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The Governance Institute

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Dear Sirs

ICSA response to the Department for Business, Energy and Industrial Strategy (BEIS) consultation on Insolvency and Corporate Governance

We welcome the opportunity to comment on new proposals to improve the governance of companies when they are in or approaching insolvency.

ICSA: The Governance Institute is the professional body for governance. We have members in all sectors and our Royal Charter purpose is to lead ‘effective governance and efficient administration of commerce, industry and public affairs’. With more than 125 years’ experience, we work with regulators and policy makers to champion high standards of governance and provide qualifications, training and guidance. ICSA is the professional body that qualifies Chartered Secretaries, which includes company secretaries. Company secretaries have a key role in companies’ governance arrangements, including the development of governance policies. Our members are therefore well placed to understand the consequences of the new proposals to improve the governance of companies in or approaching insolvency.

In preparing our response we have consulted, amongst others, with members of the ICSA Company Secretaries Forum, a group of company secretaries from more than 30 large UK listed companies from the FTSE 100 and FTSE 250. However, the views expressed in this response are not necessarily those of any individual members of any of this group, nor of the companies they represent.

We set out below some general comments, followed by our responses to the specific questions set out in the consultation document.

GENERAL OBSERVATIONS

Our overriding observation is that the current legal and regulatory regime is, for the most part, fit for purpose. It is far from proven that recent instances of high-profile corporate failures have been due to weaknesses in the legal and regulatory environment. It is far more likely that corporate failures are due to the actions or inactions of individual directors. The responsibilities of directors to all stakeholders are clearly set out in current legislation. Additional legislation will not lead to better behaviour and corporate responsibility. Robust enforcement of current regulations would send a clear signal that inappropriate behaviour will not be tolerated and individuals will be held to account.

That said, if the Insolvency Service has identified some areas where it feels it needs additional powers, such as the ability to take action against the former directors of a dissolved company, we would support minor amendments to legislation or regulation to close such loopholes.

RESPONSES TO SPECIFIC QUESTIONS ON INSOLVENCY AND CORPORATE GOVERNANCE

Sales of businesses in distress

Q1 Do you think there is a need to introduce new measures to deal with the situation outlined?

No. We do not believe there is a need to introduce new measures in relation to the sale of businesses in distress. We do not believe there are any systemic issues that need to be addressed and believe the proposed changes are unlikely to prevent another situation arising, similar to the recent high-profile company failures highlighted in the consultation.

In addition, we believe the proposed changes would undermine the principle of limited liability and the structure of company law. If a company has limited liability this fact is made clear to all stakeholders, including creditors. The company is required to publish information on its operations and its financial statements. This information is available to any person or organisation carrying out its due diligence process before deciding to enter into a contract with a company that has limited liability.

Q2 Should the new measures be limited to the sale of a subsidiary or should a new measure extend to any act procured by the parent (though its directors), which operates to the prejudice of the creditors of the subsidiary once that subsidiary is insolvent?
Might such measures create material conflicts for directors? If so, how might they be resolved?

We do not believe it is appropriate for the directors of a parent company to be held liable if a former subsidiary enters administration or liquidation within two years that subsidiary company being sold, and we would highlight the following points.

- It is the nature of entrepreneurial businesses that some succeed whilst others fail. Any such success or failure is very often the result of one or more decisions taken by the directors, but the ramifications of those decisions are not always immediately apparent.

- The suggested period of two years from the point in time when a business is sold is misaligned with the current basis of assessment of a business as a ‘going concern’ which looks forward for a period of 12 months.

- Once a business is sold, the previous owners no longer have any control over the company and cannot direct its operations. Management of the company is then entirely under the control of the new owners.

- It is also impossible for directors to know what might be viewed by an external party, with hindsight, as something that “could have been reasonably foreseen at the time of the sale” that “would have led to a better outcome for creditors”.

- A further difficulty for directors of a parent company is that it is not clear which creditors would be considered. The company’s creditors will change over the two-year period from the day of disposal, and it is not made clear whether the creditors in these circumstances would be those at the date of sale; those at the end of two years; or creditors at any time during the two-year period.

- It is also not clear which creditors would be included in this assessment. ‘Creditors’ could include the company’s defined benefit pension scheme - without any clarity as to how, or when, any liability to the scheme should be valued.

The consultation document makes it clear that “the proposal does not require there be any causal link between the sale and the failure”. It will be established that “the director could not reasonably have believed that the sale was in the interests of creditors … by a worsening position followed by formal insolvency”. This proposal would therefore create substantial risks to the directors of a company by making them liable for the actions of the new owner(s) and new management. They would be liable for circumstances outside their control and for outcomes during the two years following disposal of the business.

These are serious risks, which directors are unlikely to take. This would probably result in potentially viable companies being wound up, rather than being sold to new owners prepared to invest in the business and attempt to return it to profitability. This outcome may very well be to the detriment of creditors, employees and other stakeholders. There is a long track record of successful turnaround investment and management in the UK which would be imperilled.

**Q3 Should the target be the parent company directors responsible for the sale?
If not, who else should be targeted; or who in addition?**

No. As discussed above, we believe the proposals would have the opposite effect to that intended. Rather than safeguarding the interests of creditors and other stakeholders, the proposal to make parent company directors responsible for the outcome of the sale of a distressed subsidiary for up to two years following disposal, will result in potentially viable companies being wound up rather than sold. Directors should be, and are, under s172 Companies Act 2006, required to promote the success of the company for the benefit of members as a whole, having regard to the interests of stakeholders. Therefore, the law already provides for circumstances where the directors have not acted in good faith. We suggest that there should be greater focus on effectively enforcing liability for non-compliance with director’s statutory duties.

We believe that a better solution would be for the Insolvency Service be given powers to take action against the former directors of a dissolved subsidiary if they have breached their duties as directors.

Q4 How can we ensure that there is no impact on sales which genuinely seek to rescue distressed businesses, or bring new investment into distressed businesses?

We do not see how this can work. As highlighted above, we believe the proposals would have a substantial impact on the potential for distressed companies to be sold to new owners willing to try to rescue the business. Making parent company directors responsible for the outcome of the sale for up to two years following disposal will result in distressed but potentially viable companies being wound up rather than sold, as the risks to the parent company directors would be considered to be too great. Not all turnarounds are successful. Here the parent company directors would be liable for any that were not, even though they have no control over the actions taken by the new owner(s) which might include actions which could be interpreted as either improving cashflow or asset-stripping, depending on the perspective of the observer.

Value extraction schemes

Q5 Are new tools needed to enable insolvency office-holders to better tackle this behaviour? Or could existing antecedent recovery powers be expanded to ensure this behaviour is tackled?

No. We do not believe that new tools are needed. We believe the existing law on directors' duties under s172-177 Companies Act 2006 covers the circumstances. The consultation document sets out examples of transactions that may unfairly benefit certain parties whilst putting creditors in a worse position. Directors are required to conduct all transactions the company enters into at 'arm's length' and on commercial terms, and the company must not be insolvent at the time of the transaction. If this is not the case, the directors have breached their duties under the Companies Act and are personally liable to the company for their actions. The Insolvency Act 1986 also provides for creditors to be given primary consideration when a company is approaching insolvency. It makes directors liable for wrongful or fraudulent trading (s213 and s214). In addition the provisions covering transactions at an undervalue (s238) and transactions defrauding creditors (s423) would appear to cover the circumstances set out in the consultation document.

We therefore do not believe additional legislation will address the issues. The emphasis should be on enforcement of existing legislation. It is for the court to challenge the directors over the actions they have taken and whether certain parties were put in a better position than they would otherwise have been. If found to be at fault, the liability of directors is unlimited. The Court should, and in our experience will, take into consideration the need to permit the directors to make legitimate business decisions. However, as discussed above, if the Insolvency Service believes it does not have the powers to take action against directors in such circumstances, we would support measure to increase its powers in this regard.

Q6 Do you agree the Government should introduce a value extraction scheme reversal power as outlined? Do you agree that the insolvency test in the current powers is not appropriate in the circumstances outlined?

No. We do not think a value extraction scheme reversal power would be helpful. As acknowledged in the consultation proposals, the terms "unfairly" and "excessive" are subjective, but they will also cause uncertainty as one man's 'value extraction' will be another man's attempt to refinance or boost cashflow. It is likely that this uncertainty, combined with the potential for arrangements to be unwound, will preclude the possibility of failing companies being acquired and returned to profit, as the costs and effort required would be outweighed by the risks. We believe the emphasis should be on enforcement of existing legislation.

Q7 Could the proposal adversely affect the availability of finance for distressed companies? Could it have other adverse effects? If so, how might the proposal be modified to mitigate these effects? Are there any protections that should be given to investors?

Yes. We understand the Government's concerns but think that this proposal is likely to inhibit the rescue of distressed companies, particularly small start-up companies that often require many years of investment before becoming profitable. We believe this proposal is likely to discourage innovation and impede finance streams for entrepreneurs.

A balance needs to be struck between the competing interests of all parties in such circumstances. A distressed company will have creditors who are at risk, but the rescuer of such a company will be putting their investment at risk too. In many cases the 'rescuer' will be investing client money and has a responsibility to preserve their clients' investment.

Q8 How could the proposal be developed to ensure that only those schemes which unfairly extract value and harm the interests of other creditors can be challenged by the insolvency office holder? Should concepts such as "unfair" and "excessive" be defined or left to the courts to develop through case law?

It is our view that the possibility of arrangements being unwound if they are considered, subjectively, and in hindsight, to be "unfair" or "excessive" will tend to result in distressed companies being liquidated, rather than acquired with a view to returning them to profit. The associated risks for both parties would outweigh the potential return from a sale of the business.

Dissolved companies

Q9 Do you agree that there is a problem in this area and that action should be taken to prevent directors from avoiding liabilities and scrutiny by dissolving their companies?

Yes. We agree there is a problem with some limited liability companies applying to be struck off the Register of Companies. We think there is also a problem with some such companies opting for a 'pre pack administration' process and simply starting up again with the same name, directors and registered address. We agree that action should be taken to prevent directors avoiding their liabilities in such circumstances.

Q10 Do you agree that director conduct in a dissolved company should be brought within the scope of the Secretary of State's investigatory powers?

Yes. We agree that if there is evidence of unfit conduct by directors, as described in a) – c) on page 22 of the consultation document, then this should be brought within the scope of the Secretary of State's investigatory powers. As discussed above, we would also support minor changes to legislation or regulation, if needed, to provide the Insolvency Service with powers to take action against the former directors of dissolved companies.

Do you have any other comments on the proposal?

We believe that the process of striking off a company could be improved by requiring an auditor's statement, in addition to the current requirement for a directors' statutory declaration of solvency.

Strengthening corporate governance in pre-insolvency situations

Q11 Are stronger corporate governance and transparency measures required in relation to the oversight and control of complex group structures? If so what do you recommend?

No. UK company law already requires groups of companies to disclose their structure in their Annual Report and make clear which companies have limited liability. This is a publicly available document and potential creditors can, and should, check this information before entering into a contract with the company. It is important that potential creditors carry out effective due diligence before making such a decision.

If, as occasionally happens, some of the published information is found to be inaccurate or missing, this would be due to a failure of internal controls and the audit process, rather than any failure of corporate governance. Stronger corporate governance would not address the problem.

Q12 What more could be done through a revised Stewardship Code or other means to promote more engaged stewardship of UK companies by their investors, including the active monitoring of risk?
Could existing investor initiatives to hold companies to account be strengthened (eg through developing the role of the Investor Forum)?
Could better arrangements be made to ensure that lessons are learned from large company failings and controversies?

We think this question covers an extremely wide sphere of activities and raises a number of broader questions around the monitoring and enforcement of the Stewardship Code; compliance with the spirit of that Code; and the level of investor engagement with companies. We think it would be better to include these questions within the wider review of the Stewardship Code due to be carried out during the second half of 2018. However, we believe a main weakness of the Stewardship Code is the lack of any meaningful enforcement mechanism.

Q13 Do you consider reforms are required to the legal, governance and technical framework within which companies determine dividend payments?
If so what reforms should be considered? How should they be targeted so as not to discourage investment?

We think the current framework within which companies determine dividend payments (as set out in Part 23 Companies Act 2006) works well. All dividends need to be supported by the company's relevant accounts showing sufficient distributable profits to provide for the dividend payment. What constitutes distributable profits is clearly set out in s830 to s836 of the Companies Act 2006. If directors pay dividends that are not supported by the relevant company's accounts these are unlawful as defined in the act and there is a potential liability of the Directors for breach of their duties under s172-177 Companies Act 2006.

In some recent corporate failures there has been criticism that dividends have been paid to shareholders even though the company's pension schemes are in deficit. In the vast majority of cases, companies, pension trustees and the Pension Regulator agree deficit funding plans without artificially reducing distributable reserves and impacting companies' ability to pay dividends in the ordinary course of business. This recognises that pension funding has an extended longer-term time-horizon and that assets and liabilities will fluctuate over time. Any proposals to increase protection of pension liabilities by, say, imposing a more stringent funding requirements to be reflected on companies balances sheets and reduce distributable profits, would have significant impact on investors (including Pension Providers).

However, we would support a requirement that companies publish the audited figure for distributable profits in their accounts. This figure is known to the company, and can be calculated from the published accounts, so we see no reason to object to its publication.

We believe that the Financial Reporting Lab's October 2017 report on *Disclosure of dividends – policy and practice*[1] provides some helpful background on this subject.

Q14 There are perceptions that some directors may not be fully aware of their duties with regard to commissioning and using professional advice. Do you agree, and if so, how could these be addressed?

No. We do provide training on director's duties, but our experience is that the vast majority of directors, especially in larger and regulated companies, are well aware of their duties in relation to taking professional advice. We are not aware of any evidence to the contrary beyond assertions made by those not present in the boardroom, possibly with an interest in the decision taken.

We would be most concerned were Government statements or action to lead directors to believe that they should not take independent professional advice. Directors need to receive advice from experts in technical areas outside their expertise, but they take this advice in order to fully understand the issues under discussion and enable the board to make its own decision. For the avoidance of doubt, we do not believe that directors should always follow that advice but, whatever their decision, the advice received, relevant discussion and the decision taken should always be properly recorded in the board minutes. Where independent advice has been received and acted upon, it is our view that the default position should be that this was a reasonable decision for the directors to take.

Q15 Should Government consider new options to protect payments to SMEs in a supply chain in the event of the insolvency of a large customer? Please detail suggestions you would like to see considered.

We understand the desire to provide some protection for SMEs in the supply chain in the event of the insolvency of a large customer, not least as a relatively small debt, in absolute terms, can be crippling for a small business, but it is difficult to know how such protection could be provided without putting other legitimate creditors at a disadvantage. It could be argued that it is the responsibility of those SMEs to seek protection in such circumstances, but we understand that insurance is difficult to obtain and prohibitively expensive. Which of their small suppliers would have expected, for example, that Carillion would become insolvent. There may be an appetite for some national scheme and the Government may wish to investigate this, but the details will be difficult to get right.

[1] https://www.frc.org.uk/getattachment/3a7972af-35ae-4354-8136-0b395f5bbbba/Dividends-implementation-study-Lab.pdf

The Reporting on Payment Practices and Performance Regulations 2017 are a helpful step in this direction.

Q16 Should Government consider removing or increasing the current £600,000 cap on the proportion of funds that can be ring-fenced and paid over to unsecured creditors (the "prescribed part") or enabling a higher cap in larger insolvencies?
What would be the impact of increasing the prescribed part?

Yes. We think this should be reviewed. However, we think this requires thorough consideration and a detailed proposal before the potential impact could be assessed.

Other issues

Q17 Is the current corporate governance framework in the UK, particularly in relation to companies approaching insolvency, providing the right combination of high standards and low burdens? Apart from the issues raised specifically in this consultation document, can you suggest any other areas where improvements might be considered?

Yes, we think the current law and governance framework provides the right level of high standards and low burdens. We do not think there is anything fundamentally wrong with the corporate governance framework in the UK and we believe it is important that failure by individuals is not automatically seen as a failure of corporate governance. It is also important that failures of enforcement and accountability are not interpreted as failures of the UK corporate governance framework.

We hope you find our comments helpful and would be happy to expand on any of these points should you wish to discuss them further.

Yours sincerely

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