Consultation Response

Insolvency and Corporate Governance

June 2018

Introduction

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We have a statutory duty to work in the public interest, a duty which we are strongly committed to achieving through our work to promote a strong, varied and effective solicitor profession working in the interests of the public and protecting and promoting the rule of law. We seek to influence the creation of a fairer and more just society through our active engagement with the Scottish and United Kingdom Governments, Parliaments, wider stakeholders and our membership.

The Society's Banking, Company and Insolvency Law Sub-committee welcomes the opportunity to consider and respond to the Department for Business, Energy and Industrial Strategy's consultation on *Insolvency and Corporate Governance*.[1] The Sub-committee has the following comments to put forward for consideration.

Response

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

Yes. We are aware that there has been at least one real-life instance of a situation similar to the example in the consultation paper.

2. 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 (through its directors), which operates to the prejudice of the creditors of the subsidiary once that subsidiary is insolvent?

If the intent or the effect of a procured act operates to the prejudice of the subsidiary once that subsidiary is insolvent, the penalty for the parent company directors should be the same as on the sale of a subsidiary under the circumstances posed above.

[1] https://www.gov.uk/government/consultations/insolvency-and-corporate-governance

Might such measures create material conflicts for directors? If so, how might they be resolved?

It is possible that conflicts might arise in this context. If the subsidiary is loss-making, it would be the duty of a director of the holding company to act in the best interest of the holding company by getting rid of the loss-making subsidiary through any legal means. Selling the subsidiary, even by means of paying the purchaser to take the subsidiary away, might still be considered a valid act. But if the same director of the holding company is also a director of the subsidiary, he is under a duty to consider the interests of the creditors of the subsidiary if he identifies a risk of insolvency under CA 2006 s.172(1)(c). He is thus conflicted unless he abstains from any decision-taking.

It is likely that it would not be possible to resolve this conflict. One solution might be that a director in this particular position has to accept that the duty to consider, or have considered the interests of the creditors in the subsidiary company overrides his duty to the holding company until such time as the subsidiary is no longer in danger of insolvency or the period of two years from the sale of the subsidiary has elapsed. The problem with that is that the holding company could then guarantee the solvency of the subsidiary for two years and then abandon it. There would need to be a qualification to the extent that the two year protection would not apply where the only way the subsidiary was being kept afloat after disposal was being provided by the holding company in order to protect the interest of the director.

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

In principle, yes, but it might be possible to target any subsidiary directors responsible for the sale even if they were not parent company directors, but acting under the instructions or recommendations of the parent company directors. There could perhaps be a new section in the Company Directors Disqualification Act to the effect that in the circumstances of the sale (as indicated above) there is a rebuttable presumption that the director of a parent company is a shadow director of any subsidiary.

We also note questions 1-3 put considerable responsibility, sometimes after the event, onto the liquidator or administrator. Investigation of directors for these reasons could be time-consuming, expensive and expose the insolvency practitioner to challenge should his application to court for the directors to contribute to the subsidiary's creditors be rejected by the court.

4. 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?

Under s.245 of the Insolvency Act 1986 an otherwise improper floating charge may still be valid to the extent of new money lent (or other services provided, or a debt reduced) at the time of the granting of the floating charge in certain circumstances. A clearly bogus charge for which no consideration was given, unless given far enough ahead, will not stand; but a charge for which genuine consideration is given is acceptable, particularly if the purpose is to keep the company going.

Something similar might be established, whereby the directors of a parent company in good faith that underwrites a loan to the Newco that acquires the subsidiary, or undertakes to indemnify certain creditors (eg pension scheme) for up to two years, are protected. Where the loan or the underwriting by the parent is designed to rescue or bring new investment or management (as in a management buy-out) into the distressed subsidiary, the benevolent intent behind that should be recognised.

5. 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?

In our view, the existing statutory antecedent recovery powers are insufficient. They were drawn up when some of the current methods of extracting value would not have been considered or would have been used in a different way. We consider that it is an appropriate time to review the current antecedent recovery regime another look and identify how it might be improved in the light of recent corporate collapses, in particular to review the ability of investors to protect themselves at the expense of other creditors as indicated in the consultation paper.

6. Do you agree the Government should introduce a value extraction scheme reversal power as outlined above?

Yes.

Do you agree that the insolvency test in the current powers is not appropriate in the circumstances outlined above?

Yes.

7. 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?

While changes to the law may prevent the more questionable practices continuing, they may also deter some genuine and honourable attempts to finance distressed companies, or cause the cost of finance to increase as an unintended consequence. It might be possible to devise a “but for” test: a defence to an investor whose investment is being challenged by a liquidator or administrator is to argue that “but for” the investment that was proposed, the company would have collapsed earlier, and to be allowed to prove that the interest rates, management fees and other practices were not the reason that the company in question collapsed.

8. 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?

We note that it could be difficult to define terms such as “unfair” and “excessive” to ensure that the law would operate as intended in diverse circumstances. It would therefore be very difficult to devise complex provisions to determine what is or is not an excessive rate of interest or an excessive management fee and the provisions themselves would be difficult to draft. As with the former legislation on extortionate credit transactions, one solution would be for the onus to be on the investor or creditor to justify a particular rate of interest, management fee or other method of extracting value at the expense of other creditors.

9. 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?

We are aware that problems do arise in this area. We also note that purpose of a creditors’ voluntary liquidation is to allow directors to put the company into liquidation and walk away from their companies’ liabilities without further consequences provided they have not broken the law. The point of difficulty arises when the directors clearly have done something wrong, but it is too expensive for the creditor to do anything about it.

Furthermore, the proposal may enable the Insolvency Service to target appropriate cases for investigation, this is contingent upon the Insolvency Service having sufficient resources to deal with what might be a considerable and complex case-load. The may mean in practical terms that Insolvency Service will focus on cases where a concern or complaint has been raised by the public or creditor and where there is a realistic chance of recovery or of penalising the director in question. The proposed change in the law would probably still not deter or catch directors determined to act dishonestly.

The legislation may nonetheless serve as a deterrent for those tempted to abuse the privileges of incorporation.

10. 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.

Do you have any comments on the proposal?

See above. The success of any change to the legislation may depend in practical terms on the extent to which the Insolvency Service is given sufficient resources to carry out its increased role.

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

This question is somewhat unclear.

In terms of the need for stronger corporate governance from the members' point of view, there are three issues here:

- The first is corporate governance as a concept, and whether or not it is working well;
- The second is whether complex group structures deserve a special type of corporate governance different in some way from what exists at present – and whether that special type of corporate governance would achieve better decision-making; and
- The third is whether complex group structures need "stronger" corporate governance than less complex businesses.

As recent corporate scandals have shown, corporate governance as a concept is unquestionably desirable. The problem lies in how well it is exercised within large organisations. One of the key purposes of non-executive directors it to hold other directors to account, but some recent cases have demonstrated that this has not always succeeded and chief executives have not been kept in check by fellow board members. On those occasions, there was poor corporate governance and chairmen, company secretaries and non-executives did not properly fulfil their functions. However, the failure of individuals to perform their duties does not point to a problem with the concept of corporate governance per se.

In addition, we are not convinced that complex group structures require any special type of corporate governance. Good corporate governance is necessary whether the business is complex or not.

As regards "stronger" corporate governance, it would be our contention that it is not the strength of the corporate governance that it is an issue, but rather better engagement with corporate governance is required for all companies' directors, whether the business is complex or not.

We also note that in businesses where the chief executive and their nominees have control of the company through shareholdings, the governance issues may be different from those where there is greater separation between directors and shareholders. In practice, any non-controlling members are likely to be aware of the circumstances but it is important that governance arrangements are sufficiently transparent to ensure the directors are accountable to those minority shareholders.

If the issue is ensuring clearer accountability for decisions made by directors this could point to the situation where directors appear not to know or to bear responsibility for decisions that may affect creditors and customers adversely and so avoid being held to account (for example, banks' decisions to sell PPI or sub-prime securities). Governance in this sense relates to internal processes such as minuting of meetings and internal chains of command. This is a separate issue, and again is not connected to the complexity of an organisation. It was to do with proper minuting of meetings and internal chains of command. The difficulty and cost for any investigatory authority of establishing the level at which a decision was taken, or the actual knowledge of any particular director may be disproportionate to the fine or compensation to be imposed upon that director.

Although by no means a solution, the recent rules on whistle-blowing may go a little way towards preventing such deleterious behaviour happening again. A whistle-blower would now enjoy a degree of protection not available ten years ago, although an employee will still have concerns about taking the decision to whistle-blow. Furthermore, as also indicated later, it is harder than it used to be, because of the presence of social media, for directors to pretend ignorance of inconvenient or unflattering facts about their own organisations.

12. 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 (e.g. 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 are of the view that the proposals contained in the consultation could prove helpful, and at the least would do no harm. There seems to be some recent evidence some institutional shareholders are taking a more activist line, particularly in relation to issues with which their own clients and investors are engaged.

Anecdotal evidence suggests that many domestic investors lack the inclination or time engage in stewardship. Increasingly clients' shares are held in managed portfolios and clients are relatively far removed from the companies where their portfolio managers have invested their funds. The clients do not see the accounts, nor are invited to the AGM. We do not anticipate that this lack of engagement is likely to change.

As regards asset managers being required to monitor and engage on how the directors of the companies in which they have invested fulfil their duties under s.172 of the Companies Act 2006, our view is that while some asset managers may be willing to do this, others might see it as a disproportionate burden. It also assumes that s.172 operates well, which may not always be true (see further answers to questions 14 and 17). Asset managers may have different assessments of the impact of s.172, and it is possible that some might choose to just sell the company's shares if they think the directors' lack of engagement with s.172 will harm the company's prospects. Requiring asset managers to monitor and check the directors' compliance with the duties required under s.172 could effectively discourage long-term shareholdings.

A stewardship oversight group would probably do no harm, but may not have impact without meaningful power that go beyond pointing out that breaches of corporate governance are not a good thing. The financial press fulfils this function already, without noticeably causing some directors to behave any better.

As for lessons being learned from corporate failings and controversies, these were originally one of the objectives investigations previously carried out by DTI. While these are very comprehensive, the process was a lengthy and expensive ones and reports could be outdated by the time the investigation had concluded. The rise of the internet and the use of social media is speeding up the release of information about companies activities, thus making it harder than it used to be to avoid scrutiny in practical terms. Naturally companies will continue to behave "badly" from time to time, but it is harder than it used to be to hide bad news and to avoid the unwelcome publicity arising from it.

13. 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?

In principle, the law should not be stating how directors should make their decisions about dividends. If the suggestion is that “distributable profits” as a term should be re-examined, this should be consulted upon to take into account the experience of the accountancy profession as regards best practice.

14. 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?

We do not have any evidence as to the extent of commissioning and using professional advice. Furthermore, we note that CA 2006 s.172 does not impose any specific requirement in this regard, albeit that it may be regarded as good practice. There would also be cost implications to any mandatory advice-seeking requirement which could be a particular concern for small companies.

There may also be a wider debate to be had as to the extent to which some directors are fully engaging with the requirements of s.172. Furthermore, even where professional advice is sought, it may not be followed and indeed directors will not necessarily be in breach of their duties where they do not follow advice obtained.

15. 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?

It must be recognised that if one particular set of creditors is to be favoured, it will inevitably be at the expense of another set. Those creditors likely to receive less in the event that SMEs are favoured, and who are in a position to do so, will find other ways to minimise their risk. The risk is then shifted onto those creditors who are neither SMEs nor in a position to insist on terms favourable to themselves, such as HMRC, local authorities, employees or involuntary creditors. This is ultimately a political decision.

16. 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 on increasing the prescribed part?

We note that in a large administration, the figure of £600,000 may be merely “a drop in the ocean” and the cost of disbursing the small sums involved to a large number of qualified creditors can quickly mount up. The returns for those entitled to the prescribed part may therefore be minimal. However, with a small administration with a relatively small number of qualified creditors, who would previously have received nothing, the sums involved will be very welcome. The prescribed part scheme is not without merit and it could be beneficial to raise the cap.

17. Is the current corporate governance framework in the UK, particular in relation to companies approaching insolvency, proving 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?

The problems relating to corporate governance are by no means unique to the UK. Many countries have a problem dealing with the situation where directors behave in an improper way and apparently walk away scot-free from their companies' difficulties. Another familiar problem is that the cost of taking action against directors personally can be considerable. Even if a director is found, say, liable for wrongful trading, unless the director is exceptionally wealthy, he may be unable to make any payment that significantly improves the position for creditors.

Most companies are run by directors who will, on the whole, choose to abide by the requirements of company law. However, where it is the larger companies which go wrong, that tests the limits of the efficacy of corporate governance and company law.

We note that the wording of s.172(1) of the Companies Act 2006, although well-intentioned, has not proved particularly effective in positively making directors behave properly. Many directors would probably have done what s.172(1) suggests anyway but this is not where the problem lies. Most larger companies, and certainly listed ones, will have directors who will be advised by their company secretaries of the requirements of s.172(1). The problem is not that there is ignorance of this provision but rather in terms of compliance. The directors merely have to produce evidence that they will "have regard" to the interests of the various stakeholders. Having had regard, they are not obliged to do any more than that. Furthermore, their liability for breach of this duty is not to the stakeholders themselves but to the company as a whole. If the directors or their family control the majority of the shares, the company is not likely to take action against the directors. There would be nothing to prevent the directors recommending high dividends if that is what the company wanted, even if that were at the expense of the employees' pension fund. This means that directors who do not wish to take s.172 seriously are rarely compelled to do so. Although it would be possible for members to raise a derivative claim against the directors for their failure to adhere to the requirements of s.172, few members would ever wish to do so – it would be easier just to sell their shares.

We note that there is no requirement in UK law that directors should either act "honestly" or indeed "responsibly". This wording is used in Ireland and it is submitted that the addition of these two words, while not resolving all the problems associated with breaches of directors' duties, might go some way to ensuring that directors cannot with their present impunity carry out acts which are clearly not good for their companies' customers, creditors, employees or the company itself. The degree of honesty and responsibility expected should be judged on an objective basis, not merely the directors' own and possibly skewed interpretation of what honesty might be.

The virtue of the use of the word "responsibly" is that the word contains the implication that the director does not act purely in his own or his company's members' interest alone. He is obliged to take a wider picture into account.[2] This could help to mitigate against the example situation where a director recommends a dividend payment at the expense of the company employees' pension fund as it could be difficult to explain how such a course of action would be considered "responsible" in this wider sense.

For further information, please contact:
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[2] For a more detailed academic discussion of this point see Grier, N., Enlightened shareholder value: did directors deliver? 2014 Juridical Review 95-112 https://www.napier.ac.uk/research-and-innovation/research-search/outputs/enlightened-shareholder-value-did-directors-deliver