ICAEW
REPRESENTATION 68/18

INSOLVENCY AND CORPORATE GOVERNANCE

Issued 11 June 2018

ICAEW welcomes the opportunity to comment on the consultation on *insolvency and corporate governance* published by BEIS on 20 March 2018 a copy of which is available from this link.

The BHS and Carillion insolvencies have given rise to some wide ranging criticisms including of individual conduct, culture of business, the role of audit and actions of regulators. A number of initiatives have been taken or proposed to address these, including changes in pensions regulation. ICAEW supports many of these initiatives. We also welcome some of the proposals included in this consultation, including for review of the law on distributable profits and have some suggestions for other initiatives. However, we believe that the proposals on parent company director liability, value extraction reversal and supplier priority would have unintended consequences likely to outweigh any likely benefits and so should not be taken forward as proposed.

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This response reflects consultation with ICAEW's Insolvency Committee which is a technical committee made up of Insolvency Practitioners working in large, medium and small practices. The Committee represents the views of ICAEW licence holders. The response also draws on expertise from other specialist committees, including on business law, financial reporting and corporate governance.

ICAEW is the largest single insolvency regulator in the UK licensing some 700 of the UK's 1,700 insolvency practitioners as a Recognised Professional Body.

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MAJOR POINTS

1. The BHS and Carillion insolvencies have given rise to some wide ranging criticisms including of individual conduct, culture of business, the role of audit and actions of regulators.
2. Government has already introduced or proposed a number of relevant reforms. For instance: the priorities of the Pensions Regulator have changed in light of the BHS experience and new powers and sanctions have been proposed in the pensions White Paper; the role of the FRC is under review; and new late payment reporting requirements have been introduced.
3. We support many of these initiatives and some of those proposed in this consultation. We suggest, however, that proposed reforms on insolvency law should be considered holistically with other proposals, so that it is as effective and coherent as possible. The UK's insolvency regime is respected internationally and proposals for improvement were made in the 2016 consultation. On balance, we believe that the proposed reforms on parent company directors' liability, value extraction reversal and supplier priority would have unintended adverse consequences that would outweigh perceived benefits and that the underlying concerns should be addressed through other initiatives first if possible. If there are harms that cannot be addressed except through regulatory change, we believe that a more thorough impact assessment is required so that any unintended consequences can be minimised.
4. The UK's distributable profits regime has given rise to a number of concerns over many years and we believe that it should be reviewed. In particular, a regime based on a solvency test could be easier for creditors and others to understand and might be more effective in focussing the minds of directors on their duties to creditors where a company is in financial difficulties. This would be a significant change in long established law and would require further consultation. The current basis is also, in effect, mandated under EU law for public companies.

Sales of Businesses in Distress

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

5. This proposal appears to be driven by the example given in the consultation (presumably based on the BHS case) showing how the sale by a subsidiary may affect defined benefit pension scheme funding. While DB pension schemes continue to cover a large number of employees and have an important place in the economy, the trend for many years has been towards DC schemes so that the relative number of companies affected is declining. If the main driver of the proposal is protect DB pension schemes (and the PPF), then we believe it would be better addressed through pensions regulation than company law, which applies to UK companies more generally.
6. Government is already taking action to protect DB pension schemes. DWP issued a White Paper in March 2018 outlining proposals for reform. These include introducing a new criminal offence to punish 'wilful or grossly reckless behaviour of directors (and any connected persons) in relation to a DB pension scheme'. The Pensions Regulator has also signalled that it will exercise its powers more robustly as a result of criticism from recent cases and is to be given additional powers. It is, therefore, unclear what, if any, further reforms would be required to address the concerns so far as they relate to DB pension schemes.
7. There is little doubt that making directors personally liable for potentially large (and uncapped) amounts is likely to influence their behaviour. While there will be exceptions, most directors are likely to err on the side of caution. It is, therefore, important that the impact of this proposal, including potential unintended consequences, is carefully analysed and supported by concrete evidence where possible.

8. As regards stakeholders other than pension schemes, it is unclear exactly how they might be put in a worse position as a result of a sale by the parent, or what the scale of the perceived problem may be. It is also unclear to what extent government has considered whether existing powers (for instance in relation to actions of shadow directors and wrongful trading carried on by the subsidiary) might apply in relevant circumstances.

9. Given the number of questions that arise in relation to this proposal and potential harmful outcomes (further outlined in the Appendix), we do not believe that this proposal should be taken forward.

10. If government is going to review existing powers in this context, it should do so in a holistic way, including considering whether to take forward reforms already proposed elsewhere, for instance in the 2016 review (particularly proposals for a business rescue moratorium).

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 (through 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?

11. We are not clear what sort of acts are envisaged here and it would be helpful to have further explanation, including evidence of harm envisaged and its economic impact. However, it seems likely that similar concerns would arise as arise in respect of a sale.

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

12. The liability proposed for directors may arise irrespective of any dishonesty or intent to deprive creditors of assets. If the objective is simply to deter sale, the proposal may well be effective as noted in answer to Q1. If, however, it is to recover money for creditors, then its effectiveness would depend upon the financial position of the directors concerned. Another obvious target for payment of compensation would be the parent company itself, although making the parent company liable would encroach on principles of limited liability for shareholders and practical issues of recovery might arise.

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?

13. We are not sure that possible adverse impacts of a proposal like this can be avoided. We have suggested that concerns about DB pension schemes could be addressed by other means. If there are other specific areas where government believes existing law is deficient, reform should be targeted accordingly.

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?

14. There are various recovery powers available under current law: transactions at undervalue; preferences; extortionate credit transactions; transactions defrauding creditors; contributions from past directors and shareholders (for payments made out of capital by a private company) and under common law rules.

15. The example given in the consultation would appear, in principle, to be vulnerable to challenge under one or more of these, although whether or not a challenge would succeed in any given case would, naturally, depend upon the detailed facts. The consultation does not provide detailed facts or evidence as to which of the current procedures is considered unsatisfactory or why. Rather it suggests that the complexity of restructuring or sophistication of some investors puts some parties at an unfair advantage.

16. Many business arrangements are complex so it is inevitable that restructuring and rescue arrangements (and business failures) will be complex too, not least because of the complexity of the law in this area. Complexity of itself is not indicative of improper motives or behaviour in this context. Those providing finance necessary for business rescue will typically be 'sophisticated' because they are putting large sums of money at risk, may be acting for the benefit of others (eg underlying investors) and will naturally seek such protections as the law allows. They might be considered negligent for failing to do so.
17. Injection of fresh funds can improve the lot of all creditors and those funds may only be made available on a secured basis and on commercial terms that investors perceive adequately reward the risks involved. The proposed new powers appear broad and undefined and can be expected to lead to uncertainty of outcome that would deter provision of rescue finance and may therefore harm the interests of creditors as a whole.
18. Feedback we have received from consultations with insolvency practitioners licensed by ICAEW is that the introduction of such broad new powers would be unwelcome. They would overlap with existing powers, so adding to complexity and cost. Insolvency practitioners would frequently need to consider whether to use the powers, may need to seek advice and can expect to face litigation where seeking to exercise those powers in any unclear cases.
19. We suggest that government consider further exactly what are the shortcomings of the existing powers and seek to address those shortcomings in a targeted way rather than introducing a new broad and overlapping power. It should also consider whether any shortcomings are felt only in the context of rescue finance or might impact creditors more generally to avoid fragmentation of insolvency law. It may be, for instance, that existing powers are not fully used because of practical issues, such as costs outweighing potential returns, which new powers in themselves might not address. We would be happy to help government in any such detailed exercise.

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

20. See answer to Q5 above.

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?

21. It is unclear exactly what shape the proposed power would take, but if it introduces a concept of 'fairness' or a 'commercially reasonable' test or the like it is likely to reduce certainty of transactions which will inevitably impact the availability (or cost) of finance for distressed companies and increase the amount of litigation involved, which is also costly.

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?

22. The current law on antecedent transactions is now well developed and, while the position will depend upon the circumstances in each case, insolvency practitioners and investors can proceed with a reasonable degree of certainty in most cases. If government seeks to prescribe what is unfair or excessive in such broad terms, it risks causing considerable harm as it is not in a position to assess differing risks and therefore appropriate compensation for all types of transaction, which, it has already noted, can be extremely complex and may involve many stakeholders with differing interests.

23. Leaving the matter to the courts means that there will be a high degree of uncertainty until such time as case law develops and case law may develop in ways that government does not currently envisage. Litigation is expensive, and the costs may ultimately be borne by the creditors.
24. If government were instead to consider in more detail what problems there are under existing powers and target any shortcomings more clinically, we believe that this would reduce the risk of adverse consequences. For instance, if insolvency practitioners are deterred from pursuing claims for reasons of costs, government might consider restoring the exemption from the Jackson reforms (Legal Aid, Sentencing and Punishment of Offenders Act 2012) for insolvency litigation.

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?

25. We agree that there is a problem and the proposal seems reasonable.
26. Even without a change in law, we believe that the Secretary of State could alleviate the issue by using existing powers to have dissolved companies re-instated on the register more frequently. The power could, for instance, be exercised where there have been substantiated complaints or where the directors have been involved in a series of dissolutions in suspicious circumstances. This might act as a deterrent to those who think they can get away with conduct of this kind and not call into question the integrity of the register or be unduly costly.
27. We believe that all companies should be required to file closing accounts before dissolution. This would assist the authorities in assessing whether or not there are, or may be, unpaid liabilities and HMRC might be able to object to dissolution before it occurs.
28. HMRC is also consulting on tax abuse and insolvency and government should consider responses to that in the context of this consultation, particularly as regards 'phoenix' companies. We do not believe that government currently exercises its powers as effectively as it might. For instance, it issues VAT numbers to companies whose directors have a history of repeat failures and the Insolvency Service does not pursue all cases that insolvency practitioners believe should be pursued (as noted in their reports to the Insolvency Service).

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? Do you have any other comments on the proposal?

29. Yes (see also above comments).

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?

30. We agree that best practice should be promoted, including through government initiatives such as the UK Corporate Governance Code and the proposed code for large private companies. See also our answers to Q13 and Q14 below.

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 (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?

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31. We believe that investors and groups such as the Investor Forum should learn from experience, but it is not clear that further measures from government are required. If government does propose intervening, it should provide a cost versus benefits analysis first.

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?

32. The reports into both BHS and Carillion considered at some length the dividend practices of the companies before they became insolvent.
33. The current distributable profits regime is based on the concept of capital maintenance. It is required by EU Company Law Directives for public companies. The UK applies similar principles to UK private companies, although with considerable flexibility to reduce capital.
34. The regime was designed to protect the interests of creditors, but many commentators believe that it fails to do so. For instance the Rickford report of 2004 suggests that the 'theory is disproportionate in its effects, ill-targeted for its purpose, inconsistent in its own terms and has led to widely divergent and misleading measures of implementation. Some provisions are readily avoidable. Others simply represent loopholes or gaps in the scheme of protection. In short the regime is incomplete, dysfunctional, avoidable……. [1]'
35. Development of generally accepted accounting practices particularly in relation to fair value accounting, mean that the distinctions between realised and unrealised profits are less clear cut than used to be the case. ICAEW and ICAS have for many years provided guidance on realised and distributable profits under the Companies Act 2006. The latest version of this (Tech 02/17BL) runs to more than 150 pages, which in itself suggests a level of complexity that is unlikely to be helpful to business.
36. An alternative is a solvency based regime, under which the amounts available for distribution to shareholders would depend upon the solvency, and prospects, of the company at the time. The Accounting Standards Board (in responding to a Department of Trade and Industry consultation in 2005) advocated reform 'focussing on aligning any restrictions on distributions with their underlying purpose – safeguarding of creditors' interests. This seems most likely to be achieved by a solvency based approach…… …..' BEIS (then BERR) included reform of the relevant EU Directive as the top simplification measure for removing burdens on business in its 2008 report '25 Ideas for Simplifying EU Law' and ICAEW has advocated reform of EU law to allow member states to adopt a regime of this kind if they wish[2]. Other countries, including the US and New Zealand have regimes of this kind and international comparison may be useful (although it would be necessary to look at the issue in context of other relevant applicable laws and not in isolation).
37. A reform of this nature would have wide reaching ramifications for long established elements of company law in the UK and a change to EU law would be required to enable reform for public companies (subject to Brexit considerations). Further consultation would be required, including whether there should be a forward looking solvency test and what the nature of that test might be.
38. Some of the criticisms of the current regime might be addressed to some extent through more targeted measures. For instance, some have suggested that distributable profits should be disclosed as a line item in accounts and this might be addressed through development of

[1] *Reforming Capital – Report on the Interdisciplinary Group on Capital Maintenance,* ed Jonathan Rickford (2004).
[2] ICAEW Rep 113/07 in response to the EU Commission communication on a Simplified Business Environment for Companies in the Areas of Company Law, Accounting and Auditing. ICAEW Rep 72/12 responding to the EU Commission's consultation on the Future of European Company Law.

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good practice outlined in FRC's Lab project report: Disclosure of dividends – policy and practice (November 2015).

39. There is also a question as to whether the formulaic nature and complexity of the regime detracts directors from their general duties as directors under s172 of the Companies Act (and to creditors as a company becomes financially distressed) when they consider dividend payments. Measures aimed at ensuring directors are aware of these duties may have a role to play in this context.

40. If case law is not clear on relevant points or is producing results not intended by government, reform to the relevant aspects of law might be considered in a targeted way. For instance, if it is too difficult for dividends lawfully paid from available distributable under the s830 of CA 2006 to be challenged in appropriate circumstances as transactions defrauding creditors or transactions at undervalue, government might consider reform in that area.

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?

41. S174 of CA 2006 requires directors to act with reasonable care, skill and diligence, including with reference to the general knowledge a director may in fact have. Case law has further refined this and ICAEW and others have provided guidance on these duties. Where relevant, directors should seek professional advice and, by doing so, they demonstrate a desire to understand and comply with relevant laws. We agree that directors should be aware of these responsibilities and would support initiatives to increase awareness and understanding.

42. When a company is in financial difficulty, it is particularly important that directors seek relevant advice at an early stage so that chances of avoiding insolvency can be maximized. Government might consider how this could be encouraged.

43. It is also important that relevant laws are designed in a way that is helpful to directors in performing what can be a difficult role. The law on distributable profits is an example of a law that might, in practice, be operating in a way that detracts directors from their wider duties, particularly duties towards creditors when their company is in financial difficulty.

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.

44. We understand that small suppliers can be severely affected by insolvency of major customers (even becoming insolvent themselves). Government has taken a number of initiatives to protect SMEs, including introducing late payment reporting and a small business commissioner. It also consulted on retention payments in the construction industry. We believe that the concerns should be addressed through these sorts of targeted initiatives, rather than through altering general priorities of creditors with a view to protecting particular types of creditor.

45. Prioritising one type of creditor comes at the expense of others. HMRC is often by far the largest creditor so that, for instance, prioritising small suppliers would be at the expense of taxpayers (who are not in a position to influence their exposure). Even if they were to be offered some kind of priority, SMEs will, in practice, continue to face significant losses where a large customer becomes insolvent, because there is often no, or little, money available for distribution to general creditors. The practical outcome may, therefore, be much the same in many cases, irrespective of priority.

46. Accordingly, it is important that SMEs exercise due care in their business dealings with others, for instance, by having a diverse customer base and managing cash flow and credit

risk (including seeking security where available or credit insurance). Protecting SMEs as a class of creditor might promote bad business practices by creating the impression of reduced risk. Government could usefully seek to improve awareness of SMEs on issues like these, in addition to raising awareness of directors of contracting companies of their duties.

47. If government introduces new categories of creditor into the insolvency regime (for instance, 'SME creditors' of 'large customers'), it risks further complicating the regime and adding to cost, leaving less available for creditors as a whole. Government should also consider whether it risks deterring businesses from growing if it protects 'small' businesses at the same time that it is imposing additional regulatory burdens on 'large' businesses, at least at the margins of any definition of the terms.

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?

48. The absolute amount of the cap (and any other absolute amount) is necessarily somewhat arbitrary. Government should consider why this amount was chosen (at the time of the Enterprise Act 2002) and whether it would be appropriate to increase it in line with inflation to maintain its amount in real terms since then. It might also consider index linking in future.

49. If a more radical change is envisaged, there could be an impact on the willingness of banks and other creditors with floating charges to extend credit to the business. For instance, removing the cap completely would mean that floating charge holders would have effective security over only 80% of the relevant assets. This would affect pricing of credit or willingness to extend credit at all. There are of course, many alternatives, including reducing the percentage amount over a certain level, but government should consider whether the number of cases where there are likely to be sufficient assets for this to be a material issue and whether the end result would ultimately make much difference to the unsecured creditors government seeks to protect. There is a risk of further complicating the regime for little tangible benefit.

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?

50. Directors are often slow in realising that their company is in financial difficulty and in seeking appropriate help. Government, together with business, could usefully consider how to raise awareness in this respect.

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APPENDIX

(Further comments on proposal on parent company directors' liability)

1. The proposal on parent company directors' liability only applies to large private and unlisted public companies but it is unclear why this should be (if it is a good idea). It concentrates on parent/subsidiary relationship, but does not explain why other scenarios are not covered, such as where there are chains of companies or companies owned by individuals (rather than companies). If the proposal only applies to UK parent companies, the potential effect on groups organising themselves in other jurisdictions should be considered. There would be questions about enforceability if the proposal were to apply to non-UK parents. Innovative businesses that decide to set up subsidiaries in order to control risks, are likely to consider ease of exit at the outset, so that, by making exit more difficult, enterprise may be deterred.
2. It would be necessary to identify which directors would be liable, for instance those approving the sale, those who were directors at the time or otherwise.
3. A near inevitable consequence of the proposal is that parent companies wanting to exit a business carried on in a subsidiary in financial difficulty would be deterred from selling it and be more likely to allow it to be liquidated instead (or to use an insolvency procedure such as selling through a pre-pack administration). The proposal therefore appears designed to accelerate insolvency of a business and it is unclear why the government should want that.
4. It is not clear how the position of creditors could be improved following a sale of an insolvent company (as creditor rights crystallise on insolvency). As regards subsidiaries that are not insolvent but are in difficulty or would be insolvent absent a parent company (or other group) guarantee, the reason why parent companies provide guarantees to subsidiaries in financial difficulty is typically to support them so that they can return to financial health and provide profit to the group as a whole whether through ongoing dividends or through sale. If directors of the parent company could be personally liable at some point in the future for providing this support, this will make granting of guarantees less likely so potentially accelerating insolvency.
5. The proposal includes a number of tests that would apply in order for a director to be liable. These may be intended to limit the impact of the proposal on transactions that might ultimately benefit creditors, but they give rise to a number of concerns, for instance, those noted below.
6. One test relates to belief that the sale 'would' lead to a better outcome for creditors. This seems to imply a standard of 'more likely than not' at least. However, a parent company may decide that it has little prospect of turning its subsidiary around itself, but that a purchaser has, say, a 20% chance of doing so (which is why the purchaser, who may actually be more optimistic, is willing to buy). The directors could not conclude that this sale 'would' result in a better outcome, so this 20% chance would be lost. The same logic applies however small the percentage. It is also unclear why a 'better' outcome would be required and how directors would be in a position to assess this (and in relation to which creditors).
7. Another test is that the interests of a subsidiary's creditors must have been adversely affected between the date of the sale and the liquidation or administration. This gives rise to a number of questions. For instance, how would this this affect would be measured and against which creditors? If the directors of the parent company are to be liable for the acts of the former subsidiary once it is sold (and so outside their control), will they be expected to seek contractual or other protection and might this increase costs or reduce the likelihood of finding a buyer?

8. The proposal covers guarantees provided by a parent company, but there are other ways that support might be provided. If government pursues this proposal, it may need to include anti-avoidance provisions. These would extend the reach of the provision, so increasing the potential adverse impact and complicating conduct of business in the UK through groups of companies.
9. It is unclear how the proposal would work in the context of the company law requirements for directors of the parent company to promote the success of the company. In cases where the directors believe that the company's success would best be promoted by sale of the subsidiary (even if that might not ultimately be better for creditors of the subsidiary than liquidation), the potential personal liability involved might deter them from doing so.

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