no expectation that a bond claim will need to be made). In the latter case, there is clearly a need for a much wider number of insolvency practitioners to be able to act as a successor insolvency practitioner. Insolvency practitioners should remain free to elect their successor in the event of their retirement or illness.
69. Consideration would need to be given, however, to the potential problems with such an approach for cases where a successor insolvency practitioner is appointed and discovers instances of fraud or dishonesty in the successor cases, although this was not suspected

prior to the transfer of cases from the original office-holder. In these instances, would it be necessary for another block transfer of cases (with the relevant costs and time involved) to occur to a successor insolvency practitioner who is also a panel member, and so able to investigate instances of fraud or dishonesty? A more sensible approach could to be to require, in these rare instances, that the successor insolvency practitioner agrees to observe the protocol and the processes contained within this in relation to any bond claims.

c) A requirement that investigation costs must be proportionate to loss

70. Further evidence is required as to what extent investigation costs for successful bond claims might have been disproportionate to loss; R3 cannot provide such evidence.
71. R3 believes that to specify that investigation costs must be proportionate to loss is not an appropriate measure to control successor insolvency practitioner costs. Instead, the protocol should focus on transparency and approval processes. The approval processes may need to accommodate engagement with the bond providers, as well as the normal creditor approval provided for in the insolvency legislation. It may be appropriate for it to distinguish between certain elements of the costs incurred.
72. It may also be appropriate for such measures to apply to other costs, such as legal costs, which may be undertaken by other professionals such as solicitors.
73. Any such requirement should also apply to any other profession which is qualified to take on the investigatory work of a successor insolvency appointment, such as an auditor or forensic accountant.

d) Greater transparency over rates for investigation of fraud and dishonesty.

74. There needs to be far greater transparency over the rates for investigation of fraud and dishonesty. Both bond providers and creditors/members need to have this information available to them when either approving a fees estimate or when settling a bond claim. Successor insolvency practitioners should also make clear in statutory reports to creditors/members what effect any difference in rates from their predecessor's has had, or is likely to have, on the overall costs to the estate.

<u>Question 4:</u> Are there any other issues that you would like to see addressed through a claims management protocol?

75. As noted earlier, the claims management protocol should not be overly detailed nor seek to cover all possible scenarios, but should instead use a principles-based approach. It should clearly outline the successor insolvency practitioner process and ensure that the processes used when dealing with successor cases are transparent, and able to be adequately monitored by the RPBs. Consideration could also be given to whether the principle in SIP 2, which requires an insolvency practitioner to consult with creditors before undertaking detailed investigations, especially where there are funds in the estate that could otherwise

be distributed, should also be included in the protocol for instances where an estate's funds could be being used to fund an investigation by a successor practitioner into a potential bond claim (especially if the suspicion originates from another case).

Legislative changes – options

Option 1 – Do nothing

<u>Question 5:</u> Do you think the introduction of a claims management protocol and regulatory action, alongside the existing legislative framework, would be sufficient to resolve the weaknesses identified with the bonding system?

76. While a claims management protocol, and contemporaneous changes to regulatory and monitoring processes, should be introduced as the initial steps towards resolving the issues and weaknesses in the current bonding system, the weaknesses identified in the legislation cannot be resolved without legislative change. Weaknesses in legislation cannot be solely addressed through non-legislative means, as the legislation will always have priority over any non-legislative/voluntary arrangements, such as a protocol.
77. Whilst R3 believes that the introduction of a protocol would be a positive first step, R3 also believes that further consideration should be given as to whether legislative change or removal of the bonding system entirely (in effect, the repealing of the legislation relating to bonding, which has occurred in other jurisdictions) is required. R3 recognises that any legislative changes will take time to implement and may not currently be of particular priority for the government. Nonetheless, it will be necessary if the weaknesses identified with the current system are to be properly resolved.

Option 2 – Repeal legislative requirements

Question 6: what do you consider would be the likely impact of removal of the statutory bonding requirements for a) insolvency practitioners and b) the protection of creditors?

78. It is not possible to predict the likely impact of removing the statutory bonding requirements, without it first being clear what the replacement for these arrangements would be. It would not be advisable for these requirements to be removed without first having another mechanism in place to protect creditors/members in instances of fraud and/or dishonesty by insolvency practitioners or their staff. The impact of removing bonding arrangements could be positive for insolvency practitioners in terms of business costs and resulting competitiveness, but this would depend on the nature of the replacement. For example, extended professional indemnity insurance would probably result in higher premiums which would have to be borne by insolvency practitioners, but it is not possible to judge the likely costs of these premiums based on the current information available.
79. R3 understands that the requirement for bonding was removed in Australia and replaced with a version of extended professional indemnity insurance cover. R3 would suggest that the Insolvency Service undertakes research into how the insurance systems for insolvency

practitioners operate in other jurisdictions, and then undertakes a detailed analysis and consultation as to what would be the most appropriate replacement for bonding in the UK, if it were to be removed entirely.

Option 3 – Amend the current legislation.

a. **Amend the current prescribed terms of a bond**

80. The current prescribed terms of a bond need to be amended. Amendments should include statutory definitions for dishonesty, collusion, and connivance. Further amendments could be made to ensure that the language in the legislation is clear, which will help with reducing inconsistencies in bond wordings.

b. **Provide that the proceeds of a claim for the benefit of creditors are ring-fenced from the investigation costs**

81. Given the importance and complexity of the work being undertaken, it is important that there is no perception (or reality) of successor insolvency practitioners being expected to undertake this work for no payment. If arrangements are put in place to ensure that there are robust requirements for transparency and approval of the costs and fees involved, R3 does not believe that the ring-fencing of a bond claim is appropriate or necessary.

c. **Provide for investigative costs as a prescribed requirement of the bond**

82. The paragraphs above relating to the introduction of a protocol envisage closer interaction between the bond providers and the successor practitioners, which should promote common goals to ensure that portfolios of cases where fraud and dishonesty are suspected are reviewed at an appropriate cost. It may be appropriate to bring an element of this into legislation in due course if it would assist to ensure that all bond providers now and in the future are required to promote such a pragmatic approach. It is important that flexibility exists so that the circumstances of each case or portfolio of cases are dealt with appropriately.

d. **Agree or legislate for a 'de minimis' maximum indemnity period**

83. R3 would support the introduction of a two year period to submit the bond claim post appointment of the successor insolvency practitioner or post the original office holder ceasing to act as the appointment taker. This time limit has been in place in most bonds that were written in the past and seems to be sufficient to allow for the notification of claims.

e. **Remove requirements for monthly cover schedules and provide for an annual or global bond cover**

84. . An annual or global bond cover may not be appropriate for all members of the insolvency profession and must be researched thoroughly.

f. Amend the existing monetary limits of the GPS/SPS

85. While R3 considers that other mechanisms would be more effective at resolving the issues in the current system, amending the existing monetary limit for the GPS or SPS could be supported, provided that extensive analysis is undertaken and other measures introduced to minimise any associated rise in premiums for insolvency practitioners, much of which would be borne by the insolvent estates.

g. Introduce a duty that investigative costs must be proportionate to loss/cover

86. Please refer to R3's comments at paragraphs 69 to 72. R3 does not believe it to be appropriate to include a legislative duty requiring investigative costs to be proportionate to loss and/or cover.

h. Protect estate from non-payment of the bond premium

87. Mechanisms need to be implemented to ensure that bond premiums are paid, and that estates are protected from any non-payment of premiums. It is not clear, however, why this should require legislative change. Alterations to the communication and monitoring processes of the RPBs and the bond providers may be more effective at ensuring that the estate is protected. It is important that any changes introduced are not so onerous as to force (the commercially unviable) result of a bond provider being forced to pay on a bond claim where bond premiums have not been met, as this may have unintended consequences in terms of the attractiveness of bonding insolvency practitioners for bond providers, who may then decide to leave the market. It may be that if cover is to be refused for non-payment of a bond premium, there could be a requirement for the termination of the bond cover to be formally notified to the insolvency practitioner's RPB, with a clause allowing reinstatement of cover should the RPB choose to pay the outstanding premium, in its role as beneficiary of the bond.

i. Include professional indemnity as a requirement for security, including run-off cover

88. While this does not necessarily need to be a statutory requirement, more consistent regulatory requirements for professional indemnity insurance, including run-off cover, could be considered. R3 would, however, have concerns regarding the potential cost of providing this run off cover and would suggest that the associated costs should be considered.

j. **Agree or legislate for IP firms to hold fidelity guarantee or similar insurance to protect creditors from fraud by people other than the IP**

89. A requirement for insolvency practitioner firms to hold fidelity or similar insurance has merit. This is a particular gap in protection for creditors, who are currently not shielded from fraud committed by employees or other associated parties without the collusion or connivance of the insolvency practitioner. As with the other changes to arrangements, careful consideration would need to be given as to any increased costs for insolvency practitioners associated with this change.

Question 7: Do you consider we have correctly assessed the advantages and disadvantages of these options set out above, and the potential impacts? If not, please give your reasons.

90. The advantages, disadvantages, and potential impacts of the options have been outlined in both the Call for Evidence and in this response. Nonetheless, it is also worth emphasising the importance of ensuring that the consequential increases in premiums for insolvent estates and insolvency practitioners are taken into account when considering any changes to the current system.
91. If a claims management protocol is introduced, consideration should be given to the level of scrutiny required to ensure that all parties are properly engaging in the process, and with which body the responsibility for ensuring this should lie.

Question 8: Do you agree the paper sets out the full range of issues, or is there anything further which should be considered?

92. It is essential that the Insolvency Service also considers the key performance indicators which will be used to determine that the implemented changes are successful in resolving the weaknesses and issues identified with the current bonding arrangements.
93. Measurements for success need to be determined, so that any change can be evaluated in terms of the positive impact that it has made. Potential measurements for success which the Insolvency Service could consider include:
    - More insurers entering into the market (if the bonding system is retained), with associated decreases in premiums which will allow smaller practice insolvency practitioners continued access to bonding.
    - Greater transparency over the appointment of successor insolvency practitioners and also increased monitoring and transparency of the processes used to deal with their cases.
    - An increased understanding of the bonding system and the processes used for making claims, which could be evidenced by a decrease in the number of bond claims being denied due to issues with cover originating from the initial office-holder.
    - A reduction in fraud and dishonesty bond claims across the profession. This could be the result of either education initiatives and/or more robust monitoring processes

which would be capable of picking up instances of potential fraud or dishonesty at an earlier stage.

Question 9: Of the proposed options for legislative change, which would be your preferred approach and why?

94. R3's preferred approach would be to introduce a claims management protocol in the first instance, whilst sufficient evidence is gathered to determine whether the bonding system should be removed entirely or whether amendments to legislation will be sufficient to resolve all of the issues identified with the current system.

Question 10: Do you have any further comments you would like us to consider in relation to bonding?

95. It should be noted that R3 is not a primary source of data or statistics. It is expected that the Insolvency Service will be seeking necessary data from the primary sources, that is, successor insolvency practitioners, bond providers, creditors, and the RPBs.

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