MAKING CREDITOR PROTECTION EFFECTIVE

Michael J. Mumford and Alan J. Katz
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ABOUT THE AUTHORS

Michael Mumford and Alan Katz are Research Fellows in the International Centre for Research in Accounting (ICRA). ICRA is an independent, self-financed charity attached to the Department of Accounting and Finance at Lancaster University Management School.

Michael taught at Lancaster University from 1972 to 1995, including terms as chair of the Management School and head of department. He served on the Council of the ACCA from 1982 to 1997, and on the CCAB Board of Accreditation of Educational Courses and the CCAB International Accounting Committee. A graduate in accounting and also in economics, his special interests include corporate financial reporting, transaction cost economics, and corporate insolvency.

After Alan graduated from the London School of Economics, he spent his career with Arthur Andersen, originally as an auditor and from 1979 as an insolvency practitioner (and partner with the firm). He has served as senior moderator of the Joint Insolvency Examinations Board since 2002, as well as on the Technical Committee of R3, the Association of Business Recovery Professionals, since 1985. A Research Fellow of ICRA since 1999, he has conducted several studies, usually with Michael and mostly of an empirical nature, into the practical operation of insolvency practice.
We acknowledge with thanks the financial support of the ICAEW’s charitable trusts – through its grant reference 5-419. Particular thanks are due to Gillian Knight for her help in managing this project, to her colleagues in the CBP who aided publication of the report, and to the two referees for their comments on an earlier draft. We appreciate the willingness of the CBP to extend the period of research so that we could consider important recent publications by Professor Andrew Keay, by the Fédération des Experts Comptables Européens, and by KPMG, all of which materially aided our thinking. We are also grateful to the many people whom we interviewed (listed below), and also our generous and learned colleague Professor David Milman. For those faults that remain, despite our careful endeavours, we express our regrets; however, we cannot accept responsibility for any use made of the report.
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TO THOSE INTERVIEWED

This project involved interviews with members or staff of some 25 organisations (also listed). We have not identified people by name in the text, but we have indicated, in bold type face, the organisation to which they belonged when citing their views. The interviews were intended to elicit the views of the individuals concerned, whether or not these were representative of their organisations. Views expressed are not to be taken to represent the views of the organisations themselves.

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R3 Technical Committee
The British Bankers’ Association
The European High Yield Association
The Insolvency Service, London
The Institute of Credit Management
The Institute of Directors
University of Lancaster, Departments of Accounting and Finance and of Law
University of Manchester, Department of Law
This project reviews basic precepts about the protection of creditors by the great majority of UK corporations that are registered with limited liability. We were able to look at the framework of company and insolvency laws and practices that regulate companies in this area. We were also able to discuss our ideas with individuals and groups of experts in accounting, auditing, insolvency practice, law and insolvency regulation, and we make some recommendations.

Three reasons motivated us to undertake the work in 2005. The first was the passage of time since the Insolvency Act 1986, and a growing sense that it was time to revisit corporate insolvency following experience of the operation both of that Act and of the Enterprise Act 2002, which came into force from 15 September 2003. The latter made the procedure of administration the standard response to corporate insolvency, rather than administrative receivership, provided that there was some realistic prospect of saving the company or its underlying business.

The second development was the adoption of International Financial Reporting Standards, in place of Financial Reporting Standards originating with the UK’s own standard-setting body. This further weakening the usefulness of accounting-based rules for capital maintenance (as explained in the Rickford Report 2004, then recently published). Rickford’s work has since been reflected in continuing discussions within the European Commission on the possible relaxation of the capital maintenance rules set out for public companies in the Second Directive on Company Law.

The third development was the prospect of company law reform in the UK, following upon the extensive work of the Company Law Review Steering Group. The 2006 Companies Act, which went through Parliament during the course of our work, included several provisions that bear upon insolvency, including the redefinition of directors’ duties.

We expected, in early 2005, that the work would only take us until the end of October 2006. In the event, the project needed extensions – more than once – as new and important sources of material became available to us. Thus, our original deadline was extended when we became aware of two important pieces of work then impending. The first was the new study Company Directors’ Responsibilities to Creditors by Professor Andrew Keay, a leading academic insolvency lawyer. His book is concerned with much the same subject matter as our report, but with emphasis on the law rather than on accounting and finance (Keay, 2007). The other was a major study by KPMG ‘Feasibility study on an alternative to the capital maintenance regime established by the Second Company Law Directive 77/91/EEC of 13 December 1976 and an examination of the impact on profit distribution of the new EU-accounting regime’ (KPMG, 2008). This was prepared for the European Commission, and it sought to establish how the capital maintenance regime was actually being applied throughout the different member states of the European Union (and to some extent beyond its borders).

We were not aware, of course, when we submitted the draft of our report in May 2008, that the ‘credit crunch’ was imminent, with the result that insolvency would rapidly become a much more pressing problem confronting many UK companies and their creditors.

This report has been drafted with several readerships in mind. We expect it to be of interest to accountants working within companies or as auditors. While they may find our section on accounting somewhat elementary, we hope that they will find new insights, particularly in the later sections, on the working of insolvency law and the problems facing insolvency practitioners.
Lawyers who deal with corporate clients in good financial health as well as bad may find our comments on accounting information instructive, particularly in contemplating the (not infrequent) calls made upon accountants to come up with a single clear, robust and reliable valuation method for business enterprises. They may like to note how very difficult it is to come up with a single comprehensive valuation figure for a business in either state but particularly for those facing financial distress (Meeks and Meeks, 2009).

It may also interest UK insolvency practitioners (some 2,000 qualified people, of whom about half take appointments); bankers and financiers with a close professional interest in debt recovery and creditor protection, particularly in issues of priority and security; and company directors and their advisers who will find ideas and arguments here that are supportive to the successful running of their companies. We believe that the proportion of directors who deal irresponsibly or dishonestly with their creditors is very small, even though the temptation to do so may arise when business conditions turn unfavourable.
1. INTRODUCTION

1.1 BACKGROUND

A central issue in social policy is how far people should be left to run their own affairs, with a minimum of state interference, and how far the state needs to play a role, for example in protecting the rights of individual citizens. Clearly, there is a need for balance between the extremes, but where to draw this balance is a key question, as significant in economics and law as it is in public administration.

In the context of insolvency and creditor protection, the first point of view is reflected in the case for the maximum possible freedom for willing and informed parties to form their own contracts in any terms they wish. Much of nineteenth century economics demonstrated the theoretical benefits, to individuals and to society, of allowing market forces to prevail in trade and production, in order to reflect individual preferences and priorities and maximise social welfare (offering what has come to be known as ‘Paretian optimality’). Under this view the state has a role to encourage trade and help individual citizens to go freely about their business. Creditors, for example, can decide for themselves whether to make loans or extend credit rather than insisting on cash payments. They can demand information as a condition of providing credit and secure their loans by way of charges on assets if they think it necessary, although in practice only certain forms of information are likely to be available. Charges can be taken by creditors on assets but these are only effective provided that they are recognised and enforceable in priority over the claims of other creditors.

Forming effective contracts requires three conditions to be met. There needs to be agreement between the parties as to what the contract involves by way of offer and consideration. Then, it must be possible to monitor performance, in order to tell how far the agreed conditions have been met. Finally, if conditions have not been met, it must be possible to enforce the terms or obtain redress. None of these stages necessarily needs to involve the state, provided that the parties have enough power to resolve matters themselves. Often they do. Simple contracts, for example for the sale of well defined goods or services at a clear price, involve sufficient information on both sides to enable a speedy conclusion to be made to the deal. The terms can be fully spelled out and understood. Such contracts are often said to be ‘complete’. There are also many forms of ‘incomplete’ contract, in which relations are established for long periods of time, with repeated dealings between the parties and occasional re-negotiation of the terms. Even these can often be left to the parties to handle themselves, where both have enough prospect of future gain to make it worth while to continue dealings and to resolve any disagreements between themselves.

The state still has valuable functions to perform, even within this model of free enterprise. A framework of law may assist in the formation of contracts and their enforcement. For example, it may lay down standard terms that economise on the need for parties to negotiate all contract provisions for themselves. However, the interplay of market forces does not necessarily lead to the best possible outcome for society. For one thing, the economic analysis of free markets takes for granted the initial distribution of wealth in society. It means going beyond the basic model of competitive markets to argue whether, and if so how, wealth might need to be redistributed. Also laws may be needed to protect the weak from stronger predators, for example by restraining robbers and punishing cheats. Moreover, state intervention may provide for the supply of goods and services where there are social costs and benefits that cannot effectively be captured in the pricing process. This is the strongest reason for the state production of services such as defence, prisons, education and some utilities.

Considerations such as fairness and equity may also need the state to moderate relations between the various members of society. The state may also play a supervisory role. In relation to companies, this role is exercised mainly through the Department for Business, Innovation and Skills.
During the twentieth century a new branch of economics analysed the problems for contracting that arise when information is incomplete and costly to obtain, when parties have incentives to disguise their motives, and when contract enforcement is unpredictable. This new branch, ‘transaction cost economics’ (TCE), throws light upon insolvency at all three stages of the contracting process – formation, monitoring and enforcement – and it throws light on many of the problems that arise at each stage. It explains why it is quite impossible that all the functions performed by a company could realistically be carried out by forming a network of legal contracts for the supply of all the necessary inputs, the sole function of the firm being to arrange the contracts. TCE also helps to define what activities a company needs to run for itself as ‘core activities’, and what it can sensible outsource. It also confirms certain roles as being more suitable for government than for private enterprise.

In the context of creditor protection, it is true that parties are generally free to make loans between one and another, on any terms that they agree. The parties can seek to enforce the contract if these terms are broken. However, this will be within a framework of detailed regulations that already exist to govern the creation and running of legal institutions such as companies. Moreover, there are limits on what it feasible in the practical world of business. Thus, if the enforcement of contracts is to involve third parties such as a court of law, rather than depending on the power of the principals themselves, then verifiable evidence will need to be available in order for legal processes to go ahead. This evidence may show the way that the parties have behaved or the outcomes that their behaviour has yielded. Either way, however simple the disputed contract may be, the basic facts will need to be established in a form that a court or tribunal can consider. Witnesses will be needed, including the parties themselves and third parties who can demonstrate the facts of the case (usually with documentary proof).

In practice, the complications can increase profoundly. What if a bank loan has been agreed in order for a group of customers to engage in one form of activity, whereas in fact they use the money for something quite different? How ‘different’ would it need to be to justify the bank in recalling the loan immediately or in enforcing its right to foreclose on the customers’ assets?

In practice, considerations such as these are not limited in their effect to the parties themselves. The bank’s reputation may be at stake, with consequences for its relations with other customers and perhaps even for its status as a deposit-taking institution. The social consequences will rarely be a matter solely for the parties directly involved.

For much of the 1980s and 1990s, political rhetoric favoured keeping the power of the state to the minimum possible, and letting market forces operate as far possible. It is likely that the ‘credit crunch’ of recent months will produce pressure in the opposite direction, with calls for greater state intervention, tighter regulation, and more surveillance. This is likely to include the surveillance of companies generally, as well as directors, professionals and their regulatory bodies. There has already been a notable increase in state ownership of bank shares, for example, as well as unparalleled increases in the provision of state finance. Perhaps this heralds a change in priorities.

In working on this report we have been conscious of the need to keep a sense of balance between pursuing the lowest possible costs of regulation, on the one hand, and maintaining equity and social justice on the other. Insolvency is a widespread danger but it will not directly affect the majority of companies, whose directors have plenty of other preoccupations from day to day. Thus, some of the proposals that we put forward at the end of this report involve reducing mandatory filings particularly by private companies, provided that creditors are offered a new form of protection (in the form of solvency statements). Other proposals accept a need for closer state participation in order to pursue social benefits (such as greater involvement of the Insolvency Service in the costs of investigating directors suspected of offences meriting disqualification). Some of our proposals are the same as those suggested elsewhere, but others are not. Formal cost benefit analysis has fallen outside the boundaries of our study and some of our proposals would need further discussion, elaboration, and possibly testing before being accepted.

While we stress the need to keep a balance between a market solution to the problems of insolvency and state intervention, there is another (related) form of balance that has also occupied us. The ability of creditors to protect their own interests for themselves is greatly helped if they have access to full and accurate information about the financial health of the companies which owe them money. Some of this information can be provided as a matter of private bargaining, for example as between a company and its main bankers. Some is required by law to be in published form, accessible to anyone who wants to see it at the Companies Registry. This is mandated mainly by the Companies Acts, as part of a social bargain that insists that where shareholders enjoy limited liability for the debts of the company, then that company is obliged to file an annual report and a set of accounts. The accounting and auditing provisions of the Companies Acts are supplemented by more detailed accounting and auditing standards.
set out by regulatory bodies authorised by statute. We review the strengths and weaknesses of information disclosure in the annual report and accounts before considering the possibility of other forms of disclosure specifically about solvency.

Until 1985, most of the legal provisions on corporate insolvency were set out in the Companies Acts. However, these were then transferred to the Insolvency Act 1986 (IA 1986), which, together with related provisions of the Company Directors Disqualification Act 1986 (CDDA 1986), is now the main source of regulation on the subject. It is augmented in detail by insolvency rules made under the IA 1986 and by professional statements issued by the relevant regulatory bodies. We have taken the opportunity offered by this project to review some aspects of the IA and its rules to see whether there are improvements that can be made.

The need for specialised legislation, both in company and insolvency law, reflects a general acceptance that the law should provide for the creation of corporate entities that have some of the powers of private individuals. These need a standard set of rules to govern their conduct, performance and termination. Similarly, the existence of distinct professions of accountants (including the sub-set of auditors), lawyers and insolvency practitioners evidences the complicated and skilled nature of practice in these areas, and a perceived need for the several areas of work to be reserved to those qualified to undertake them, under supervision of the relevant professional bodies.

1.2 STRUCTURE OF THE REPORT
The second section of the report considers existing financial accounting techniques as predictors of insolvency, noting the limits of data capture and valuation. The majority of UK companies publish unaudited abbreviated financial accounts and many that publish full sets of accounts do not have them audited. Some important user groups find they can rely less upon the accounts than they used to do before disclosure thresholds became so high. Even the rules that are currently prescribed by company law, accounting standards and professional practice are not always applied correctly. The report examines how accounting reports are used for ratio analysis, both for individual companies and also to segregate groups of companies into those at higher risk and those at lower risk. The rise of the capital maintenance doctrine is also traced. We also review the role of auditors, mainly in the context of those larger companies that are required to have audits (including listed companies).

In section three the report looks at two important recent reports on capital maintenance in the context of distributions by public companies (the Rickford Report 2004 and the FEE Report 2007). Both argue for the abolition of the capital maintenance rules set out in the European Second Directive on Company Law. Both insist that existing legal rules fail to provide adequate creditor protection and pay insufficient attention to cash flow forecasts as the most reliable predictor of insolvency. We largely agree with the analyses presented by Rickford and FEE, although (from their terms of reference) neither of them addresses private companies, among which we believe insolvency to be the greater problem, nor the issue of solvency statements filed outside the context of distributions.

In section four the report reviews the main features of current insolvency law. We note some of the consequences for corporate insolvency of the Enterprise Act 2002 (EA 2002), particularly the rise in frequency of administrations and the relative fall in administrative receiverships and in liquidations. We then review six areas in which there are legal and application problems in using the provisions of IA 1986 and CDDA 1986, adding some further comments about pre-packaged sales and other issues of public policy connected with corporate insolvency. We then revisit some of the key problems in creditor protection.

The final (fifth and sixth) sections present conclusions and 24 recommendations as explained in the report. The recommendations are that:

1. The concept of ‘general purpose accounts’ needs further development.
2. A larger proportion of companies need to publish full accounts than at present.
3. A larger proportion of companies need their accounts to be audited than at present.
4. Public companies should be required to use solvency statements with their distributions.
5. Solvency statements should replace the need for filing abbreviated accounts wherever these are permitted at present.
6. Cash flow forecasts are needed by boards to underlie these solvency statements, subject to:
   • how much to publish;
   • what form they should take;
   • how much detail they need to embody;
• agreement over their time horizon: positive assurance on the part of directors for one year and negative for the further future;
• auditor and/or other professional involvement in the cash forecasts eg, attestation;
• frequency of board review; and
• accepting the process as a discipline on board.

7. To modify directors’ duties and behaviour, there needs to be encouragement to review solvency periodically, with more frequent reviews if insolvency is seen as likely.

8. Directors’ duties need to be expressed towards the entity – rather than (as at present) towards shareholders and towards creditors where there is a risk of insolvency.


10. The timing of the onset of insolvency needs clarifying, to establish the principle in West Mercia.

11. Administration should be seen as the standard gateway to take upon insolvency.

12. CDDA 1986 undertakings should be linked more closely with IA 1986 actions.

13. The Disqualification Unit should monitor compliance with undertakings.

14. There is a case for a more pro-active role on the part of the Insolvency Service.

15. Insolvency Service financial support would be useful to help fund actions, as in New Zealand.

16. Moves are welcome to make wrongful trading illegal across Europe.

17. Consideration should be given to whether easing commercial funding of actions and insurance (including insurance for directors and officers).

18. Consideration should be given to whether altering priorities over benefits and costs, giving more unsecured creditor protection.

19. Consideration should be given to whether further usage and extension of the ‘prescribed part’.

20. Recovery of office-holders’ costs needs to be improved, either from court awards or from the ‘prescribed part’ where it exists; and public contribution towards the costs of public interest activities.

21. Consideration should be given to whether fraudulent and wrongful trading actions need be brought only after formal insolvency procedures have been started; consistency needs to be improved between the main procedures, liquidation and administration, as to which recovery actions may be brought.

22. Consideration should be given to whether the above actions need be brought only by office holders.

23. Creditors’ committees be made more effective – steps are needed to improve participation.

24. Pre-packaged sales be made more transparent, although we note with approval Statement of Insolvency Practice No 16, published after our draft report was submitted.
2. WHY FINANCIAL ACCOUNTING INFORMATION OFFERS INADEQUATE PROTECTION FOR CREDITORS

2.1 THE USE OF ACCOUNTING REPORTS TO MONITOR CREDIT AGREEMENTS

2.1.1 It is a basic proposition of transaction cost economics that firms exist to take in investors’ capital, commit it to specific assets with a limited range of alternative uses, and then use the specialised knowledge and ability of the staff to convert these assets into goods and services that will yield larger cash flows in future. Managers may do all this using their own capital or the equity capital of co-owners. Or they may use loan capital in place of some of the equity, and in that case they assume particular responsibilities towards creditors. The great majority of companies registered in the UK offer their shareholders limited liability, so the directors have a particular duty of care to the creditors, who can only recover their debts from the company and not from the shareholders nor (usually) from the directors.

2.1.2 Although companies are not usually forced to incur credit, it is very rare for them to forego it, whether for short- or long-term finance or for both. There are two reasons for this – its flexibility, and the tax status of debt interest. It is typically easier and cheaper to raise loans than new issues of equity. It is also nearly always easier to repay loans than paid-up share capital when the funds are no longer needed. Lenders will seek security when they are able to do so. Some assets are much more suitable as security for loans, particularly assets-in-place with a wide range of alternative uses (such as adaptable property assets which can often be mortgaged as security for loans).

2.1.3 By contrast, intangibles – and those other forms of assets-in-prospect that need specialist skill to exploit them – are less suitable as security for lenders since they typically cannot be sold to other users unless as part of a going concern. Lenders are, of course, aware of these threats and loan agreements offer some protection in response, such as fixed rates of interest, restrictive covenants imposed on the borrower, negative pledges, and the right to invoke insolvency procedures if due payments are not made on time. (Williamson (1988) analyses the use of loans from the perspective of ‘efficient’ – i.e., wealth-maximising – corporate governance. He takes a transaction cost economics view of asset finance).

2.1.4 The other advantage of loan finance is the differential tax treatment of loan interest and dividends, giving rise to tax shields under various assumptions about corporate and investor tax rates. Loan interest is a tax allowable expense to the company but taxable income to the recipient. By contrast, dividend payments from equity earnings are made out of net-of-tax income to the company, whereas reinvested profits usually produce capital gains on which tax can typically be deferred – and to some extent avoided – by individual shareholders under UK law. Thus, the abolition of advance corporation tax in the UK in the Finance Act 1988 meant that, after April 1999, there was no longer equal tax treatment of corporate earnings regardless of whether they were retained or distributed. The ‘imputation’ system of tax meant that, for some years before 1999, income tax deducted at source from dividend payments was treated by the Inland Revenue as an advance payment of corporation tax, thus reducing the ‘mainstream’ corporation tax payable. Since 1999 this has no longer been true, so that dividends since that time have borne more tax than undistributed profits (once as part of profits in the hands of the company, and again as dividend income in the hands of the shareholder). This means that loan interest has become relatively cheaper than equity as a source of finance.

2.1.5 One result of this is that levels of corporate gearing have risen rapidly since 2000 in the UK, although there may well be other factors also at work such as the rise of asset financing and the venture capital sector. Debt gearing among UK non-financial public companies rose from 21.4% to 31.1% in just five years, between 1998 and 2003 (from £460m out of total financial liabilities of £2,151m in 1998, to £840m out of £2,702m in 2003, according to the UK National Accounts ‘Blue Book’ 2004, Table 2.2.9, p153. The 2008 ‘Blue Book’, Table 3.1.9, p119, shows similar gearing in 2007, with debts of £1,210m out of total liabilities of £3,944m).
2.1.6 Finance theory is discussed in many textbooks on the subject eg, Brealey and Myers *Principles of Corporate Finance* (currently in its ninth edition). Finance theory usually makes the simplifying assumption that borrowers and lenders can lend unlimited amounts at the same constant market rate of interest (adjusted for risk, measured by the variability of market returns on the investment). In practice, however, transaction costs generally mean that access to new loan capital is uncertain in terms both of availability and cost to individual firms, particularly when they may be facing financial problems. The prospective cost of financial distress – in the US, the term ‘bankruptcy’ is used for companies as well as for individuals – is the key factor that limits the amount that a company will want to borrow, despite the fact that borrowing may be cheaper than equity, even in some simplified theoretical models. In other words, there are limits to the level of borrowing that a company will be expected to take up. Partly this is a matter of its having suitable assets to offer as security, and partly it reflects the risk of borrowing too much.

2.1.7 Some creditor relations are set out in contractual terms specifically and in detail, such as bank loans taken out for specific projects. Debt covenants may be expressed in terms of the behaviour of the company, for example to refrain from borrowing further without the express permission of existing creditors (‘negative pledge’ agreements). Covenants are also often set out in terms of financial ratios, based on balance sheet or income statement variables. The use of such covenants has been studied in some depth by Day and Taylor (see for example their 2001 paper). They clearly have a role to play in the UK, even if they are relied upon less than they are in the US. They also rely heavily on accounting numbers, whose reliability is questioned at some length below. It is common for banks to demand details of the uses to which new loans are to be put, together with copies of recent and forecast accounts and cash flow statements, often supported by personal guarantees from the directors. Financiers (often bankers holding secured charges and bondholders) typically possess greater knowledge and bargaining power than those unsecured lenders whose relations arise in the course of supplying goods and services on deferred payment terms.

2.1.8 Before granting credit, trade lenders will usually make enquiries as to the credit status of the customer (from other firms in the industry and from credit reference agencies), but there are also some classes of creditor whose status arises without their willing agreement (for example, redundant employees and claimants under warranty). Investigating the credit status of a company involves costs in terms of time and money. Updating that information is also costly, and creditors (particularly unsecured trade creditors) may prefer to protect themselves by spreading credit risks amongst a diversified portfolio of debtors without monitoring their credit status.

2.1.9 Periodic reports may already be available to give some information relevant for monitoring credit agreements, including the statutory financial accounts and any special purpose accounting publications. The latter may be provided either to the creditors themselves, so that they can watch over their loans, or to someone else (such as an insolvency practitioner) who can help protect creditors’ interests. Problems arise over the form, contents, timeliness, and dissemination of such financial information.

2.1.10 It is rare that credit reports are provided in just the form that the creditor would want (although banks, for example, can usually insist on certain items of information being provided as part of their negotiations over credit terms). Most borrowers are of course honest and reliable with funds that they borrow. However, even with regular monitoring information, it is often very difficult to tell whether directors are performing with competence and with the best of good faith. To tell whether or not this is the case in an individual case involves information about directors’ behaviour, individually or as part of a group, a matter on which verifiable evidence is often hard to establish (particularly some time after the event).

2.1.11 Most businesses are going concerns, whose operations will continue indefinitely into the future. Periodic financial reports for continuing activities are more difficult to prepare than for those ventures whose assets have been fully converted into cash or cash equivalent. The future outcomes of continuing actions are uncertain – often highly uncertain – and accounting for them involves assessing past and present activities whose results have not yet taken determinate form. Most outcomes depend on decisions that still need to be taken and actions that are still to be performed in the future. This gives rise to valuation problems in the accounts, even though external users often extrapolate this imperfect information to form cash forecasts.

2.1.12 The need to predict future cash flows (and possible insolvency) lies at the heart of creditor protection. Important issues arise from the fact that the most relevant information takes the form of cash forecasts. Future cash flows are uncertain in timing and amount, and forecasting them is best done with subjective estimates of a highly sensitive commercial nature. It is
impossible to publish all the relevant information to the world at large, although some of it – even commercially sensitive information – may be given in confidence to a limited set of readers, sometimes acting as proxies for creditors in general. Thus, a bank that closely monitors the solvency of its customers by observing cash flowing through their bank accounts may, through its activities, provide incidental benefits for other creditors who can ‘free-ride’ on the bank’s work to protect their own interests. On the other hand, there may be an element of conflict between the interests of the bank (typically protected by a floating charge over the borrower’s assets) and those of the unsecured creditors (Franks and Sussman, 2000).

2.1.13 If contract performance departs from the agreed terms – for example, if a borrower fails to pay a debt on time – the question then is what to do next. Once insolvency threatens, measures to protect creditor interests can include re-negotiating credit terms with the company, enforcing security over some or all of the debtor’s assets by selling them to recover the debt, installing a manager or administrator with power to protect the creditors’ interests, and (if all else fails) liquidating the company (with or without the prospect of making the directors personally liable to contribute towards the company’s assets).

2.1.14 An alternative approach to creditor protection would be to take the burden of credit risk from the creditors themselves and offer them insurance cover. This could either be at their own expense, or at the expense of the debtor. Vehicle drivers are legally obliged to take out third-party liability insurance as a condition of being allowed to use public highways, and employers must have insurance provisions in order to employ staff. So, too, it might be made compulsory for borrowers to have insurance cover to protect creditors, or they may find it commercially attractive to obtain such cover on a voluntary basis, rather as many UK travel companies are covered by an industry-wide scheme to indemnify travellers in the event the travel operator fails financially. The effect of this is to put the monitoring task in the hands of specialised experts, rather than expecting large numbers of infrequent customers to undertake costly and often complex investigations of their own.

2.1.15 The objections to this idea are not hard to find. Credit relations are so numerous and varied, involving so many different types of party and transaction, that there is relatively little expertise that an underwriter can call upon. There is also much too great an element of moral hazard offered to creditors and debtors, who might be quite happy to see claims settled by an insurer rather than by one of their own number. It is significant that the Company Law Review Steering Group (CLRSG) specifically addressed a proposal that companies should supply a form of insurance (a bank guarantee) in the specific context of a proposal to the court for a reduction of share capital: the February 1999 Consultative Document (p82, para 5.4.5) considered whether the court might require a bank guarantee under such circumstances to protect present and future claims following capital reduction, regardless of the financial strength of the company. The Steering Group commented, ‘We do not regard this rule as efficient’. On the other hand, insurance arises as an important concern in the context of directors’ personal liability, discussed later in the context of the responsibilities of directors and officers below.

2.1.16 The discussion so far has proceeded on the assumption that insolvency is a matter of formal rules and enforceable contract law, but in practice a great deal is left to informal procedures, incomplete contracts, and social norms (Mumford 2003). There is good reason for this. Formal rules tend to be costly to put in place, costly to monitor, and somewhat unpredictable to enforce. The analysis of transaction cost economics has increased the interest of economists in trust as a valuable feature of business (Frank, 1998; Fukuyama, 1995). This stress on informality is more consistent with the reliance amongst lenders in the UK upon out-of-court negotiations, as characterised by the term ‘The London Approach’ (see, for example, Armour and Deakin, 2001). This London Approach requires cooperation among lenders, encouraged and coordinated by the Bank of England. Armour and Deakin quote evidence (both from theory and practice) that the renegotiation of loans under the threat of financial distress is easier where the lenders are homogeneous and correspondingly more difficult where lenders’ interests diverge. By far the most numerous cases of insolvency in fact arise with small companies. For this reason, most of our accounting recommendations will be concerned with these and with the need to reduce exemptions limits. However, we are well aware that insolvency also affects very large companies too.

2.1.17 As the European High Yield Association (EYHA) has pointed out on its website, large companies may have extremely complex financial structures, with many levels of debt. The EYHA has been lobbying for UK law to introduce legislation similar to Chapter 11 in the US corporation code which protects incumbent management by stopping actions being brought by creditors to allow time for complex conflicts to be resolved. EYHA also urges new provisions for super-priority lending where a company is already facing financial distress. The informal approach that has served well in the UK in the past, they argue, is now out of touch with present conditions.
2.1.18 Indeed, it does seem likely that the London Approach, which grew up between the 1970s and 1990s, has since been undermined to some extent by institutional changes in the UK. This partly reflects the rise in bond finance (including US hedge and ‘vulture’ funding), negative pledge and complex mezzanine agreements, and asset financing (whether secured by ownership, or by fixed or floating charges) in place of bank loans secured by floating charges (Armour and Deakin 2001; Frisby 2006). Whether Chapter 11 and super-priority lending are appropriate answers is debatable. The former entrenches the very managers who have presided over the slide into financial distress, while the latter has the effect of shifting the complex networks of relations between creditors. Both have effects that are hard to predict.

2.1.19 Whatever the protective measures may be, they need some trigger to set them off. Creditors may not be able to tell from outside the company how imminent its insolvency may be. Indeed, neither may the directors themselves – and even if they can do so, the directors may prefer discretion rather than choosing to publish the information. They may prefer ‘window-dressing’. Lennox (2001) studied the disclosures made by 120 failing UK companies, and found that they tended to hide bad news; a 1997 study by Sharma and Stevenson showed that impending corporate failure induced directors in Australia to adopt discretionary accounting policy changes that would improve the public presentation of the company; and Charitou et al (2007) shows similar practices among 455 US companies that filed for bankruptcy over the period 1986–2001. (We note that Meeks and Meeks, 2009 p23, cite different sources of evidence with similar findings for Australia, Clarke et al, 1997, and for the US, Sweeney, 1994.) Thus, directors of financially distressed companies often face a difficult dilemma: should they keep quiet, or should they massage the data in the hope that they can avert financial disaster? This may later be construed in court as misfeasance against the company and its creditors.

2.1.20 In the UK (as in most other countries), payments into company funds may be sought from the directors personally, under the Insolvency Act and the Companies Acts, if it can be shown that they have not acted properly to protect creditors’ interests. Thus, directors may be called upon to contribute towards creditor losses, and they may also suffer disqualification from holding appointments (under CDDA 1986). They may also have given their personal guarantees to creditors, although this reduces their ability to contribute towards general company funds for the benefit of other creditors. There tends to be a conflict between measures designed to deter directors from committing an offence, through retribution, and those that encourage them to make restitution, but in some important respects they work together. Thus, the disqualification of directors under CDDA 1986 serves both to protect the public from directors who have performed unsatisfactorily in the role and to encourage directors to address their obligations more zealously.

2.1.21 The greater the threat of insolvency, the greater the onus on directors to consider the (increasing) risks to creditors, and similarly the more significant is the need for them to maintain verifiable evidence concerning the actions and decisions they take – evidence which could if necessary be produced in their defence before a court. Such evidence may be difficult to document fully, particularly since the forecasting of uncertain cash flows involves judgement. Moreover, it is often very hard to tell when, and with what degree of certainty, insolvency becomes an imminent threat.

2.1.22 Creditor protection depends upon forecasts of future cash flows. Thus, there is an empirical question to consider. What information that is currently available serves as the best predictor of future cash flows? And how far can such information be made available to creditors, either on public record or to specific users? Historically, it has often been assumed that accounting data available from published company accounts will serve to guide readers adequately about future cash flows, using the balance sheet, the income statement and cash flow statements. In this report, we reject this approach. We are convinced that direct cash forecasts made by the directors, including the uses of unpublished information (for example, on the state of the order book, customer enquiries, production capacity and so on), will enable better predictions to be made of the future ability of the company to meet its debts as they fall due than published accounting history can offer. There are several reasons for this, as set out in the following sections.
2.2 NOT ALL COMPANIES PRODUCE RELIABLE AUDITED FINANCIAL ACCOUNTS

2.2.1 We argue in this report that predicting insolvency is better done on the basis of internal cash flow forecasts than on the basis of published accounts. However, company law has required the publication of accounts for a very long time. The formation of companies by a simple process of registration, rather than needing a royal charter or a specific act of parliament, dates from 1844. In 1855 it became possible to register a company with limited liability. At the outset, companies were required to publish accounts each year and file them on public record with the registrar of companies. This soon changed with the 1862 Act, which removed this requirement. Accounts had to be produced and sent to shareholders but not filed on public record.

2.2.2 To quote the Cohen Report (Board of Trade 1945):

‘The history of company legislation shows the increasing importance attached to publicity in connection with accounts. The Act of 1862 contained no compulsory provisions with regard to audit or accounts, though Table A to that Act did include certain clauses dealing with both matters. In 1879, provision was made for the audit of the accounts of banking companies, but it was not until 1900 that any such provision was made generally applicable. It was only on 1 July 1908, when the Companies Act 1907 came into force, that a provision was made for including a statement in the form of a balance sheet in the annual return to the Registrar of Companies, and that provision exempted private companies from this requirement.’ (Board of Trade, ‘The Cohen Report’, 1945 para 96.)

The Companies Act 1907 thus created the distinction for the first time between public and private companies. From 1929 a profit and loss account had to be laid before members each year in general meeting, together with the balance sheet, and filed by public companies.

2.2.3 CA 1948, while increasing materially the level of accounting disclosures in the annual return, still excluded most private companies from this requirement (by creating a new category of ‘exempt private companies’). Also under the 1948 Act, consolidated accounts (as well as the balance sheet of the parent) effectively became mandatory for groups of companies. Cash flow statements are also now required for all larger reporting entities (by accounting standards and by Stock Exchange rules for listed companies). Creditors have traditionally been seen as major users of accounts (see, for example, Reiter, 1926). They still are.

2.2.4 It was only between 1967 and 1994 that all registered companies, private as well as public, had to produce and file audited accounts with the relevant Registrar of Companies. (There are separate Registrars of Companies in England and Wales, in Scotland, and in Northern Ireland.)

‘Between 1967 and 1994 all registered companies were required to use chartered accountants because they were required to file audited accounts. The introduction of audit exemptions in 1994, with subsequent increases in the audit exemption threshold in later years, means that there is no longer any obligation on directors of most small companies to use professional accountants...’ (POBA 2006 p19.)

Reference to ‘chartered accountants’ here means practising members of the four UK professional bodies recognised for the purpose – the three institutes of chartered accountants plus the Association of Chartered Certified Accountants. There are also a few registered accountants who are not chartered. There are also numerous firms of ‘unqualified’ accountants who are neither chartered nor registered under the Companies Acts to undertake audits.

2.2.5 CA 2006 formalises the law further, distinguishing between private and public companies (eg, at ss4, 58, 59, 437–444); small and medium-sized companies for the purposes of preparing accounts (ss381–4 and ss465–7); quoted and unquoted companies (ss385); dormant and non-dormant companies for the purposes of audit (ss480–1); and the audit obligations of private and public companies (ss485–491). Private companies also have particular provisions when it comes to reducing share capital (ss642–3), redeeming or purchasing their own shares out of capital (ss709–723), and making distributions (ss381, although only by imposing the ‘net asset restriction’ to public companies alone).

2.2.6 There are important differences, then, between the reporting requirements laid by law upon companies of different sizes and legal status. Most companies, being small, are under no legal obligation either to publish full sets of accounts or have them audited, although they must all file an annual return with the Registrar of Companies (ss444) and prepare accounts for...
their members and debenture holders (s423). The members themselves can decide whether or not they wish the company to have the accounts audited (s476), and to have the report and accounts laid before a general meeting of the company. CA 2006 has moved further than the previous 1985 Act in recognising that most small companies are owned and controlled by a relatively small group of people, sometimes just the directors, who can choose whether or not they want audited accounts and a formal schedule of meetings.

2.2.7 The CLRSG was keen to redress what it saw as an imbalance in company legislation between the needs of large and small companies, although it urged that the provisions that apply to small companies should be included within an integrated Companies Act, rather than forming a completely separate regime. The CLRSG advocated a ‘Think Small First’ approach in its February 1999 consultation document, and in the March 2000 consultation paper it commented (p220, para 6.6 et seq., parenthesis added and some text deleted):

‘6.6 The responses to the Strategic Framework Consultation Document, and the work undertaken during this phase of the Review, have supported that approach [ie, the ‘integrated approach’]. In particular, they have confirmed the importance of focusing on the needs of small companies.

6.7 The private company limited by shares accounts for the great majority of companies registered in Britain. Of all the companies registered at Companies House as at 31 March 1999 there were over 1.2 million private companies limited by shares as compared with 11,600 public companies.

6.8 Research carried out for the Review by ICC showed that the large majority [some 65%] of ‘live’ companies have a turnover of less than £250,000, while at the other end of the scale, only some 2 per cent have a turnover of more than £5m… .

6.9 The research also showed that over 70 per cent of companies have only one or two shareholders. Some 90 per cent have fewer than five shareholders. We have not been able to ascertain the number of companies where there is a complete identity of directors and shareholders … . However, a small scale survey of company auditors indicates that a significant proportion of companies would fall into this category … .

6.10 … However, the Act is largely structured around the needs of the large public companies. …

6.14 A further difficulty for small companies is that the various provisions which might help to make their corporate life simpler are not conveniently grouped together in a way which would make it relatively easy for someone to ascertain what a small private company must do in order to comply with the law, or how much flexibility it has to arrange its internal governance in the way which it finds most convenient. For those without expert legal advice it is not easy to establish what the law requires. And yet it is precisely these small companies which are least likely to have access to legal expertise, or to have the resources to devote to finding their way round the Act.’

2.2.8 The CLRSG expressed dissatisfaction with abbreviated accounts, both in its February 1999 and its March 2000 Consultative Document. In the former (p120, para 6.15), the CLRSG wrote:

‘Abbreviated accounts might be replaced by a certificate of solvency as in New Zealand. But this would require modification of the 4th Directive (which currently requires published balance sheets and profit and loss accounts for all limited companies).’

2.2.9 In its March 2000 paper (p283, paras 8.33–4), the CLRSG reported:

‘A number of respondents to the recent DTI consultation on accounting thresholds questioned the value of abbreviated accounts, in particular to users. The responses came from both large and small firms of accountants, small companies, and professional and industry bodies. Respondents felt that the information presented in the abbreviated accounts was simply not meaningful to creditors and denied them access to relevant information. Consultees found it hard to see the merits of continuing to place on the public record through Companies House large amounts of information seen as of dubious value or interest. They also noted that the sole acknowledged benefit to the company was that of denying certain information, particularly turnover and operational figures, to competitors.'
Why financial accounting information offers inadequate protection for creditors

8.34 The responses to our Strategic Framework Consultation Document echo these points, which were reiterated in evidence to our working group. We have considerable sympathy with these views. As with many aspects of accounting and reporting, weighing the benefits to companies against the costs to users is difficult and is a matter of judgement. Our own view is that the disadvantages of the abbreviated accounts facility for small firms greatly outweigh their benefits.

2.2.10 CA 2006 s444 retained abbreviated accounts provisions similar to those set out in s247 and Part I of Schedule 8 to the 1985 Act, except that s396 and s404 now authorise the Secretary of State to regulate the form and content of accounts, rather than setting these out in a Schedule to the Act.

2.2.11 Out of an estimated 4.3 million business enterprises in the UK at the start of 2004, about half were incorporated. (Most of the others were sole traders or partnerships.) Out of the 2.2 million companies on the register of companies in 2005, about 1.2 million were ‘non-dormant’ and filed accounts. Of the non-dormant companies 95% were thought to be ‘small’ as defined at the time in the CA 1985, as amended, where this definition meant that they had, in respect of two out of three criteria for their last three years: an annual turnover below £5.6m; a balance sheet totalling no more than £2.8m; and an average number of no more than 50 employees. (CA 2006, s382 thresholds have since been raised to £6.5m, £3.26m and 50, respectively.) Another 35,000 companies were classed as ‘medium’, where the above limits are raised to a turnover of £22.8m, assets of £11.4m, and 250 employees (now £25.9m, £12.9m and 250, respectively). The remaining 15,000 to 20,000 were ‘large’. Some 3,000 of these have securities listed on a stock exchange in the UK, and they must therefore also comply with the additional rules laid down for them both by CA 2006 and by the relevant Listing Rules. Out of the 1,200,000 non-dormant companies, between 15,000 and 20,000 (that is to say, between 1% and 2%) have become insolvent each year in recent years (Insolvency Service 2008), but these numbers will regrettably increase considerably, no doubt, in the current economic recession. Most of these insolvencies consist of small companies, although some very large failures have received understandably greater attention in the media.

2.2.12 Small and medium-sized companies may choose to file unaudited ‘abbreviated’ accounts and the majority of them appear to do so (POBA 2006 p24). It is worth noting, however, that (by CA 1985 Sch 8) even these abbreviated accounts are required to include balance sheets that show, under separate headings; total amounts owed to their creditors for the present and the previous year (analysed into those falling due for payment within one year, those falling due after one year, and those falling due after five years); and also their current assets (analysed into stocks, debtors, investments and cash). In respect of each heading of creditors, the aggregate amount must be shown of each item for which the company has provided security (Schedule 8A 8(1), retained by CA 2006). Although many companies produce un-audited accounts, where this choice is available to them, many of these nevertheless have their accounts compiled by firms of registered auditors even where they are not audited.

2.2.13 Under the Financial Reporting Standard for Small Entities (FRSSE, effective from January 2007), it is also required that in the accounts provided for their members, whether or not these are audited or filed, companies must show their debtors divided into five classes: trade debtors; any amounts owing by group undertakings and undertakings in which the company has a participating interest; any other debtors; any prepaid pension costs; and any uncalled share capital. Information must also be supplied on the amount of factored debts, any debtors under long-term contracts or under leases, and any debtors not receivable within one year. As regards creditors, analysis is required of bank loans and overdrafts; trade creditors; amounts owed to group undertakings; and other creditors. Any amount of convertible debt also has to be shown separately, as do obligations under finance leases and hire purchase contracts. Many small companies agree to provide these full sets of accounts to banks and other creditors when pressed, and also send them to HM Revenue and Customs as support for their tax returns. However, this is not an obligation set out in company law or in standards. On the basis of their risk assessment processes, HMRC only check in detail in a sample of cases that self-assessment tax returns are supported by a company’s accounting data.

2.2.14 The POBA report (2006), reviewing how accountants support the needs of small and medium-sized companies and their stakeholders, includes comments based on interviews with some major user groups. They report that up until 1994, the Institute of Credit Management used to use company accounts:

‘to make fairly safe and more accurate assessments of companies based on financial accounts ... Credit providers and agencies now collect data from other sources but may still be left with less certainty that could be reflected in more cautious credit policies’. (POBA report 2006, p23.)
POBA adds:

‘Credit managers were concerned that many small businesses do not have monthly management accounts or forecasting systems in place. This can result in many companies only discovering that they are in financial difficulty when it is too late to remedy the situation.’ (POBA report 2006, p31.)

2.2.15 Similarly, the British Bankers’ Association (BBA) notes that, following the increase in the audit threshold, its member banks now:

‘…do not routinely request annual statutory accounts from their small company clients. The banks meet their information needs primarily by looking at the businesses’ financial acumen and free cash flow as evidenced by the operation of bank accounts rather than accounting information.’ (POBA report 2006, p23.)

POBA reports that:

‘Banks told us they expect to see management accounts from clients with larger business loans. For at least one bank, the existence of timely management accounts is seen as providing greater assurance that appropriate financial management and control processes are in place in smaller companies than a decision to have the financial accounts audited.’ (POBA report 2006, p31.)

2.2.16 As noted, mandatory accounting requirements for smaller companies are laid down in the Companies Act and in the FRSSE for accounts to be prepared for members of the company, with lighter obligations set out for the accounts that must be filed on public record. This begs the question how far these requirements are met in practice. The 2006 POBA report was primarily concerned with this matter of compliance by small and medium-sized companies. It also sought to find out whether accounts in which qualified accountants had some part (either as auditors or as compilers) differed in quality from other sets. The survey examined 355 sets of SME accounts drawn at random from the company registries in England and Wales (185), Scotland (85), and Northern Ireland (85).

2.2.17 The POBA survey found:

‘The majority of accounts reviewed were generally informative but appeared to include some technical disclosure or minor computational errors. In many cases, notes to the accounts were not fully compliant with relevant accounting standards … A sizeable minority of the sets of accounts examined … appeared to include more significant technical issues, material computational errors or other evidence of a lack of care in preparation that, taken together, could undermine the usefulness of the accounts. Examples included: balance sheets not balancing by a material amount; prior year adjustments when the company was incorporated during the year; and in audited accounts, called up share capital exceeding that authorised. Problems with the quality of accounts filed at Companies House were found across sets of accounts where no professional accountant was named, where a professional accountant was named but no audit carried out, and audited accounts. Similarly, problems were found across sets of accounts prepared by all types of firms, from sole practitioners to the “big four”.’ (POBA report 2006, pp25–6.)

2.2.18 Thus, even the accounts which the law insists on being filed on public record may not be reliable. The Registrar of Companies has a duty to accept accounts submitted for filing, but not to monitor their compliance with either the law or with accounting standards. On the other hand, the professional accountancy bodies have responsibility for the conduct of their members holding practising certificates, in those cases where accounts have been subject either to audit or independent financial review, or where accounts have been compiled by their members. These bodies are reactive, rather than pro-active.

2.2.19 At the other end of the spectrum, accounts filed for public companies are detailed and often lengthy. They are also audited. In the case of listed companies, audit is usually by one of the large international firms. It is often questioned whether these accounts are read by their shareholders, even the more concise ‘summary financial statements’ often sent by companies under CA 2006 s426. We comment below (in 2.5.2 and 2.5.5) on some of the problems of assessing the solvency of complex groups of companies, but on the whole we are less worried about the financial reporting of large companies than we are in the case of smaller companies. Narrative reports on principal risks, in the Business Review, are required of all except small companies by CA 2006 s417 and these include financial risks where these are significant for the future of the company.
2.3 THE LIMITATIONS OF ACCOUNTING DISCLOSURE

2.3.1 Quite apart from questions about the implementation of existing disclosure requirements, there are strong reasons to doubt whether financial accounts could in any case be relied upon to provide creditors with sufficient information for them fully to protect their own interests. As explained below, the contents of the published accounts do not directly address the question whether the company will be able to meet its debts as they fall due for payment in the future. On the other hand, some provisions of the law currently specify the use of a test apparently based on balance sheet information. Thus, a company may only make distributions out of profits available for the purpose, and in the case of public companies such payments are subject to the additional provision that the amount of its net assets afterwards ‘is not less than the aggregate of its called-up share capital and undistributable reserves’. In CA 2006 s831 this requirement is repeated from earlier legislation established over many years, but these provisions currently face strong criticism (notably from The Institute of Chartered Accountants in England and Wales).

2.3.2 The apparent reason for this rule is to prevent companies from returning capital to their shareholders, thus depriving creditors of assets out of which to recover their debts. The capital maintenance provisions of the companies’ acts have a long history, and they have been much disputed (see, for example, Yamey, 1962). Our contention in this report will be that only cash flow forecasts are sufficient and necessary to define solvency and hence protect creditors. In those cases where the balance sheet reveals a surplus of liabilities over assets, the company may well be insolvent (although this does not necessarily follow, since some assets may be missing or understated). However, the converse cannot be relied upon to show that the company can meet its obligations as they fall due. Balance sheet tests are poor guides, loosely defined and potentially spurious (see sections 2.4 and 2.5 below).

2.3.3 It has always seemed obvious that one of the major purposes behind the publication of accounts has been the protection of creditors, particularly after limited liability became the norm. This seemingly obvious precept is now probed further. The balance sheet lists many, but not all, the assets that the company controls, fixed and current, and it also shows the sources from which their acquisition has been funded. It shows whether the company is using any loan capital alongside the owners’ equity capital (the latter including any retained profits). The greater the proportion of funding that comes from creditors, the greater the solvency risk is thought to be, both to the shareholders and to the creditors. On the other hand, contingent and prospective liabilities, both of importance in the context of insolvency, are not shown in the published accounts (although contingent liabilities are likely to be shown in notes attached to the accounts). Moreover, the amounts shown in the balance sheet as the value of liabilities only loosely reflects the timing of the payments due (even though, even in ‘abbreviated accounts’, liabilities must be analysed into those due for payment within 12 months, those due between two and five years, and those due in more than five years, as noted in 2.2.12 above).

2.3.4 While the balance sheet shows a static picture as at the balance sheet date, the income statement (or ‘profit and loss account’) serves to show whether the resources of the company have increased or fallen as a result of trading activities over the past trading period (after allowing for any capital introduced or withdrawn by shareholders). The cash flow statement (where available) shows how net cash holdings have changed over the period, distinguishing between the main sources and applications of the balances. These two sources will be helpful in showing how far financing costs such as loan interest have been covered by inflows from operating income in past periods, and how far financing activities have produced cash resources.

2.3.5 There have always been difficulties in defining assets and liabilities, and – still more – profits and losses. Just what to include in the books of account and what to exclude has in the past been as much a matter of convention as it has been of exact prescription by law. CA 2006 specifies that ‘every company must keep adequate accounting records’ (s386 (1)), and that these must contain in particular ‘entries from day to day of all sums of money received and expenses by the company and the matters in respect of which the receipts and expenditure takes place, and a record of the assets and liabilities of the company’ (s386 (3)). In practice, this record of the assets and liabilities is not exhaustive, for reasons addressed below. While the accounting system captures all receipts and payments of cash, it has conventionally adopted the accruals system to indicate the timing at which non-cash assets are included or excluded from the records.

2.3.6 The most important single activity of the company is the purchase and sale of goods and services. Indeed, a business exists in order to generate sales of those goods and services in which it specialises. Both purchase and sales transactions give rise to a debt of a precise amount that can be proved in court, even though the debt is not necessarily due yet for
The evidence takes the form of an invoice – detailing the goods and services, their prices and payment terms, delivery details and so on – giving written notice to the customer that their account has been charged in the books of the supplier, and that a debt exists as from that date. If debtors do not agree with the details as set out in the invoices, they are well advised to respond promptly, otherwise the presumption will be that the debt is valid and accepted by both parties. The date of the invoice does not necessarily reflect the legal transfer of title to goods. It is issued at a point of time (in the case of the supply of goods, typically the date when the goods are despatched) when the supplier has substantially completed all that needs to be done.

2.3.7 We note with interest the discussion paper issued by the European Financial Reporting Advisory Group (EFRAG) in July 2007 that distinguishes between various ‘critical events’ that can give rise to revenue recognition, and suggests that these can be disaggregated to a degree that virtually allows for the continuous recognition of income. The EFRAG paper expresses a wish to see a single definition of revenue adopted, but this rather understates the possibility that different forms of commercial contract give rise to different forms of critical event, at times when invoices may be raised to secure agreement between supplier and customer. (The EFRAG paper makes no mention of invoices, to our surprise.)

2.3.8 In principle, it has always looked plausible that the accounting system would work perfectly well in calculating profits or losses by using an alternative approach, by comparing the closing quantum of owners’ net assets (ie, total assets minus external debts owed to creditors) with the opening quantum at the start. The difference would seem to equal the amount by which shareholders’ capital had risen or fallen, which would equal the proprietor’s profit or loss for the period (after adjusting for any capital introduced or withdrawn). However, this has not been the way in which accounting has traditionally worked (except to prepare estimated accounts from the incomplete records of some small businesses). Despite s386, noted in 2.3.5 above, balance sheets cannot be relied upon to capture all the assets or liabilities of the business. Some assets do not appear because they have previously been fully written off as expenses against revenues (even though they may be still in use), and others because they have never been recorded. The latter may be too insubstantial to identify or to value (such as internally generated goodwill that has not been purchased in the market). Other intangibles not recorded in the accounts include the skill and commitment of the board and staff, the condition of the order book, technical details of productive facilities, specialised knowledge, potential lines of credit, strategic alliances, and so on. These may be vital to the success of the business, but they are mostly not reported (even in optional notes to the accounts).

2.3.9 The practical difference between the two approaches (‘income matching’ and ‘comparative balance sheet’ analysis) lies in the focus of attention that is brought to bear on the problem. The former, traditional, method starts by aggregating income realised in the year, primarily from invoiced sales, and then seeks to estimate the costs incurred in producing that income. The latter method involves listing a set of recognisable closing assets and liabilities to compare with the opening set on a commensurate basis. The recognition criteria differ since the sorts of judgement involved are based on different forms of evidence.

2.3.10 Conventionally, the accounts begin with the opening balance sheet that records balances carried forward from the previous period. The accounts then capture all the transactions recorded in the period before calculating the closing balance sheet that results. The balance sheet represents unexpired balances rather than a conscious effort to put a value on the business. The heart of the system is the record of the sales total for the period (ie, all those sales invoiced in the period). There are then deducting, as expenses, estimates of how much it has cost to generate those sales. This usually involves a need to estimate some costs of the past period that have not yet been recorded in the accounts, for example because suppliers have not yet sent invoices for past services. This accruals system involves ‘matching’ costs against revenues, a process that involves some uncertainty since joint costs (such as the depreciation of fixed assets) need to be allocated to time periods on an arbitrary basis. But the great merit of the system is that it seeks to tell an important story – how much the directors have managed to achieve in terms of the prime purpose of the firm, to sell at a profit goods and/or services to customers who can be held legally liable to pay for them. It reflects those achievements over which the directors have the greatest element of control, minimising the effects of external events outside their control, such as the movements of prices in the markets for fixed assets in which (by definition) the firm does not usually trade.

2.3.11 The UK’s Accounting Standards Board (ASB) rejected this traditional interpretation of the accounting process in its 1995 draft Statement of Principles and its rather different 1999 Statement of Principles, and it sought to replace the matching process with a process which began by comparing opening and closing balance sheet values. For this purpose it was essential to arrive at more robust definitions of assets and liabilities than previously had been used, in the belief
that it was more feasible to do this than it was to demonstrate that the costs matched against sales for any particular period were verifiable (non-arbitrary) amounts that the directors could not manipulate to suit their own purposes. The International Accounting Standards Board (IASB) has continued in this. Moreover, IASB standards have required greater use of current market values (which are referred to as ‘fair values’), with revaluation gains and losses included in the income reported for the period. This produces greater volatility in reported profits and losses, and can materially affect the ability of companies to pay dividends within the limits imposed by the European Second Directive on Company Law. Indeed, it was largely because of the high level of concern among UK listed companies about this that the Rickford Report was instituted.

2.3.12 Wilson et al (2001 p71) warned of the huge impact within Europe to be expected with the adoption, by all listed companies, of International Financial Reporting Standards based on a system of International Generally Accepted Accounting Principles:

‘This is because, by embracing International GAAP, Europe is embracing also a vision for financial reporting that is not necessarily particularly widely known or understood. It is a vision that considers fair value measurement to be paramount, rejecting historical costs, accruals and the realisation principle as irrelevant. A vision that regards the determination of taxable income or realised profits as having no place in financial reporting.

This vision is based on an approach to company financial reporting that has been developed over the past several years by a group of Anglo-Saxon accounting standard setters, and has now been adopted by the International Accounting Standards Board. This approach is based on a balance sheet oriented, fair value model, where the emphasis is on measuring the fair values of companies’ assets and liabilities. This means that the accounting process will in future be focused extensively on the recognition, derecognition and measurement at fair value of companies’ assets and liabilities. The measurement of income will rely heavily on changes in the fair value of net assets. Income will be reported in a single statement of financial performance that aggregates all accrual-based income with all value changes, whether realised or unrealised.’

They go on to show that particular sources of volatility will arise with the need to include in net income the effects of changes in the fair value of (i) leases currently held off balance sheet, (ii) pensions net assets or liabilities, (iii) share options, and (iv) financial assets and liabilities. Unrealised revaluations do not, of course, reflect any change in cash or liquid balances.

2.3.13 Geoffrey Whittington, formerly a member of the ASB (and until recently a member of the IASB and leading aide to its chairman), has explained that, even while preparers of accounts typically want to identify a concept of earnings which is separate from other forms of gain and loss, the three plausible rationales for doing so – ‘operating or “core” earnings; recurring rather than non-recurring earnings; and earnings that are within management’s control – all present difficulties to standard-setters (specifically in this instance the International Accounting Standards Board). The IASB holds to the opinion that these rationales ‘were examined and found to be too subjective to provide information that was comparable across different entities’ (Whittington 2005 p148). This is disputable (see, for example, Watts 2006 for an alternative view, more in line with traditional practice). For one thing, it would be possible to insist upon more detailed rules for identifying the process by which core earnings are recorded on a consistent basis, requiring this to be defined in detail to make the results comparable with earnings reported elsewhere. This insistence on the key importance of operating profits is reflected, for example, by the stated views of The Corporate Reporting Users’ Forum, expressed in a letter of 23 October 2007 to the chairs of the IASB and FASB (the US Financial Accounting Standards Board).

2.3.14 In an international survey of investors and analysts by PricewaterhouseCoopers, reported in November 2007 (PricewaterhouseCoopers 2007), both these user groups stress how important the sustainable income figure is in the prediction of future cash flows, excluding the effects of assets revaluations that are not expected to be realised. We consider below (in section 2.6) how far accounting ratios are likely to prove reliable, either to predict the insolvency of individual companies or to partition statistical samples of companies into those more and less likely to fail. It is also worth noting that most of the institutional investors in the 2007 survey reported that they prepare their own cash forecasts, using data from the published accounts, and they find the published cash flow statement of limited help in this. There appears to have been little progress since Lee and Tweedie surveyed a similar population in 1980, reporting that:

‘Organisations, typically, appeared to compute their own financial ratios and funds flow statements, despite the existence of these data in many corporate
financial reports. Few entities were prepared to rely on such reported data without at least some verification of their computation. (Lee and Tweedie 1981 p136; the term ‘funds flow’ was used in those days rather than the term ‘cash flow’.)

2.3.15 The Global Public Policy Symposium recently discussed published accounts and expressed a lack of confidence in the balance sheet:

‘A world in which balance sheets become almost irrelevant has been floated in a radical vision-shaping document from the chief executives of the six largest firms (of auditors), the Big Four, plus Grant Thornton and BDO’.

They foresee a move ‘towards greater real-time reporting and finding different reporting systems that pay more regard to intangible assets’ (as reported in Accounting and Business January 2007 p5). The accounting framework is a matter for continuing debate and controversy. In a discussion paper published in January 2008, the same group stated:

‘Certainly, investors are interested not only in how financial statements reflect the current state of the business, but also how they can be used as a predictive tool (e.g. enable users to predict future cash flows). Principles-based standards should be designed to elicit information that can empower investors in that regard and also continue to report on the stewardship of management.

Further, faithful representation of the economic consequences of transactions can be enhanced by supplementary information about the underlying cash flows via disclosures. For example, measurement of an item at fair value may provide a market based assessment of the fair value of the expected cash flows, but will not provide information about the timing and risks associated with those expected cash flows even though those risks have been reflected in the fair value measurement.’

(Global Public Policy Symposium ‘Principles-Based Accounting Standards’ New York, January 2008, p4, emphasis added.)

2.3.16 Assume, for example, that reported fixed assets include £1m in the form of a mining concession that has been written down to recoverable amount. This figure (discounted at 5%) could equally well represent cash flows in the form of a perpetuity of £50,000 a year, or a 10 year ordinary annuity of £81,444.73, or perhaps £3.386m. recoverable only as a single figure after 25 years. These amounts, discounted, all have the same value. But in terms of their ability to meet commitments to redeem a £0.5m debenture due for settlement in, say, six years’ time, they are significantly different. Similarly, short-term creditors may have legal powers to require payment when they choose (repayment at immediate notice, in the case of an overdraft, or alternatively in 10 days or 10 months).

2.3.17 Proponents of the use of the discounted cash flows in accounts point out that they form the basis on which the market prices of financial instruments are calculated. There is no reason, they argue, why assets of this kind may not be sold to realise cash at any time before they mature, thus enabling the payee to meet any outstanding obligations. This may be true of widely traded instruments such as listed bonds and bills of exchange accepted (endorsed) by reputable banks, but it is far from true of many other forms of asset – particularly fixed assets including goodwill, but also including financial assets where the counterparty is not well known, or where (as is the case with executory contracts) payment is conditional upon further work still to be performed. The more specific these assets are to the company that owns them, the less likely it is that they could sell them to a third party under pressure, even for their ‘recoverable amount’.

2.3.18 Greater difficulties typically arise in establishing values for intangible assets, whether for individual assets or for ‘cash generating units’. Indeed, as Hart (1995) points out, the firm only has good economic reason to own assets if synergies arise from combining them with other assets that it owns. Values based upon prospective cash flows arise from joint ownership of the assets, which cannot then be allocated to them individually (except arbitrarily). For example, there is no point in a firm owning a fleet of taxis each of which operates independently of others unless there is some benefit to come from common ownership, such as sharing a telephone booking service or benefitting from economies of scale in purchasing or servicing facilities.

2.3.19 Meanwhile, the comparative balance sheet framework is being used to set current standards, despite some major problems in operating the present system. Certain liabilities (for example, provisions in the form of ‘constructive obligations’) remain arbitrary and uncertain. Moreover, the rules of the ASB and IASB on ‘recoverable amounts’ have introduced a greater degree of conservatism than previously existed. Under the ‘impairment rule’, fixed assets must not be shown at a figure in the balance sheet unless they are believed to be able to generate in future an amount that is equal to that book figure plus a notional return on the capital.
involved. Previously, it was not generally held that balance sheet asset values should be capped at the discounted value of cash flows they embody, including some notional return to equity shareholders, but merely the aggregate amount of cash that they were expected to yield (ASB 1998a). Impairments affect the closing balance sheet values of assets, and thus affect the income figure in the year that the expectations are revised. The amounts recognised can be very large.

2.3.20 Whatever the weaknesses, however, the ASB has always claimed – and commentators would no doubt agree – that the published accounts in any case only represent ‘general purpose’ statements that can be no more than a starting point for any specific decision relying upon the measurement of assets, liabilities, profits or losses. Any particular decision usually requires information relevant to that specific decision (and often to no other). Whether it is economically worthwhile to seek out that particular information depends on the value of decision and how far it is sensitive to the accuracy and relevance of the information. The general purpose nature of accounts implies a warning against using them for rigid mechanistic tests. As noted below, such tests are implied in IA 1986 s123(2) and s214 (6), and also in CA 2006 s656 in the context of a serious loss of capital (see 2.4.12).

2.3.21 From the point of view of creditor protection, it would be of interest to a particular creditor to know what assets the company owns in its own right (and will own while the debt is outstanding); how much they might realise, whether in the ordinary course of business or in a forced sale; how much the company owes (and will owe) to its various creditors, both under trading conditions and in formal insolvency; the relative ranking of such creditors in the event of liquidation and the security that each possesses over the assets; and whether the company’s operations are serving to increase or diminish the assets over which the creditor may have a claim. While some important facts are displayed in the published accounts, some of the most important items of information do not appear, and are arguably too confidential for disclosure – these include current overdraft limits, some of the potential lines of credit available to the company (including the capacity and willingness of directors to issue guarantees), and any unused capacity of the company’s assets to act as security for further loans. It would also be valuable to know how far realistic realisable values from a forced resale fall below reported values; and to present some measure of the volatility of future cash flows, dependent on contingencies within and outside the company’s control.

2.3.22 How far it is safe to assume the business will continue, and the magnitude and timing of the cash flows it could safely be assumed to generate from its future activities, are key issues underlying both solvency certification and ‘wrongful trading’ (under IA 1986, which we discuss further below). Some of the information is available in published accounts prepared for large and medium-sized companies under Financial Reporting Standards (FRSs, including 4 and 25) and International Financial Reporting Standards (IFRSs, including 7 and 32). In our conclusions, we accept that some of the problems of predicting insolvency may be less acute in the context of public companies, which have audited accounts, despite the problems presented by complex group relations (see 2.5.5 below). However, many of the items of information – including cash flow statements – are not required of small companies. These constitute the vast majority both of companies and of insolvencies, and they usually only publish unaudited ‘abbreviated accounts’. Some other problematic features of accounts for solvency prediction appear below.

2.4 ACCOUNTS ARE USUALLY RECORDED AT HISTORICAL COST

2.4.1 Transactions are usually recorded at the monetary amount involved. This makes sense since it is obviously important for the company to record actual amounts that it becomes obligated to pay and that it becomes entitled to receive in future. Once recorded at these historical values, however, there is controversy over whether, and if so how, any subsequent changes in the values of assets and liabilities can and should be recorded. Company law and accounting standards promulgated by UK and international standard-setters allow accounts to record values either at historical cost or alternatively (under the ‘Alternative Valuations Rules’) at current market values. International Standards are more permissive. In practice, UK companies mostly use ‘modified’ historical costs (which may include some ‘marking to market’, a particular issue for example in the accounts of insurance companies, banks and others with substantial financial assets). We make no recommendations in this report as to the valuation basis best adopted in published accounts for other user needs. We merely observe that these historical costs are not the most relevant information that a creditor would want to know for the purposes of self protection.

2.4.2 Creditors might well be more interested to know the realisable values of assets and the settlement values of liabilities – the amounts for which assets could be sold if this were necessary to meet outstanding claims, and the amounts for which liabilities could be discharged. Indeed, Lee and Tweedie (1977) found (albeit some 30 years ago) that realisable values are the values which most individual private investors believed that company balance
sheets in fact show for the assets. Some assets – particularly current assets, defined as those held to be realised in the ordinary course of business – are relatively easy to value at current market selling price. Trading stock, however, is not usually shown on this basis. It must be marked down to realisable value if this is lower than its cost, but this is the exception rather than the rule in valuing stocks of material, work in progress and finished goods. Marking up inventory to sales prices higher than cost would anticipate the unrealised profit on sales not yet invoiced to customers and, of course, not yet legally enforceable. In any case, to show the inventory at expected realisable value (or net realisable value, excluding estimated costs of bringing them to saleable condition) involves hypothetical estimates, which accountants regard with misgivings and only report in the case of obsolete stock that is not expected to recover its costs.

2.4.3 Tangible fixed assets are even less amenable to reporting at net realisable values: the whole point of owning them is to use them rather than to sell them. Where the ASB permits them to be valued at what they term ‘fair value’, they usually mean by this the current market replacement cost (provided the asset is not obsolete). Current UK accounting standards also insist that if an entity reports its fixed assets at ‘fair value’, it must keep revaluing them (at buying price) every few years. This obligation deters companies from doing so. The replacement cost figure is in any case often uncertain (since technical change typically means that fixed assets are not actually replaced with similar ones), and the figure would usually be higher than their net realisable value, so it is of limited relevance to creditors.

2.4.4 Assuming, for the moment, that it is possible to establish an agreed and comprehensive list of all the assets and liabilities, even then the values attaching to the aggregates on both sides in the face of possible insolvency might need to be quite different from the figures shown in the accounts. It is no longer plausible to take for granted ‘going concern’ valuations, either for assets or for liabilities, when the company is a ‘gone concern’. Are the assets to be valued individually or in asset classes, or can they be valued collectively in terms of the notional selling price of the business as a whole, or as a set of separable segments if this should give a higher figure? Moreover, now that there is a presumption of distress, how urgent is the need to sell taken to be?

2.4.5 It may also be difficult to attach values to the liabilities. It is not obvious that the book amounts shown as owing in the accounts is the relevant figure, even if these were all currently due for payment. Some creditors may be prepared to settle for a figure less than that shown in the accounts, particularly if this means saving the company and securing future business once the financial situation improves. Other creditors would go to court (possibly as a matter of principle) rather than settle for less than the face value of their debt. The inclusion of ‘prospective’ amounts that would arise on insolvency implies that attention must also be paid to debts that are not yet due for recognition in the accounts (see 2.4.8).

2.4.6 Thus, the fact that assets shown in the accounts have a value exceeding the amount of liabilities can give little reassurance that the company is solvent, in the sense that it has the ability to meet all its debts as they fall due at every point of time up to the planning horizon. There may well be plenty of assets, but in a form that cannot be realised (certainly in the short term) without destroying firm value. Many fixed assets fall into this category. They are not (under normal circumstances) owned for the purpose of resale, but for use in the ordinary course of business. It may be a convenient assumption of finance theory that funds can be borrowed just as readily against the security of cash-generating fixed assets as from the sale of current assets, but in practice substantial transaction costs are involved in using plant and machinery as a source of finance. Sale and re-lease agreements, for example, are costly to set up, since the nature and condition of such assets are hard to establish. Even well traded financial assets, shown at estimated market value in the accounts, might only be saleable before maturity at a substantial discount (see financial assets, shown at estimated market value in the accounts, might only be saleable before set up, since the nature and condition of such assets are hard to establish. Even well traded financial Reporting standards permit in certain cases (but do not require) borrowings to be machine as a source of finance. sale and re-lease agreements, for example, are costly to of current assets, but in practice substantial transaction costs are involved in using plant and borrowed just as readily against the security of cash-generating fixed assets as from the sale course of business. It may be a convenient assumption of finance theory that funds can be of assets, but in a form that cannot be realised (certainly in the short term) without destroying firm value. Many fixed assets fall into this category. They are not (under normal circumstances) owned for the purpose of resale, but for use in the ordinary course of business. It may be a convenient assumption of finance theory that funds can be borrowed just as readily against the security of cash-generating fixed assets as from the sale of current assets, but in practice substantial transaction costs are involved in using plant and machinery as a source of finance. Sale and re-lease agreements, for example, are costly to set up, since the nature and condition of such assets are hard to establish. Even well traded financial assets, shown at estimated market value in the accounts, might only be saleable before maturity at a substantial discount (see Re Cheyne Finance [2007], where discounts around 7% of reported value of the financial assets were foreseen). The onset of financial distress may also trigger loans to become repayable immediately, so in practice it will often be difficult to establish any definitive and reliable list of assets capable of being sold and of liabilities that need to be met at specific future dates. A member of The Institute of Chartered Accountants in England and Wales (ICAEW) Company Law Committee pointed out to us that International Financial Reporting Standards permit in certain cases (but do not require) borrowings to be shown at ‘fair value’, which could well mean reporting lower liability figures as a company’s credit rating falls.

2.4.7 Insolvency law currently invokes the use both of cash flow forecasts and of balance sheet tests, although the latter tests are not limited to the same information as appears in the published accounts. It was not until 1985 that these forms of test were seen as distinct. Now IA 1986 s123 sets out alternative criteria to define when a company is insolvent. It will be ‘unable to meet its
debts’ as one criterion, and it will also have assets less than its liabilities. For this purpose, s123 (2) refers specifically to the need for a further test that compares assets with liabilities.

2.4.8 IA 1986 s123 (2) states (emphasis added) that:

‘A company is (also) deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company’s assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities’.

While there is no doubt that the balance sheet presents lists of the assets and liabilities, it does not follow that the s123 (2) test relies on the balance sheet values as published in the annual report and accounts. Section 123 (2) leaves discretion to the court to probe and investigate the picture portrayed not merely in the published accounts but also in any supplementary evidence submitted to augment those accounts. Logically, the comparison between assets and liabilities specified in s123 (2) has to refer to the ability of the assets to meet the obligations, which implies using the realisable value of assets and the settlement value of liabilities. It plainly does not mean forecast cash flows or it would say so: the use of cash flows is implied in s122 (1) (f) and s123 (1) (e), concerned with ability to meet debts as they fall due, but not in s123 (2).

2.4.9 Davies (2002) comments on the limits to the value of a balance sheet test:

‘In fact, a company with no legal capital probably becomes insolvent on a “balance sheet” test (are assets more than liabilities?) the moment it begins to trade, unless it is very lucky, which is no doubt why the statutory test for compulsory winding-up is the “going concern” test, i.e. whether the company can meet its debts as they fall due: Insolvency Act 1986 Ss 122(1) (f) and 123 (1) (e). A company whose assets are less than its liabilities may nevertheless have plenty of cash with which to discharge the immediate claims on it.’ (Davies, 2002, p102 fn 70, parenthesis in the original.)

2.4.10 Under a transaction cost economics view of the firm, it will be quite the usual case that the assets in aggregate will have a resale value lower than their cost as shown in the accounts (even after depreciation), and perhaps lower than the total amount of the (external) liabilities (Mumford 2000). We suggest that, in practice, the court should place its confidence more upon the cash flow test that interprets how all the available assets (including any sources of funding not shown in the balance sheet, such as guarantees from other parties) might be marshalled to meet the obligations faced by the company. This view seems to be confirmed by the ruling in Re Cheyne Finance plc [2007]. Rickford (2006 p173) points out that in the context of s123 (2):

‘the values of assets and liabilities, or indeed their existence, are not to be determined strictly by reference to the statutory accounts. These issues, of quantum and existence, are issues of fact and law for the court, although no doubt taking the accounts in consideration’.

2.4.11 IA 1986 s214 (6) specifies that an action of wrongful trading can only be brought by the liquidator of an insolvent company, and it defines a company’s insolvency as being ‘when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up’. Sealy and Milman, 2007 Vol 1 p236, describe this as a ‘balance sheet test’ (as does Keay 2007 p86). Yet cash forecast information seems also to be more appropriate in the context of s214 for defining the date at which a company can be said to become insolvent (Re Cheyne Finance plc [2007]).

2.4.12 A different balance sheet test is also invoked by CA 2006 s656 where a company loses more than half its paid up share capital. Here, the test does seem to be based upon figures in the published accounts. The company is obliged to call a general meeting of its members, but it is not clear what needs to follow next. (The matter appears again in 3.2.12 below.)

2.4.13 To quote Rickford (2004, p977, in the context of dismissing a balance sheet test as being sufficient for solvency certification): ‘The balance sheet … by its nature cannot fully portray the timing and degree of certainty of future cash flows and the company’s flexibility’. The fact that a company has consistently met its obligations in the past is, no doubt, some reassurance to creditors. Its ability to produce operating profits in the markets that it knows best may well add to that reassurance, as will be a substantial figure of liquid assets in excess of short-term indebtedness. But none of these additional facts substitutes for the judgment embodied in a cash forecast prepared by the company itself, or (preferably) a set of cash forecasts predicated on a range of likely future outcomes. There is no doubt that the need for solvency has been noted repeatedly over the years. The distinction between profits and cash flows forms a basic element in accountancy training. Indeed, French (1977, particularly pp319–320) points out that the Companies Act 1855 itself required the use of solvency tests, and he stresses the importance of the matter.

Why financial accounting information offers inadequate protection for creditors
2.5 OTHER LIMITATIONS ON THE BALANCE SHEET

2.5.1 Assets shown in the balance sheet are not usually shown at the valuation that is of most interest to creditors. Moreover, it is possible for some assets to be valued on one basis while others in the same set of accounts are valued on another (for example, most fixed assets will be shown at depreciated historical cost, and traded financial assets will be ‘marked-to-market’ – i.e., shown at a current market valuation). The aggregate figure then shows a ‘mongrel’ figure that has no clear meaning. Some of the assets shown are not in any case available to meet the debts of the company. Assets held by the company under long-term financing leases must be shown as though they belong to the user, even though the legal title remains with the financier. Details of such leased assets must be shown in the notes to the accounts, but these notes may not be obvious to the lenders. By contrast, assets held under operating leases are not (currently) capitalised or shown on the balance sheet. Only the hire costs are shown as an annual charge in the income statement, although commitments under these leases will need to be shown in a note. Many schemes are marketed by finance houses to offer users access to operating leases rather than financing leases, sometimes by subtle and complex devices. ‘Off balance sheet finance’ also operates on the margins of accounting rules, although these rules are being extended.

2.5.2 Similar uncertainties exist in relation to ‘special purpose vehicles’ set up outside the strict terms of the law and accounting standards that define the subsidiaries of groups, so that assets and liabilities (and sometimes operating losses) can be kept off the group balance sheet. This practice has been much criticised in the context of the Private Finance Initiative in the public sector, although in principle the PFI is only economically defensible (and permissible under Treasury rules) if most of the risks are actually transferred to the special purpose vehicle (Mumford 1998, particularly 7.4, pp.231–240; it is not clear how far the rules contemplate residual risks on liquidation). While the standard-setters have said that they will broaden the definition of finance leases, effectively to include all leased assets, there will always be a problem in knowing where to set the boundaries. For example, a company’s balance sheet cannot show assets that belong to another company, used by them to perform a contract for specific services. Other assets that appear in the accounts may be subject to reservation of title, giving the supplier of components the right to seize back ownership if the buyer fails to pay for them. Details of charges upon assets do not usually appear in the accounts, even though their existence must be shown in the context of any bank loans outstanding as well as being recorded on public access in the register of charges.

2.5.3 A further problem lies in knowing exactly what liabilities constitute debts of the company, as opposed to equity interests. As a BBA member pointed out, bank overdrafts present analysts with few problems when compared with financing from leveraged buyouts. Securitisation and options can also make it very hard to estimate the vulnerability of a company’s finances. Creative legal minds seek to exploit niceties of definition. FRS 4, Financial Instruments (ASB 1993) sought to establish the boundary between equity and debt capital. Many loan covenants include restrictions on corporate borrowings (usually as a proportion of shareholders’ capital), so it can make a material difference whether convertibles appear as debt or equity. The distinction between equity and debt capital was recognised as being so complex that the ASB in FRS 4 had to define a new category of ‘non-equity’ shares alongside the more familiar equity shares. Ernst & Young explained that the FRS 4 definition did not correspond to the definition implied in the 1985 Companies Act (Wilson et al, 2001, p.1182), so that debts were defined under FRS 4 to include convertible debentures, even if these were likely to be converted into shares and are clearly categorised as equity under the 1985 Act. FRS 25, Financial Instruments: Disclosure and Presentation (ASB 2004) amended the definitions, but at the time of writing both the ASB and the IASB are currently reviewing their standards with such problems in mind. The requirement to show deferred tax also raises conceptual problems, particularly since UK companies must use the ‘full deferral’ method, rather than partial deferral. This can give rise to a large credit balance in the accounts that does not really represent either an external liability (if the tax is unlikely ever to become payable) nor an equity balance. (The issue is discussed, although not fully resolved, in Chapter 24, Wilson et al, 2001, then being produced by the Technical Department of Ernst & Young. However, the successor to this 2001, seventh edition of Wilson et al, is Morris, 2005; Chapter 31 of Morris, 2005, is also on deferred tax, but it makes no mention of the matter.)

2.5.4 Of greater relevance to creditor protection is information on the ability of the business to meet its various commitments as they fall due. Thus, what is of most importance is information on the future solvency of the company as reflected in cash forecasts, rather than historical information on its past transactions as reflected in the accounts. Of course, even this information is problematic. It can rapidly become out of date, and it is highly subjective – but it has the merit of being relevant for the purpose of solvency prediction. As ever, there is a trade-off between information that is (fairly) readily verifiable and available at little cost, for example in the routine financial accounts, and the more costly information that is directly relevant to a...
specific decision – but which requires to be sought out and tailored to the purpose. Information on forecast cash flows can only originate with the company itself, and it is heavily reliant on opinions held by the directors and their advisors about the amounts, certainty and timing of those cash inflow and outflows. The accounts do not show this detail.

2.5.5 Creditors also need to be aware that assets which appear on group balance sheets may not be available to meet their debts. For example, consolidated (group) accounts set out – in aggregated figures – the creditors of individual companies in the group and the assets that those several companies hold. However, creditors of one company in the group have no legal right to proceed against assets of another group company, unless there are cross guarantees (not required in general by UK company law). Indeed, even where such guarantees exist, for example in the form of ‘comfort letters’, these may prove unreliable in practice. Deloitte and Touche, Manchester thought the accounts of subsidiaries should show the existence of any such letters of support (quoting David Caukill), but this cannot show how much would in practice prove recoverable. The fact is that consolidated accounts are of little value for predicting the solvency of individual companies in the group. Dean, Clarke and Margret (2008) discuss some of the weaknesses of group accounts in the context of Australian solvency certificates, even where the group adopts cross-guarantee deeds by which group companies guarantee the debts of other members of the group (often the case in Australian listed company groups). Indeed, it is far from the case that adopting solvency certificates, as advocated in this report, solves all the issue of insolvency prediction. A member of the One Hundred Group of Finance Directors pointed out to us that making cash flow forecasts (even for individual companies) can be highly problematic in the context of large groups of companies.

2.5.6 Creditors know little about future capital commitments entered into by the company, unless these have been contracted for by the board and thus figure in the notes to the accounts. Earlier Companies Acts required all capital commitments to be included in the notes, regardless of whether or not they had been contracted for, following recommendation to this effect by the Jenkins Report, para 369 (h) (Board of Trade 1962). The need to disclose commitments not yet contracted for was removed by CA 1985. Nor can creditors discern ‘asset substitution’ from the published accounts, where funds ostensibly raised for low-risk projects are used instead for higher risk ones.

2.5.7 While cash flow forecasts are subject to uncertainty, they have two important advantages over the adaptation of balance sheet data: (a) they focus on the particular attribute needed for this specific purpose, namely the timing as well as the magnitude of cash inflows and outflows, to try and check that funds will be available when they are needed; and (b) the directors will be explicitly responsible for their preparation, as the people in the best position to make such estimates, taking into consideration unpublished information such as contingent alternatives that might be called upon if expectations have to be revised. Since creditors look to the individual company for settlement of their debts, these cash flows must be done at the level of the company rather than the group, incorporating estimates of any amounts likely to be forthcoming from other group companies. The challenge to be addressed later in this report is just how and when such cash forecasts need to be prepared and formally presented to the board for approval. This is not necessarily restricted to the context of distributions. The need might arise in the context of major capital expenditure commitments, or of losses of capital in the course of trading. The general principle adopted in this report reflects the way that the law seems to be developing (eg, reflected in Keay, 2007), the nearer a company approaches insolvency, the more often, and in more detail, the directors need to review cash flow forecasts.

2.6 CONVENTIONAL LIQUIDITY RATIOS AND RATIO ANALYSIS

2.6.1 Despite the doubts expressed about them above, published financial accounts may not be totally irrelevant. After all, they show the levels of credit in use by the company at the balance sheet date. If there are no creditors and plenty of liquid assets, there is little reason to doubt the solvency of the company (at least, as at the date of the balance sheet, even though matters can change very rapidly after that date). Moreover, some conventional analysis may still be helpful. Students of accountancy have always been shown how to calculate liquidity ratios – current assets (including stocks and work in progress) over current liabilities (the ‘current ratio’), and the ‘quick assets ratio’ (excluding inventories). It has usually been asserted that a current ratio greater than one (or, say some commentators, two) offers a reasonable measure of safety for a particular company. But this is simplistic to the point of falsehood. For example, major retailers such as Tesco and Sainsbury’s have been operating for decades with a liquidity ratio of 0.5, with no apparent danger. Their businesses involve no credit sales and very fast stock turnover, so they can finance part of their long-term operations through short-term trade credit with little risk, just as some companies make continuous use of overdraft facilities as part of their permanent capital base even though these are recallable by the bank on demand. Conversely, a company with a healthy liquidity ratio may be faced at very short notice with bad debts that
push it into a financial crisis. And it is well known that, by borrowing further, a liquidity ratio of 0.01 can be changed to a ratio of 0.99 – a ratio that would generally pass as being quite acceptable. Thus, a ratio of £1/£100 could be transformed by borrowing £10,000, to produce a ratio of £10,001/£10,100. Ratios do not, of course, reflect the scale of the debts.

2.6.2 If published accounts are to assist creditors to assess companies to which they extend credit, those accounts need to present usable data. Responses to PricewaterhouseCoopers survey of institutional investors (November 2007), referred to in 2.3.14 above, showed that fixed income investors in particular (both supply and demand side analysts) were unhappy with the information currently available in published accounts for use in predicting cash flows. Published information lacks detail, they say, particularly as regards timing.

2.6.3 Both Altman (1968) in the US and Taffler (1978) in the UK have for some decades studied the uses of financial ratios based on published accounting data. They find that they can partition groups of companies into those at high risk and those at low risk, using a combination of a few ratios such as the rate of profit on sales, the level of sales as a multiple of assets employed, the ratio of external debt to capital employed, and so on. Baruch Lev (1974, chapters 9 and 10) presents good basic analyses of the prediction of corporate failure and of the related issue of the prediction of bond risk premiums and ratings. He reviews the extant literature, noting in passing that Altman was not the first to suggest using a multivariate approach: Lev cites such a partitioning of corporate failures from non-failed companies some 30 years earlier, by Secrist (1938). He also points out that Beaver (1966) had extended the modelling by using matched pairs of failed and non-failed companies, and considered the uses of non-accounting information, notably the use of stock prices (relying on the ability of an efficient capital market to impound all published information about the company, including all published accounting data). The search for reliable predictors continues to this day. Thus, Agarwal and Taffler have recently compared empirical studies using Z-score models with others that take a contingent claims valuation approach using market (stock price) data (Agarwal and Taffler 2006). They find that ‘the two approaches capture different aspects of bankruptcy risk’; they conclude there is little difference between their predictive ability in the UK.

2.6.4 New techniques are apparently even better than Z-scores at distinguishing between safe and risky companies. Thus Charitou et al (2004) analysed matched samples of 51 failed UK companies and 51 non-failed UK companies, and found that a parsimonious model (using two accruals-based financial ratios and an operating cash flow variable) could successfully classify 83% of the sample from their accounts one year earlier. This outperformed the more traditional logistic regression and neural network techniques. In a later study, Neves and Vieira (2006) suggest that ‘Hidden Layer Learning Vector Quantization’ outperformed both discriminant analysis and neural networks to classify 583 French firms that became bankrupt from 1998–2000. Moreover, they claim that their method is better than others at avoiding ‘type 1’ errors (ie, wrongly identifying an insolvent company as healthy) rather than identifying a healthy company as insolvent. Type 1 errors are more costly since the unpredicted insolvencies mean losses to the lender, whereas type 2 errors only mean refusing loans to healthy firms. (A good review of this more recent literature is to be found in Balcaen and Ooghe 2006.) Jones and Hensher (2007) have since extended the prediction techniques to include a ‘multinomial nested logit analysis for unordered outcomes’ where these outcomes address a wider range of definitions of corporate failure than the bare (binary) existence or non-existence of a subsequent state of formal insolvency.

2.6.5 These findings might suggest that such analyses of the accounts can serve as a basis for creditors to work out credit policies, setting terms that reflect the level of risk involved. If it is possible to partition a sample into two groups, it is presumably possible (as Jones and Hensher 2007 show) to partition them into finer categories (in the extreme, ranking all the debtors and adjusting the credit terms accordingly). Trade creditors, for instance, are able to decide the terms on which they are prepared to offer credit to different groups of companies, rather than insisting on pre-payment or cash on delivery. While such a line of argument is appealing, it is somewhat superficial. As Balcaen and Ooghe note, most statistical prediction tests compare matched pairs of companies in which half the sample is (already) known to have failed (eg, in Charitou’s UK study, by entering either receivership, administration or liquidation). This is not the same thing as using ratio analysis to assess ex ante each individual member of a bank’s portfolio of corporate customers. And, as Lev commented (1974 pp149–50), all such studies of this sort are retrospective, rather than predictive. Moreover, these prediction models do not attach an accurate probability of failure to individual companies, still less forecast the date when failure will arise or how much the deficit will prove to be. The statistics may be impressive, but the limitations are unavoidable for the very reason that published accounts do not capture information about predicted cash flows. Furthermore, as a scholar at City University pointed out to us, the analyses were concerned with large (listed) companies, rather than small ones (with which we find the greater difficulties in securing creditor protection).
2.6.6 In their 1998 paper, Barth, Beaver and Landsman demonstrated that the incremental predictive power of published accounts is affected by the financial health of the company. They write (p1–2):

‘Although the balance sheet and income statement both provide valuation relevant information, a distinctive role of the balance sheet is to facilitate loan decisions and monitoring of debt covenants. It fulfils this role by providing information on liquidation values to show the amount available to debt-holders in the event of default. In contrast, the role of the income statement primarily is for valuing equity. It fulfils this role by providing information about the firm’s abnormal earnings opportunities, i.e. unrecognised net assets.’

They add that both equity book value and net income are priced into security values, and omitting one or the other potentially leads to model misspecification (op cit p3), but the significance of the two measures varies according to the financial health of the company. This is not very surprising. The income statement of a profitable company will usually reflect far more benefits derivable from unrecognised intangibles, whereas a company with few intangibles will find more of its value captured by the conventional balance sheet. This still does not mean that the balance sheet actually shows liquidation values.

2.6.7 Our support for cash flow forecasts, as opposed to accounts-based ratios, might look like an assertion testable with empirical evidence. We should be able to construct tests that show, for a sample of companies that allow the researchers access to their confidential managerial systems, that cash forecasts (or even less detailed solvency statements that might be published by the board) are better predictors of insolvency than other test data, such as solvency ratios. Appealing as this may appear, it is not likely to work. The essence of successful solvency prediction is advanced warning of financial problems, with the aim of averting catastrophe. What is virtually impossible to test is how far companies that should have had cash forecast data (but did not) were more likely to become insolvent than companies that had proper systems in place. Only rarely does evidence become public, as in published court cases, and these follow failure rather than success. There are occasional insights available; thus, the two directors of Hawkes Hill Publishing Co Ltd (Ward v Perks and another) [2007] were both found not guilty either of wrongful trading or of granting preferences, in part because they had in fact prepared cash forecasts over the relevant periods.

2.7 CAPITAL MAINTENANCE RULES THROUGHOUT EUROPE

2.7.1 From the middle of the nineteenth century, company law has sought to protect the creditors of limited companies. As noted earlier, this protection has included the publication of financial accounts. There have also been related measures that have attempted to prevent directors from defeating the claims of creditors by making distributions to shareholders. An extensive set of rules was built up, first to define share capital and non-distributable reserves and then to insist that distributions to shareholders could only be out of profits of the company that could be paid out without reducing the share capital and reserves. CA 2006 s830 thus states that: ‘A company may only make a distribution out of profits available for the purpose.’ Furthermore, by s831: ‘A public company may only make a distribution (a) if the amount of its net assets is not less than the aggregate of its called-up share capital and undistributable reserves, and (b) if, and to the extent that, the distribution does not reduce the amount of those assets to less than that aggregate.’

2.7.2 To some extent, the rules offered some rough and ready protection to creditors during the nineteenth century. Even though profit was not capable of precise definition, prevailing accounting practices before 1900 served to ensure that profit was calculated on a relatively conservative basis, so that the shareholders tended to be restricted in how much they could withdraw from the company. This might have been a matter of some inconvenience to them from time to time, but the shareholders tended to be the major beneficiaries of retained profits, ploughed back for future growth, so they usually had little reason to complain. Price levels in general were falling between 1850 and 1900, so the historical cost accounting convention generally showed lower reported profits than a current cost system that matched later (lower) input costs against revenues. This changed when, first, the Boer Wars and then the First World War produced price inflation. It then became evident that historical cost rules could not ensure that businesses were capable of replacing their assets out of earnings as they were used up for production.
2.7.3 The courts had previously been broadly satisfied that historical cost accounting gave some practical protection to creditors. Of course, the law could not ensure that companies traded profitably under all conditions, so creditors sometimes suffered losses. But at least the law could insist that shareholders were not to make withdrawals in the form of dividends unless there were reported profits from which to do so. Moreover, until CA 2006 s643 made an important exception for private companies, withdrawals of capital by a company in the UK have always required consent of the court (to ensure that creditors’ interests are not defeated). Once general price levels began to rise after 1900, however, the courts were faced with a problem. There was a strong prima facie argument that historical cost accounts failed to preserve the operating capability of the firm (and hence its future earnings), but the courts had no clear rule to guide them once the familiar capital maintenance rules based on historical costs were less, rather than more, conservative than the current cost alternatives.

2.7.4 The problem was that there was no agreement over how to make a current cost system enforceable. There were several alternatives, for example by using current market replacement costs or net realisable values. Using replacement costs would, in principle, enable the directors to estimate how much needed to be retained from current earnings in order to maintain the physical operating assets of the company. The need for such a judgement might be evident to those working within the firm, but the estimates were subjective (and thus less reliable than using historical costs). The directors could not demonstrate verifiably when productive capacity had been maintained intact. Courts might suspect that directors were being more, or less, prudent than the company’s interests might require, but they have always been most reluctant to ‘second guess’ the business judgements of management, particularly if there are no demonstrable grounds to challenge the competence or good faith of the board. Yamey (1962, pp431–3) cites Lee v Neuchatel Asphalt Co [1889] as strong authority for such a view. (Re Wolfab Engineers Ltd [1990] offers a more recent authority.) To prove the adequacy of current charges would often require the use of complex indices, weighing up how far existing assets had become depleted and how far technical change offered potential cost savings when one asset was replaced with another. As the debates over inflation accounting were to demonstrate all too clearly later in the twentieth century (between 1945 and 1954, and then between 1970 and 1985), intense controversy arose over attempts to define exactly what constitutes profit under such conditions (Mumford 1979).

2.7.5 Since the mid twentieth century, company law has distinguished between public and private companies in applying capital maintenance rules. All companies are restricted to making distributions only out of profits. Public companies also have to observe a net assets test, as specified in the European Second Directive (which applies only to public companies) and embodied in CA 2006 as noted in 2.7.1 above. The very concept of capital maintenance rules as a means of limiting distributions by public companies is now being queried and a campaign mounted to delete the rules from European company law, in accordance with the recommendations of the EC’s High Level Group of Company Law Experts (in the Jaap Winter Report, 4 November 2002). This campaign includes the papers by Rickford (ed. 2004) and FEE (2007), which are considered further below in section 3, as well as the EC’s own soundings on the matter. The European Court of Justice also raised questions about the Second Directive capital maintenance provisions (albeit by way of ‘obiter dicta’) in the 2002 Centros case.

2.7.6 On 10 July 2007, the European Commission sounded out views on ‘a simplified business environment for companies in the areas of company law, accounting and auditing’. Letters of response to the discussion document published on the EU website showed considerable support for the idea of relaxing the capital maintenance restrictions laid upon public companies by the Second Directive, even though the KPMG study was not yet available at the time. There was markedly less support, however, for the idea of a common set of Europe-wide regulations for creditor protection. Many respondents noted that national laws tended to reflect institutional differences between states. The 2007 FEE Survey on Alternatives to Capital Maintenance Regimes asked every country about their national corporate accounting laws (emphasis in the original): ‘Is your system primarily based on creditor protection or investor protection?’ Every single response placed creditor protection first or, in a few cases, joint first. It is also notable that, with the exception of Slovakia, not one of the 23 countries that responded reported any other basis for the distribution of profits apart from the individual accounts of the company.

2.7.7 The extensive (1000 page) study by KPMG (KPMG 2008), commissioned by the Directorate General for Internal Market and Services, represents a further step in the comprehensive review of capital maintenance law that followed the 2003 Communication and Action Plan on Company Law and Corporate Governance of the European Commission. The KPMG 2008 Feasibility Study on capital maintenance not merely reviews the law on the capital maintenance provisions in the Second Directive, but it surveys how these provisions are implemented in practice in France, Germany, Poland, Sweden and the United Kingdom, adopting eleven
headings for each of these five European countries: structure of capital and shares; capital increase; distribution; capital maintenance; acquisition of own shares; capital decrease; share redemption; financial assistance; serious loss of half of the subscribed capital; contractual self protection; and insolvency. It goes on to review comparable regimes in the USA (in the Model Business Corporations Act, in Delaware, and in California) and also in Canada, Australia and New Zealand. It includes summaries and reviews (using the eleven headings above) of the Jaap Winter Report, the Rickford Report (above), also studies by the Lutter Group (2006) and a Dutch Group (2005). It ends by examining the impact of IFRSs on distributable profits, and it makes estimates of the likely costs of reforming the capital maintenance regime.

2.7.8 The KPMG study points out that Canadian law requires a solvency test in connection with distributions. We note from the wording of the Canadian legislation that it seems to specify the use of (estimated) realisable values to test for solvency, which may not perform precisely the same task as a cash forecast but gets closer to it. It also requires a balance sheet test in which the liabilities plus the amount paid to the company for shares (which have no nominal value and hence no share premium) must not be allowed to exceed the realisable value of the assets.

2.7.9 The KPMG study goes on to note that, despite the emphasis in Australian law upon solvency as the criterion governing distributions, Australian law also insists that dividends should only be paid out of profits and not out of capital. Just as in Canada, shares have no nominal value, so no share premium is recorded, but the amount received for the issue of shares is not returnable without the sanction of the court. Thus, practical issues still arise over what constitutes a distributable profit, even though it is clear that the accounts must be prepared in accordance with the Australian version of IFRSs. The KPMG Study (pp222–3) sets out some guiding principles defined by Australian case law that augment their Corporations Act 2001. Undistributed profits can be carried forward to future years, and profits can be distributed in one year without making good accumulated losses for previous years. But no distribution may be made if the company is thus rendered unable to meet its debts. Australia is discussed further below in section 3, noting that amendment of the law is currently being considered.

2.7.10 The KPMG study notes that the Jaap Winter report (the ‘High Level Group’) proposes a two-stage distribution test consisting of a balance sheet test and a liquidity test. Neither would involve an audit certificate. Both would have to be satisfied before a distribution could be made. The balance sheet test requires that after the distribution, the assets must exceed the liabilities (including any provisions, but not the share capital). Winter recommended further study on valuation methods to be used for this purpose. The liquidity test says that the company must have enough liquid assets to pay current liabilities extending for 12 months after the date of payment of the dividend. It uses the (balance sheet) current ratio in place of a cash flow forecast, and offers directors no discretion. Winter also urged further study of a solvency margin (of assets over liabilities) as a means to protect creditors further (as is done in California). A Europe-wide prohibition on wrongful trading is also recommended (although the KPMG study also cites Bachner (2004), which compares wrongful trading unfavourably with a German equivalent, mainly because, it says, IA s214 actions are ineffectual).

2.7.11 The Rickford Report is analysed in some detail in the KPMG study, but we defer discussion of it in this report until sections 3.1 and 3.2 below. The point to note at present is that Rickford proposes solvency (cash forecast) and balance sheet tests, but would permit a distribution even if the balance sheet test is not passed (ie, even if the reported assets do not exceed the liabilities) – provided that the directors issue a statement to explain why the company is still solvent.

2.7.12 The Lutter paper differs from the other three in this context, in that it seeks to maintain, as far as possible, the capital maintenance regime in the Second Directive, addressing primarily the question of applying IFRSs to distribution policy. It expresses particular concern about the likely effect upon profits of including unrealised gains, as permitted by some IFRS provisions. It seeks to revise the balance sheet tests that are applied to distributions, and to link with these a new solvency test based upon cash forecasts from the management accounting records. The Dutch study (from a group chaired by J. N. Schutte-Veenstra) would require a balance sheet test and a liquidity test both to be satisfied before distributions may be made. The liquidity test addresses solvency over 12 months, while the balance sheet test is intended to ensure solvency over a longer term (assets must exceed liabilities plus provisions excluding share capital).

2.7.13 The KPMG study discusses the impact of International Financial Reporting Standards (IFRS) on profit distribution (KPMG 2008 pp7–9), noting that in ‘at least’ 17 of the 27 EU member states, IFRS may be used as a basis for profit distribution subject to member states’ legislation. In seven of the 17, the effects of unrealised profits are specifically eliminated from the individual financial statements for this purpose. As warned by Wilson et al (2001, reported in 2.3.12 above), deviations between IFRS and previous national accounting rules generally arise...
in the case of those IFRS which require or permit ‘fair value’ measurements – which the KPMG study lists (op cit p7) as being IAS 19, Employee Benefits, IAS 29, Reporting in Hyperinflationary Economies, IAS 39, Financial Instruments: Recognition and Measurement, IAS 40, Investment Property, IFRS 2, Share-based Payments, IFRS 3, Business Combinations and IFRS 5, Non-current Assets Held for Sale and Discontinued Operations. Bruce (2005) warns of the marked increase in volatility of reported profits in the UK under IFRS. But the KPMG study also notes that it is possible to disconnect the income figures presented in IFRS accounts from the determination of distributable profits, and this can be done either at a European level or at a national level.

KPMG comments: ‘Even though the direct use of IFRS for profit distribution potentially allows for excessive distributions, it must be acknowledged that IFRS as such may not necessarily cause problems for companies in their capacity to distribute profits’ (op cit p8).

2.7.14 The KPMG study includes surveys of opinions. They report (p404):

‘One interesting result of the interviews conducted with companies in the European Union and outside the European Union is the fact that companies mainly referred to their consolidated accounts as a starting point for the determination of dividends. Necessary cash flow considerations have also been conducted at group level, i.e. decisions are taken from a group perspective, not the individual legal entity. Subsequent to these assessments, dividend levels are subject to a “political decision” by the company’s management with a view to the share price. This includes aspects such as dividend continuity or giving certain signals to the capital market.’

2.7.15 KPMG sounded out views among chief financial officers of a sample of companies in France, Germany, Poland, Sweden and the UK on the possible forms that a solvency test might take. In particular, they asked: ‘Is the ability to pay dividends better determined via liquidity tests that take into account projected cash flows?’ The majority of CFOs replied that they agreed with this proposition, except for the CFOs of German companies. But when it came to sounding out opinion on possible reforms to the Second Directive, respondents still preferred to leave the determination of dividends to the companies to resolve, rather than laying down European rules based either upon current ratios or upon short-term cash solvency projections. This may simply mean that CFOs prefer to keep control in their own hands, rather than conceding it to regulators.

2.7.16 With respect to the broader matter of amending the capital maintenance rules in the Second Directive (which they refer to as the ‘Second CLD’), there are several possibilities. The KPMG study (p9) concludes that:

‘The potential amendments to the basic model of legal capital range from a limited change to the distribution rules via the introduction of a specific fiduciary duty in company law up to a full-scale reform of the Second CLD with the abolition of legal capital and the predominance of solvency tests in determining dividend levels.’

The KPMG study thus refers to the Rickford proposals as representing the most radical of the options under consideration, requiring reform of the Second Directive. KPMG notes that the purpose of the study is to present options and compare them with existing practice. They add: ‘However, this study is not intended to recommend a single model to be implemented as an alternative’ (loc cit).

2.7.17 The European Commission Directorate General for Internal Market and Services received the KPMG study in early 2008, and summarised its main findings, in the following terms (EC 2008, pp1–2, emphasis in the original):

‘1. The current minimum legal capital requirements and rules on capital maintenance do not constitute a major obstacle to dividend distribution. Members States are at liberty either to introduce higher capital requirement or to comply strictly with the 2nd Directive, which only requires a minimum legal capital of 25,000 euros, which nowadays does not represent a significant amount. This does not prevent companies from adopting a higher share capital if they consider this necessary to guarantee their creditworthiness.

As to dividend distributions, the only constraint is that this is prohibited if the so-called balance sheet test is negative. This has prompted the question whether it would not be more appropriate to replace this test by a solvency one or at least to permit the application of a solvency test as an alternative. In this regard, the study shows that:’
A ‘balance-sheet’ test is also required by those non-EU States (except Australia) which impose a solvency test;

- EU Member States are presently at liberty to introduce an additional solvency test, if they so wish;
- Most existing academic proposals to amend the 2nd Directive refer to the necessity to add a solvency test to a balance-sheet test.

2. Impact of IfRs on dividend distribution: several Member States have required or permitted the application of IfRs for individual accounts without any apparent difficulty for the distribution of dividends.

It has been argued that the balance sheet test (based on historical cost accounting in accordance with the 4th Accounting Directive) has become an inadequate yardstick for deciding whether the company has sufficient reserves for it to make distributions to shareholders, following the adoption of International Financial Reporting Standards.

According to the external study and additional information gathered by the Commission, at present, 19 of the 27 EU Member States already apply IfRs to individual company accounts, which means that in such Member States dividends must be determined with reference to IfRs. In 8 of these 17 Member States, whilst individual accounts prepared under IfRs accounting are used as the basis for distribution purposes, Member States have introduced limitations to the distribution of unrealised profits.

2.7.18 The Directorate General for Internal Market and Services comments on the KPMG recommendations as follows:

‘From the results of the study it emerges that the 2nd Company Law Directive is a flexible instrument insofar as it requires a limited (almost symbolic) amount of legal capital and allows Member States to impose higher capital requirements if they so wish. Moreover, under the Second Company Law Directive, Member States remain free to require or allow companies to prepare individual IfRs-based accounts for dividend distributions purposes. Moreover, the Second Company Law Directive already allows Member States to adopt some of the solvency-based systems existing outside the EU as well as some of the alternative proposals for reform, except the possibility to distribute profits in the presence of a negative balance sheet. Finally, it appears from the study that the compliance costs of the 2nd Directive are rather limited, and not higher than those required by the alternative regimes outside the EU.

In the light of the conclusions of the external study, the view of DG Internal Market and Services is that the current capital market regime under the Second Company Law Directive does not seem to cause significant operational problems for companies. Therefore no follow-up measures or changes to the Second Company Law Directive are foreseen in the immediate future.’ (EC 2008 p2.)

2.7.19 Despite this reluctance on the part of the European Commission to pursue changes to the Second Directive, evidence is still accumulating to support such a change. In a recent paper, Meeks and Meeks (2009, p23) show ‘that the neglected problems of asset and liability measurement for distressed firms lead to economically inefficient decisions on exit, whether in a debtor-oriented legal regime such as the U.S. or the creditor-oriented legal arrangements of countries such as the UK.’ Meeks and Meeks present four case studies and set out:

‘(E)vidence from finance, economics, law and accounting to show that assets and liabilities are continually revalued (with the effect of eroding the residual, equity) as a company becomes financially more distressed. The probability that a firm will fall affects to an economically significant extent the valuations assigned to its assets and liabilities. At the same time, of course, the valuation of assets and liabilities determines how close the firm is to insolvency – in other words, its probability of failure! The conundrum then is that it becomes impossible to establish whether a firm is insolvent independently of the markets’ views of its survival prospects.’ (Loc cit, emphasis in the original.)

2.7.20 We agree with Meeks and Meeks. The fact that capital maintenance rules are currently being observed throughout the European Union says nothing about the usefulness of such rules. We regard the use of a cash flow solvency test as both necessary and sufficient, without
2.7.21 On the other hand, while the Rickford Report refers to the position of private companies, its main thrust is the need to reform the Second Directive and its consequences for public companies. As we comment below, we regard private companies as the main problem.

2.7.22 Within the UK, CA 2006 made some concessions to the argument that capital maintenance could be eased for private companies (though not for public companies) (see 2.7.23 below), and it includes (in Part 46 of the Act, ss288–1297) powers for the Secretary of State or the Treasury to use statutory instruments to amend the law in future (not ‘company law reform orders’ proposed in the Bill). Explanatory Notes published for the House of Lords, in discussing what was then still the Company Law Reform Bill, commented in 2005 (House of Lords 2005, para 1453):

‘Three specific areas have been identified where the use of company law reform orders may be appropriate:

• capital maintenance, where the case for further reform in relation to all UK companies (both public and private) is strong, but where it may be appropriate to await possible European developments (relating to public companies specifically) before deciding on the scale and nature of the changes;

• jurisdictional migration (the ability of a company to move its registered office from one jurisdiction, e.g. England and Wales, to another, e.g. France). Again, there are likely to be European developments which will establish a new context within which provisions in UK law will need to be framed;

• company law aspects of charges, on which the Law Commission has recently reported.’

2.7.23 The Companies Bill (Clauses 561–2) proposed to allow private companies to reduce their capital ‘using a new solvency statement procedure’ (House of Lords 2005, paras 988–995; see also Deloitte and Touche 2005). These provisions duly appeared in the CA 2006, as ss641–4 (reduction of capital by a private company) and in ss709–723 (redemption or purchase by of shares by a private company out of capital). Changes are also being made to the registration of charges as security for loans, following the Law Commission Reports of 2004 and 2005 concerning the registration of charges at Companies House, increasingly through the use of electronic means. As noted in 2.7.18 above, changes in the capital maintenance provisions governing public companies do not appear to be imminent.

2.8 AUDITORS AND THEIR INVOLVEMENT

2.8.1 Audit does not guarantee the accuracy of the accounts, nor does it purport to do so. The accounts are those of the directors not the auditors. CA 2006 s495 says that the auditors must express an opinion as to whether the accounts have been properly prepared in accordance with the relevant financial accounting framework, and as to whether the accounts present a true and fair view of the financial affairs of the company. Auditors’ legal liabilities have been debated at length in recent years, and CA 2006 ss532–8 sets out new rules that permit companies to enter into liability limitations agreements with their auditors, with certain safeguards. Whether auditors might be willing and able to vouch for the accuracy of special purpose reports, such as solvency certificates by directors, is an issue considered further later in this report.

2.8.2 The statutory audit is an important form of assurance that the annual accounts and the directors’ report have been examined by an independent expert, given access to all the information and explanations considered essential for the purpose (CA 2006 ss495–502, particularly s499). There are, however, certain circumstances in which the law already requires other specific reports by the company’s auditor, and as circumstances might well be regarded as valuable precedents in the context of solvency certification, the provisions are summarised next.

2.8.3 Specific reports are required from the auditor under CA 2006 s714(6) (purchase by a private company of own shares out of capital), and s837(4) (distributions where the auditor’s report is qualified). It is significant that both these provisions are driven by the need to protect creditors’ interests at a time when funds of the company are to be disbursed, potentially at their cost, solely for the benefit of shareholders (or some of them). CA 1985 s156(4) (financial assistance by a private company) also used to require a specific report from the auditor, but the financial assistance rules were dropped in the 2006 Act s682. CA 2006 s837 is considered first.

2.8.4 CA 2006 s837 refers to the need for distributions to be made only out of profits available for the purpose, as recorded in the accounts, and in particular to the case where a distribution
is proposed out of a set of accounts for which the auditor’s report was ‘qualified’. (Initial accounts carry similar provisions by s839.) If this is the case, the auditor is required to issue a written statement saying whether ‘in his opinion the matters in respect of which his report is qualified are material for determining whether the distribution would contravene this Part’ (CA 2006 s837(4) (a)). It is clear that this statement is intended to be made in respect of a particular distribution whose amount has already been decided by the directors or is expected. In practice reports are rarely qualified under CA 2006 s495(4). In our first interview at The Institute of Chartered Accountants in England and Wales, we were told by a member of ICAEW Company Law Committee that, while an audit report might signal doubts about the continuing solvency of the client company, this would take the form of a comment on ‘emphasis of matter’ (under s495(4) (b)) rather than a formal qualification. We were also told by Lonsdale & Partners, a firm which provides audits mainly for private companies, that the firm would also seek to avoid issuing a qualified report, preferring instead to reach an agreement with the directors over adjustments or amended disclosures that would avoid the need – in the extreme, resigning the audit if such agreement proved impossible. Of course, in the case of the majority of companies there is no requirement for an audit at all.

2.8.5 The other two cases are of great interest, since both involved solvency statements that the auditor was specifically asked to comment upon. CA 1985 s156 used to refer to the power of a private company to give financial assistance to other parties to purchase its shares. In such circumstances, the directors had to declare an opinion to the effect that the company would not be rendered unable to meet its debts as a result of giving the financial assistance. It was also necessary for the auditors to state that they had enquired into the state of affairs of the company, and that they were not aware of anything to indicate that the directors’ declaration was ‘unreasonable in all the circumstances’. CA 2006 s682 made major changes to CA 1985 s156. It is stated that financial assistance is not now forbidden at all in the case of a private company. There is thus no longer a need for such an audit report. (The ss151–4 rules forbidding financial assistance are unchanged for public companies.)

2.8.6 CA 2006 s713 deals with the powers given to a private company to buy back its own shares out of capital (that is, buying them not out of available profits or out of the proceeds of a new issue of shares, either of which would be quite proper). CA 1985 s173 (on the purchase of own shares out of capital) was succeeded in very similar terms by CA 2006 s714, which sets out very similar terms to the former s173 (3)–(5), except that the solvency declaration needed for the purchase of shares out of capital now takes the form of a solvency statement. The significant point, in our view, is that the directors’ opinion still needs to accompany a report from the company’s auditor, making much the same observations as in s173 (5). We set out the CA 2006 s714 provisions below since we think that this is a very interesting precedent for a form of solvency statement (in contrast to a statutory declaration) that we think could, if wished, be adapted for use in the context both of distributions and periodic statements of trading solvency.

2.8.7 Section 714 (3) stipulates, as did CA 1985 s173 (5), with reference to the directors’ statement:

‘It must state that, having made full inquiry into the affairs and prospects of the company, the directors have formed the opinion –

(a) as regards its initial situation immediately following the date on which the payment out of capital is proposed to be made, that there will be no grounds on which the company could then be found unable to pay its debts, and

(b) as regards its prospects for the year immediately following that date, that, having regard to

(i) their intentions with respect to the management of the company’s business during that year, and

(ii) the amount and character of the financial resources which will in their view be available to the company during that year,

the company will be able to continue to carry on business as a going concern (and will accordingly be able to pay its debts as they fall due) throughout that year.’

It is not obvious to us why the test in (a) is needed, given the requirements of (b) which appears to us to encompass (a). Both tests seem to insist that debts should be paid as they fall due, whether those debts are already in existence or will be incurred in the year following the event (in this instance, the date of capital reduction). It has been put to us that (a) forms a ‘net asset test’ which extends further into the future than (b), but both suggest to us the need for a
forecast of cash requirements. We note, however, that Rickford (2006 p175) makes a distinction between what he describes as the ‘cash flow assurance’ in (a) and the ‘one-year liquidity assurance’ in (b). We infer that he sees (a) in terms of the form of test that he describes below in 3.1.8., which involves reforming the accounts so as to make ‘a balance sheet test which was a reasonable surrogate for a predictor of solvency’. He comments as follows on CA 1985 s173:

‘The one-year liquidity assurance in (b) seems satisfactory. On the other hand, the cash flow assurance in (a) should in principle be unlimited in duration and extent and not limited to debts in the narrow sense. It should thus extend to all the company’s actual and prospective assets and liabilities (including contingent and future ones in the broadest sense), but be subject to a reasonable limitation in terms of predictability.’ (Rickford 2006 p175.)

2.8.8 Section 714 (6) adds the requirement that there must be annexed to this declaration a report by the company’s auditor stating that:

(a) he has inquired into the company’s state of affairs,

(b) the amount specified in the declaration as the permissible capital payment for the shares in question is in his view properly determined in accordance with sections 710 and 712, and

(c) he is not aware of anything to indicate that the opinion expressed by the directors in their statement as to any of the matters mentioned in subsection (3) above is unreasonable in all the circumstances.’

2.8.9 CA 2006 also introduced a new provision for which a new form of solvency statement is required from the directors (with criminal sanctions if it is made recklessly). Under CA 2006 s643 a private company (though not a public company) is now permitted to reduce its capital without the need for the agreement of the court, provided that (a) a resolution to this effect is passed by the company after proper notices have been given (a special resolution is not needed), and (b) a solvency statement is given by each of the directors. Note that every member of the board is expected to make the statement. This statement addresses the same central point as s714 (3) (a) above, namely that there is ‘no ground on which the company could then be found unable to pay (or otherwise discharge) its debts’, but it does not require a report by an auditor.

2.8.10 It has been suggested to us in our discussions that any solvency certificate that might accompany distributions under the Rickford recommendations would only be credible if supported by some form of independent verification. Clearly, the auditor might perform this verification, but it is significant that the need for an auditor’s report has been removed from the financial assistance rules for a private company and not imposed for the reduction of capital. While it is no doubt rare for a company to purchase its own shares out of capital (ie, after first using all retained profits available to it), the principle of the directors making a solvency statement seems to be well established. (A very similar statutory declaration of solvency was required eg, under CA 1948 s283, in support of a voluntary winding-up, and this appears now in identical terms in IA 1986 s89.)

2.8.11 The New Zealand Companies Act 1993 places more emphasis on the need for solvency tests (defined in s4 of that Act), and it is of particular interest in the context of the present study that, by s52 (1), the directors authorise a distribution only if they are satisfied on reasonable grounds that the company will, immediately after the distribution, satisfy the solvency test. By s52 (2), the directors who vote in favour of the distribution will ‘sign a certificate stating that, in their opinion, the company will, immediately after the distribution, satisfy the solvency test and the grounds for that opinion’. There is no particular form for the solvency certificate, and it is not audited or attested by any other person (unlike the CA 1985 s173 (5) requirement in the UK, noted in 2.8.8). On the other hand, New Zealand company directors must still have regard to the figures presented in the accounts in making this solvency declaration. The solvency test set out in s4 spells out two requirements: ‘(a) The company is able to pay its debts as they become due in the normal course of business; and (b) The value of the company’s assets is greater than the value of its liabilities, including contingent liabilities.’ For the latter purpose, the directors are required to ‘have regard to’ the most recent financial statements of the company and also to: ‘All other circumstances that the directors know or ought to know affect, or may affect, the value of the company’s assets and the value of the company’s liabilities, including its contingent liabilities.’ (Loc cit.)

2.8.12 By contrast, we are not entirely convinced that reference needs to be made to the financial accounts in the course of testing for solvency, which in our view can be satisfied by forecasting the magnitude and timing of cash flows. In this respect, we prefer to follow the law...
as adopted in the Commonwealth of Massachusetts (Limited Liability Company Act, Chapter 156C) and in the Australian 2001 Corporations Act (see 3.1.14 and 3.2.5 below, and Keay, 2007). Whether any form of review by the auditor (or anyone else) is needed is a matter for debate. The terms used in s714 (6) (a) and (c), quoted above in 2.8.8, would appear to us to be appropriate as the basis for a form of confirmation in the context of a UK directors' solvency report.

2.8.13 In its 1993 study of the future of auditing, the Research Committee of the Institute of Chartered Accountants of Scotland considered several aspects of the audit function in the light of public expectations, including those towards the going concern status of the company audited in the (routine) annual financial report:

‘In our opinion, neither the directors nor the external auditors can guarantee the financial soundness of a company. However, we believe that it is reasonable to expect the directors to state publicly whether in their judgement, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to remain a going concern for at least twelve months from the date the directors approve the financial statements. We also believe that it is reasonable to expect the auditors to carry out procedures aimed at testing the directors’ stated judgment and to report publicly the result of such tests.’ (McInnes 1993 pp11–2, emphasis in the original.)

2.8.14 The series of authoritative papers on auditors’ duties published by the ICAEW Audit and Assurance Faculty includes studies of the assurance services that may be taken up by companies that are not required to have their accounts audited and do not choose to do so. These papers include The ICAEW Assurance Service on Unaudited Financial Statements (ICAEW 2006a) and Audit-exempt Companies: Company Views on the ICAEW Assurance Service (ICAEW 2006b). The latter paper reports the findings of a research study on the willingness of a sample of companies to use assurance services on a voluntary basis. It is striking that the principal reason reportedly seen by the directors interviewed for wanting such an assurance review is for raising loan capital. Clearly, it is perceived that the annual accounts are seen as useful in the negotiation of loans, despite the reservations expressed to us by bankers (reported in 5.1.4 below). On the other hand, this may reflect satisfaction on the part of the prospective lenders that the directors concerned actually take the trouble to prepare a proper set of accounts and secure expert assurance on them, rather than using specific information that the accounts contain.

2.8.15 It has become evident from the interviews (for example KPMG) that the existing form of audit already addresses the issue of solvency in the case of audited companies. The ‘going concern’ status of the reporting company is implicit in the accounts, failing which there would at least be reference to a difference of opinion on this major ‘emphasis of matter’ in the audit report. In the case of listed companies, the requirement to confirm going concern status is still more explicit (under the Listing Rules). The auditor has to review all Combined Code disclosures. Moreover, ICAEW Company Law Committee confirmed that the requirement in CA 2006 s417 that the Business Review should disclose the principal risks and uncertainties will include the risk of insolvency where that is a significant risk. KPMG commented that the Business Review would be more useful than the former Operating and Financial Review was, being less of a ‘boilerplate’ exercise. No doubt ISA 700 will require the auditor to comment if there is any apparent inconsistency between the information available to the auditor and material statements in the Business Review and in the Directors’ Report. The FEE Discussion Paper discussed in 3.3 below suggests that IAASB standards already in existence address assurance in the context of prospective information (particularly ISAE 3400, formerly ISA 810, and relevant parts of ISA 570 and ISA 545).

2.8.16 ISA 720 The Auditor’s Responsibilities in Relation to Other Information – Documents Containing Audited Financial Statements, adds to the duties laid upon the auditor to make sure that any statements made by the directors (including any that imply the company’s solvency) are consistent with the information available to the auditor from the financial statements or other sources made available in the course of the audit work. Such forms of reassurance to readers are important, but they only extend to the relatively small number of companies (mainly public companies) that are required, or that volunteer, to prepare either an Operating and Financial Review or the form of Business Review required by CA 2006. Clearly the scrutiny of listed companies is already much more extensive than it is of private companies, despite the warnings of Coffee (2006, writing primarily about the US, but making reference also to the UK) about the compromised independence of auditors.
2.9 CONCLUSIONS ON THE USE OF ACCOUNTING REPORTS TO MONITOR CREDIT AGREEMENTS

2.9.1 At several points above, we have indicated weaknesses that arise in published accounting information. The lists of assets and liabilities captured in the accounts are far from exhaustive (2.3.5). Some assets are written off before their effective life is over, while other intangibles never appear (2.3.8). Section 2.3.19 referred to forms of liability not normally reported in the accounts, and to conservatism imported into the impairment rules, while 2.3.21 noted several other items of sensitive information that creditors would want to have if only it were feasible to report them. Section 2.4 warned of the use of historical costs where ‘going concern’ was in doubt and thus where net realisable values become more relevant. Section 2.5 noted the common use of ‘mongrel’ valuation bases in the same set of accounts, and problems in defining the boundaries of the entity. Sections 2.5.3 and 2.5.5 noted the unclear boundaries between debt and equity, and group accounting limitations.

2.9.2 It is clearly tempting to lay down balance sheet tests based upon the published accounts in order that directors, auditors, and users are all given the reassurance offered by clear-cut objective procedures. However, we worry that this form of solution may present even more problems than the more subjective cash flow alternative that is directly relevant to the problem. This is not to question the good faith of the great majority of directors and accountants, but merely to recognise that there is a marked degree of uncertainty introduced once accounting ratios are invoked (Keay 2007 pp202–3). Moreover, the temptation to manipulate the numbers is undoubtedly increased by the onset of financial uncertainty. We agree with Rickford (in the 2004 report and, more strongly, in his 2006 paper) that the existing forms of capital maintenance tests do not meet the purpose of protecting creditors. We accept that they should be abolished.

2.9.3 We also agree with Rickford that, despite the likelihood that some assets and liabilities will be missing from the published balance sheet, there is merit in using balance sheet ratios as a simple screening device for directors to use alongside cash flow forecasts in identifying financial insecurity. Meeks and Meeks (2009, in an Appendix, pp42–3) examined a data set of 5,088 sets of UK listed company accounts for the years 1948–90, subject to certain minimum size conditions; they found that out of 71,111 company account years, only 29 were identified as exhibiting balance sheet insolvency, and most of these evidently failed. Where reported liabilities exceed assets, it may well be true that the company needs to pay particular attention to its solvency. Rickford recommends that a distribution made under these circumstances should be accompanied by a statement from the directors as to why they believe the distribution will not prevent the company from meeting its debts. The converse, of course, is not reliable – that a company with more assets than liabilities will be able to meet its obligations as they fall due. (The company might be over-trading, for example, as described in 4.6.10 below.) We proceed in the next section to consider the 2004 Rickford Report in more detail, and then the 2007 FEE Report. The 2008 KPMG Report (discussed above in 2.7.7 et seq) is not discussed further, since its function was to establish the facts about the way the capital maintenance rules are applied, and its terms of reference did not include making recommendations.
3. THE RICKFORD AND FEE REPORTS ON CAPITAL MAINTENANCE RULES AND THEIR RELIANCE ON ACCOUNTING NUMBERS

3.1 THE RICKFORD REPORT

3.1.1 Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance (the Report) (Rickford (ed) 2004) was produced by a high-powered cross-disciplinary group of accountants and lawyers. The Report notes that, while the relative rights of creditors and shareholders as classes are central, this area of company law also has significance for the protection of different classes of shareholder and well as creditors, in each case affecting their relative rights. Defining the relative rights and obligations of companies, directors, shareholders and creditors has traditionally involved fundamental accounting concepts, including the distinction between capital and income, the recognition and valuation of assets and liabilities, the timing of revenue recognition, and the making of distributions. The Report begins by reviewing existing company law on capital maintenance and developing accounting standards in the context of distributions. It concludes that:

‘The present law on capital maintenance) is not widely relied on in practice by creditors, is complex, expensive and anomalous, producing inconsistent results as between companies within Member States and between different Members States within the EU. Rigid linkage of distribution limits to company balance sheets and profit and loss accounts produces distortions. These accounting statements provide an incomplete and unreliable basis for distribution decisions. The modern trend towards “fair value” (or more realistic) accounting principles produces more volatile “bottom line” outcomes which impede stable distribution policies.’ (Rickford (ed) 2004, p921.)

3.1.2 After an analysis of current capital maintenance rules and an examination of two particularly problematic new accounting standards (on stock options and on pensions), the Report concludes by recommending distribution rules that incorporate ‘a two part solvency test’, to be applied before any distribution is made:

‘Having regard to the company’s annual report and accounts, the company will in the directors’ opinion immediately after any distribution (1) remain able to pay its debts and (2) have sufficient resources as a going concern to be able to meet its liabilities as they fall due for the following year. Where the latest audited balance sheet does not show a surplus sufficient to justify this view the directors should state that fact and explain why they nevertheless regard the distribution as within the test.’ (p921)

3.1.3 There is a slight ambiguity in the reference to the above as a ‘two part test’ in that it is unclear whether the balance sheet review is to be taken as the second part of the test, or the ability of the company to meet its liabilities as they fall due in the following year. The KPMG Report seems to take the first interpretation at p280, but equates the two at p282. At p284, however, it comments: ‘The second part of the solvency test requires an indefinite assurance of the company’s viability. This test is also in essence cash flow based’. We think the full text of the Report, pp979–80, shows that the two part test comprises the ability to pay debts at the time of the distribution, including contingent and prospective liabilities, and also (as the second part of the test) meeting obligations during the succeeding year and beyond.

3.1.4 The text rejects the use of a strict balance sheet test:

‘We would not as a matter of logic favour an additional net assets test, for two reasons: first once it is recognised, as in our view it must be, that such a test cannot, if it is to be of real value, be rigidly linked to the accounts, the effect of the test is, or should be, little different in substance from a view on solvency; secondly, such tests tend to be treated as mere mechanical applications of a calculation of balance sheet net asset value, an approach which we have shown above may lead to wrong results in either direction.’ (p980)
3.1.5 However, as a matter of discipline, the directors would be required to review the accounts and annual report as a whole, and where ‘the result is to declare that the company is solvent while on an application of the narrow balance sheet net assets test the result would be a deficit, they should explain why they take the favourable view.’ (Loc cit.) Neither statement would need a specific audit report, but the Report acknowledges that current audit practice would require the auditor to comment if statements made by the directors were not consistent with information contained elsewhere in the accounts. Since the report is concerned only with public companies, it follows that there will always be an audit report. The Report also suggests (albeit tentatively, and subject to further consultation) that directors would need to support all distributions with a solvency certificate based upon the company’s ability to meet its commitments.

3.1.6 CLRSG considered and rejected the argument that distributions should be accompanied by a solvency statement. In its February 1999 Consultation Document (p86, para 5.4.18) the CLRSG comments:

'We have considered, but are not attracted by, the idea that a distribution should not be made without a declaration of solvency by the directors. This has never been a requirement in the UK and experience with dividend-paying in the past does not indicate that the law has been abused significantly.'

3.1.7 By contrast, in this report we also address the wider question of whether there are other circumstances in which such a declaration should be required, and we conclude that it should accompany the annual report that must be filed with the Companies Registry where full audited accounts are lacking, even if no distribution is being proposed to the shareholders. While we think that solvency statements are undoubtedly needed for private companies (outside the terms of reference of the Report), we are not fully convinced that they are necessary to accompany the annual report for public companies or for any others that publish and file a full set of audited accounts. Although there is a strong case for these companies to publish the certificate with all distributions, as urged in the Report, it has been put to us that this is not needed in the light of current requirements for ‘going concern’ accounts, reviewed by the auditor. We accept this view, and of course the CLRSG rejected the idea.

3.1.8 If the case for a solvency statement is accepted for distributions by public companies, we would also accept the case for the ‘narrow’ balance sheet test, even though the Report was quoted in 2.4.13 above as saying: ‘The balance sheet ... by its nature cannot fully portray the timing and degree of certainty of future cash flows and the company’s flexibility’ (2004, p977). We recognise, as does Rickford, that such a ‘narrow balance sheet assets test’ must be based on the existing accounts, rather than on the expanded version of the balance sheet that Rickford sets out as being adequate for solvency prediction (quoted below). Indeed, we think that Professor Rickford himself, in his later paper, provides convincing reasons for this view that the published accounts are not fully adequate to predict solvency.

‘In fact, whether there is a real difference between solvency and an asset/liability surplus depends on how we define assets and liabilities. We could define assets to include all the resources available to a business, that is to say, all those conditions which operate to give it the means of actually or potentially generating value, and we could define liabilities similarly, as including all those conditions which give rise to actual or potential obligations to make expenditure and liabilities to destroy or lose value. We could then set a value on each of the benefits and detriments which will arise from these conditions, appropriately discounted to reflect the fact that they will arise at different points of time and for probability. Having done that, we would have produced a balance sheet test which was a reasonable surrogate for a predictor of solvency. In fact the IAS Framework [that is, the International Accounting Standards Framework] begins to go some distance in this direction in its definitions of assets and liabilities, which consciously avoid the classic legal definitions in favour of ‘real world phenomena’. But such an exercise, if it is to be made comprehensive, is very different even from the current IAS balance sheet. It would have to include all contingent assets and liabilities. A move in this direction is proposed by IASB. But it would also have to include in some form all future assets and liabilities.’ (Rickford 2006 p172, parenthesis added and paragraph break suppressed)

3.1.9 We worry that the sort of ‘narrow’ balance sheet test proposed above will constitute no more than a token comfort, to the board itself or to creditors and others needing reassurance on the matter. On the other hand, we have sympathy for directors who need to be clear in their minds what is expected of them, and some form of objective test is no doubt helpful. Indeed, we accept that where a balance sheet shows an excess of liabilities over assets, this
often indicates a real or impending state of insolvency. The most important feature of the proposal is that even where a company is not able to satisfy the ‘narrow’ test (i.e., where liabilities exceed assets) this would not prevent a distribution – it merely requires that the directors provide further justification for it. The Report differs in this important respect from the other three studies analysed by KPMG (in 2.7.7 and 2.7.10-12 above), which insist that assets shown in the balance sheet must exceed liabilities after a distribution. Directors may be tempted to overstate assets and understate liabilities, but they are not likely to do the opposite and manipulate a balance sheet so that it ‘fails the test’. We recognise that a deficit is to be taken seriously, although the converse (i.e., where assets exceed liabilities) cannot be relied upon to ensure solvency.

3.1.10 The Report goes on to recommend (p988) that: ‘there should be an EU-wide prohibition on “wrongful trading”’. Rickford’s working party was presented with terms of reference that only addressed capital maintenance in the context of distributions. On the other hand, wrongful trading is an offence associated with insolvency law rather than company law. Indeed, it is more concerned with the decision whether to continue to trade rather than whether to pay a dividend, and so might appear to fall outside the terms of reference. On the other hand, we support the suggestion (even though the 2007 FEE Survey, referred to in 2.7.6 above, shows strong views throughout the European Union against a common European measure, on the grounds that member countries have their own laws that are closely tailored to local needs).

3.1.11 After a careful review of the law, in the UK and elsewhere in the EU, on the need to preserve paid in capital and non-distributable reserves, Rickford and his colleagues stress that the central issue for creditor protection is not one of capital maintenance but of solvency – the ability of the company to meet its debts as they fall due. (Rickford’s own 2006 paper provides further arguments.) It does not matter whether or not a historical quantum of capital is protected. They propose the elimination of any strict capital maintenance rules, whether based on the balance sheet (assets must exceed liabilities) or the income statement (distributions must only be out of profits available for the purpose), although they insist that balance sheet ratios be used to guide directors’ statements on solvency where liabilities exceed assets in the way quoted in 3.1.2 above.

3.1.12 The Report addresses the nature and authority of solvency certification, noting in particular the development of New Zealand law in this area (following US precedents, particularly in the Model Business Corporations Act). But it observes that: ‘The precise nature of the solvency requirement to be applied in the UK deserves wider discussion and consultation than we have been able to conduct for the purposes of this report.’ (Op cit p979.) Of course, we hope that our present research will contribute towards this wider discussion and consultation. As noted in 2.8.12, we see much to commend in the laws of Massachusetts (quoted in 3.1.14 below) and in the Australian Corporations Act 2001 (see 3.2.5 below), both of which rely on a cash flow test without reference necessarily to the accounts, although Australia excludes smaller companies from its requirement for a solvency statement (whereas we regard such a statement as being more even important for private than it is for public companies). We note that the New Zealand Companies Amendment Act 2006 follows Australian precedents (despite a history of friendly rivalry) in the form of a new system of business rehabilitation by way of voluntary administration, enabling the administrator and the creditors to resolve the company’s position. (It also institutes new steps to deal with ‘phoenix companies’.)

3.1.13 It should also be remembered, however, that the Australian Corporations Act 2001 still stipulates that distributions may only be paid out of profits, not out of capital, a view we would not want to endorse. Indeed, one of the main reasons for wishing to abolish the capital maintenance rules in the European Second Directive is the wish to escape from complex and ineffective regulations that constrain distributions. Making these payments depend on their solvency implications seems to us to replace the need for definitions of distributable profits, with the voluminous body of statute and case law that these involve. Prior to the Companies Act 1980 in the UK, the law in this area was further complicated by considerations of whether profits needed to be realised in order to be distributable, a matter largely resolved by the Second Directive in Europe but not of course in Australia (where the law is as set out in Austin and Ramsay 2007). In January 2010, the Australian Senate introduced a bill to amend the Corporations Act. One if its provisions is to remove the need for distributions to be made out of profits.

3.1.14 The Commonwealth of Massachusetts specifies that distributions must comply with a test that is designed to protect creditors without the need necessarily to refer to the published accounts. The Massachusetts Business Corporations Act 2007, Chapter 127, specifies in Section 6.40:

‘(c) No distribution may be made by a corporation which is a going concern if, after giving it effect,
(1) the corporation would not be able to pay its existing and reasonably foreseeable debts, liabilities and obligations, whether or not liquidated, matured, asserted or contingent, as they become due in the usual course of business; or

(2) the corporation’s total assets would be less than the sum of its total liabilities plus, unless the articles or organization permit otherwise, the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

(d) The board of directors may base a determination that a distribution is not prohibited under subsection (c) either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.’

3.1.15 It seems clear to us that the condition set out in s6.40 (c) (2) above refers to the ability of the company to meet its debts if it were put into liquidation, rather than a balance sheet test based on the published accounts. Keay (2007 p208) quotes Re Healthco International Inc (1999). Here, the court took the liberal view that directors had a duty towards creditors when the company faced a ‘condition of financial debility short of insolvency but which makes the insolvency reasonably foreseeable’. The significance of this, in the present context, is that this is a Massachusetts case in which the court took a more protective stance towards creditors than was generally the case more widely, in the US or elsewhere. It is unclear which direction US law is taking in more recent cases, such as Trenwick America Litig. Trust v Ernst & Young L.L.P [2006] (see 4.5.14, below).

3.1.16 Although the debate over capital maintenance was already causing much interest while the new companies legislation was being formulated, the CA 2006 does not reflect these concerns directly. Part 23 (ss829–853) largely repeats the law on distributions from the CA 1985, although there are minor changes in the wording as well as some relaxation for private companies, as noted in 2.7.23 above. The CA 2006 makes specific reference to companies that use International Accounting Standards (s395 and s403) as well as to those that use other standards, but otherwise there are only minor amendments to the law defining distributable profits. A public company may still make distributions only out of profits available for the purpose, and with the further proviso (by s831) that, once the distribution is made, the amount of its net assets afterwards ‘is not less than the aggregate of its called-up share capital and undistributable reserves’.

3.1.17 The Report, and other critics of capital maintenance, undoubtedly made an impact, however. As noted in 2.7.23, the Companies Bill foreshadowed changes in the areas of capital maintenance and the company law aspects of charges (House of Lords Explanatory Note, 2005, paras 1451–1453). Future statutory instruments are still expected (subject to affirmative action, rather than full debate, under Part 46 ss1288–1297 of the 2006 Act), but there is no reference in the CA 2006 itself to any specific areas in which these instruments are expected to be used. The 2005 Explanatory Notes noted that the UK would need to make changes in the complicated area of capital maintenance – but only in conjunction with wider changes under the European Directives on Company Law, and the time was not yet thought to be due for these to be made.

3.1.18 While we regard the Report as very important, and strongly support most of its analysis and conclusions, we have some reservations, set out in the following paragraphs.

3.2 SOME COMMENTS ON THE RICKFORD REPORT

3.2.1 We agree with the Report that the ability of the company to meet its immediate debts and its liabilities as they fall due in the following year has little to do with its annual report and accounts. We agree with the Report that protecting the interests of creditors is fundamentally a matter of cash forecasts (usually not something which can be made public) rather than numbers contained in the accounts – still less, published balance sheet figures. Creditor protection must include its ability to meet debts at any time to its planning horizon. Rickford’s (2006) expanded form of balance sheet would include all future assets and liabilities. In protecting creditors, it will not help matters that the items are discounted to the balance sheet date, as he suggests: the statements need to show the timing at which these items will arise. If we follow Rickford’s logic, it appears that we have, in effect, rediscovered the cash forecast by another name.
3.2.2 We note that the Report seems to be unclear on how far disclosures can signal a warning of insolvency risks and aid creditors to protect themselves. It is doubtful that external users can draw strong inferences from the accounts in their existing form (even when these are available), although we have cited evidence that users seek to do so and regard it as an important function of published accounts to forewarn creditors. The proposed solvency statement is undoubtedly intended to provide some assurance, and it would no doubt do so more comprehensively if it were subject to review and comment by an auditor.

3.2.3 The Report observes that the published accounting figures can only be a starting point that needs to be augmented if external readers, including a court, are to be put in a position to confirm whether or not future solvency is a realistic prospect. According to PricewaterhouseCoopers' 2007 study, in 2.3.14 above, institutional users reportedly use them in this way. For example, the usual balance sheet excludes some of the contingent liabilities (despite the need for contingency notes as required by FRS 12 (ASB 1998b)). We maintain that it is unrealistic to expect outsiders to assess future solvency on the basis of published financial statements, for reasons already rehearsed (eg, in 2.9.1–2). Nor, of course, would external readers know about all the potential lines of credit available or funding plans under consideration by the board (despite the disclosures required by the standards on financial instruments, ASB 1998c). This means that creditor protection lies mainly in the hands of the directors, although their bankers may notice signs of strain in the course of daily banking activities that the directors may wish to ignore. It is generally left to the directors formally to decide when the risk of insolvency has become so serious a matter that the creditors must be invited to take control of the company (through a representative), although lenders – particularly secured lenders – will often take the initiative and pressure them to act in this way (Frisby 2006).

3.2.4 The Report notes with great interest the current state of New Zealand law on the subject of creditor protection. It is notable that the New Zealand solvency test includes the need to ensure that 'the value of the company’s assets must exceed the value of its liabilities, including contingent liabilities' (Report p1025, and also quoted above in 2.8.11), and the law also requires directors 'to have regard to the most recent financial accounts and to all the other circumstances they know, or ought to know, affect, or may affect, the value of the assets and liabilities, but [they] may rely on reasonable valuations' (Report p1026). In fact S4 (3) (b) of the New Zealand Companies Act 1993 says that the directors: 'may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances', expressly going beyond figures in the most recent accounts. It is not clear how much use the published accounts are going to be. For one thing, they are based on the ‘going concern’ assumption, namely that the company will continue to trade in its existing form for the foreseeable future. By contrast, creditor protection becomes a major issue precisely at the point when it is no longer safe to assume the company is a ‘going concern’ – when there is some significant risk that it might become a ‘gone concern’. Evidently, New Zealand has moved some way towards putting the onus on directors to assure external parties of solvency in the context of distributions (S52) and redemption of shares (S70), including a certificate to this effect signed by those authorising any dividend declaration or redemption. New Zealand law on wrongful trading is similar in some respects to UK law, but it is named ‘reckless trading’ (New Zealand Companies Act 1993 S135). As Keay (2007 p78) notes, this name implies culpability more than negligence. The New Zealand Companies Amendment Act 2006 recently added new provisions to the 1993 Companies Act to encourage voluntary administration, in order to aid the rescue of ailing companies along lines already available in Australia. The Report, in contrast to other commentators such as Meeks and Meeks (2009), rather disregards Australian law, which we address next.

3.2.5 Australia, like New Zealand, has moved in the direction of putting the onus on directors to protect creditors’ interests if they believe the solvency of the company is at risk. (Some features were noted in 2.7.9 earlier, in the context of the 2008 KPMG Report.) Section 588G of the Australian (Federal) Corporations Act 2001 is discussed in detail by Keay (2007). He compares wrongful trading rules under UK insolvency law with its Australian equivalent, ‘insolvent trading’ (see also Keay and Murray 2005). He notes that Australian law relies on one offence, insolvent trading, rather than the two offences in the UK of fraudulent trading (IA 1986 s213) and wrongful trading (IA 1986 s214), but S588G can involve civil and criminal offences. Keay points out that S588 only requires a single solvency test based on forecast cash flows. Section 95A defines the term thus: ‘A person is solvent if, and only if, the person is able to pay all the person’s debts, as and when they become due and payable’. It adds that: ‘A person who is not solvent is insolvent’. (‘Person’ in this context includes a corporation.) This gets to the heart of the matter. Section 588G sets out the director’s duty to prevent insolvent trading by a company, specifying seven forms of action that constitute incurring a debt. These include paying a dividend, reducing share capital, buying back and redeeming shares, giving financial assistance, and entering into an ‘uncommercial transaction’. Section 588FB defines what is meant by an uncommercial transaction.
'A transaction of a company is an uncommercial transaction of the company if, and only if, it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction, having regard to:
(a) the benefits (if any) to the company of entering into the transaction; and
(b) the detriment to the company of entering into the transaction; and
(c) the respective benefits to other parties to the transaction of entering into it; and
(d) any other relevant matter.'

3.2.6 Note that the test takes the 'objective' form, of considering whether a reasonable person would have entered into the transaction under the specified circumstances, rather than whether the actual decision taken could be construed ('subjectively') as reasonable. Insolvent transactions can take two forms under S588FC: 'unfair preferences' and uncommercial transactions, the offence taking the form of entering into the transaction or giving effect to it at a time when the company is insolvent, or alternatively causing the company to become insolvent by entering into the transaction or giving effect to it. While this appears to us to be eminently sensible, we noted earlier (2.7.9) that Australian law also insists that distributions may only be made out of profits, not capital. The 2008 KPMG study (p263) surveyed chief financial officers throughout Europe and several other countries, and asked: 'Is the ability to pay dividends better determined via liquidity tests that take into account projected future cash-flows'. A majority of respondents in Australia (by a ratio of about 60% to 40%) replied 'no' to this, although they have had such provisions in place for some years (whereas, interestingly, in the USA, Canada and New Zealand, the majority supported the principle).

3.2.7 Under the Australian Corporations Act 2001, all companies except for 'small proprietary companies' must prepare and file annual financial reports and directors' reports. (So must small proprietary companies if their shareholders or the Australian Securities and Investments Commission so direct.) The annual financial report must include the financial statements themselves, notes to the financial statements, and a 'directors' declaration' (as to solvency). This declaration (by S295 (4) states (inter alia): '(c) whether, in the directors' opinion, there are reasonable grounds to believe that the company, registered scheme or disclosing entity will be able to pay its debts as and when they become due and payable'. In the case of listed companies, this requirement is augmented by a declaration on the financial statements by the chief executive office and the chief financial officer (S295A). Note that this is a requirement of the annual report, not of any proposal to make a distribution. In the case of 'disclosing entities', a similar declaration has to be made in the half-yearly financial report. This seems to us to be a reasonable provision. However, it does not apply to small companies, which, in our opinion, are the very ones that most need a solvency declaration each year. As we have commented earlier, public companies (and, even more, listed companies) in the UK are closely monitored already, both with respect to reported profits and solvency. The greatest need for greater protection arises with small companies. Despite the political pressure currently to reduce legal formalities, we recommend that, where a small or medium-sized company does not file audited accounts, the directors should file a solvency statement instead with the annual return. Such a requirement would put the directors on formal notice that they need to make the solvency statement after reviewing cash flow forecasts.

3.2.8 Keay (2007) discusses at some length the law on company directors' responsibilities to creditors, and he takes pains to explain the difference between a 'contractarian' view of the law and a 'communitarian' view. The key difference is that the former places emphasis upon the freedom and capacity of parties to form contracts in whatever form they choose, and to have these enforced as far as possible without intervention or disturbance by others, including the state. (The distinction was discussed above in this report, in the very first paragraphs.) The latter view, without seeking to inhibit contracts more than necessary, accepts more readily that circumstances arise where the freedom to form contracts needs to be curtailed or modified, in the interests of broader considerations of fairness or expediency. Keay favours the latter view. By contrast, the Report does not explicitly take a position. This is understandable, since its purpose was to change the law, and it would probably offer hostages to fortune to take up value judgements on which opponents could seize.

3.2.9 Keay points out that some contractarian commentators argue against what they see as the imposition of insolvency law provisions that cut across the freedom of parties to agree contracts on whatever terms they choose. Wrongful trading rules are not needed, they maintain, provided that creditors of all classes are able to set out the terms on which they are prepared to enter into relations with the company. Comunitarian advocates reject this on the grounds that circumstances arise in which creditors cannot in practice secure adequate
protection by contracts. Transaction cost economics, in particular, addresses some of the key problems that arise in forming, monitoring and enforcing contracts, although some transaction cost economists regard their prime purpose as being to seek out ways in which to reduce to a minimum what they regard as contracting inefficiencies, so as to allow markets to perform as effectively as possible. Franks and Sussman, (2000, 2001) describe the UK system as ‘contractarian’, in that financial failure amongst small UK companies is typically resolved out of court by the parties involved, in contrast with Chapter 11 procedures in the US. On the other hand, we note that the UK system undoubtedly possesses a framework of legal rules, in statute and case law, which can readily be invoked by creditors who are disadvantaged by the way that voluntary debt resolution works. Key suggests a reformulation of the duty of directors, directed towards the company itself rather than to any specific stakeholder group. Meanwhile, it is clear that the Report is intended to remove what it regards as certain costly and ineffective restrictions on distributions, without specifying whether this is intended in the interests of contractarian or communitarian priorities.

3.2.10 The Report addresses capital maintenance in the context of creditor protection, and so it equates this concept primarily with the need to constrain distributions to shareholders, and the need to limit these to amounts that can properly be paid out of past earnings. This is not, in our view, the principal way in which creditors’ claims are likely to be left unmet. It is noted (eg, at Report p930) that: ‘Nothing precludes the loss of share capital by trading.’ It is further noted (p943, emphasis added): ‘However in the case where creditors are most exposed, i.e. where there are losses, the [Second] Directive allows capital to be written down without any provision for the protection of creditors... In effect it removes the requirement that when assets have been eroded to a level below the capital yardstick they should be replenished before anything is returned to the shareholders.’ Thus, the existing capital maintenance rules for distributions are flouted by the ability to write down capital after such losses and then to permit dividends to be paid out of subsequent profits. CA 1985 s135 followed earlier companies acts in permitting companies limited by shares to reduce their capital in any case, although this needs the agreement of the court, whose function was to ensure that creditors’ rights were not infringed thereby. CA 2006 ss641–4 and ss709–21 now go further, in offering private companies (but not public companies) the power to reduce capital without the need for recourse to the court.

3.2.11 We believe that the loss of share capital by trading is far more serious a problem in practice than improper distributions (even though this is not a negligible issue). In wrongful trading, the major issue for creditors (and for the directors themselves) is whether the decision to trade further is likely to make matters better or worse. This is at heart a matter of judgement, but it is the central matter, discussed by Prentice in his analysis of the judgement in Re Produce Marketing Consortium Ltd (No 2) [1989] (Prentice 1990). It is addressed directly by insolvency law in the rules against ‘wrongful trading’ in the Insolvency Act 1986 and – perhaps less directly – by company law (and the Company Directors Disqualification Act 1986) in their provisions against fraudulent trading and directors’ misfeasance. The judgement is admittedly difficult to make (see also Williams and McGee 1992: also Sprecher Grier 2002).

3.2.12 The Report notes that s34 of CA 1980 imported into UK law a requirement from the European Second Directive on company law, that if a company loses more than 50% of its issued capital, it must call a general meeting. The provision applies only to public companies. This is still in UK law, repeated in CA 1985 s142 and again in CA 2006 s656 (except that the latter now requires a ‘general meeting’, rather than an ‘extraordinary general meeting’ as in the 1980 and 1985 Acts). It is not specified in the section – or in the Second Directive – what happens next. Of course, such a meeting convenes shareholders but not creditors, and its purpose is presumably to invite shareholders to consider the next steps, such as calling a members’ voluntary liquidation (which is only possible if the company is solvent), convening a creditors’ meeting, or seeking the appointment of an administrator. Calling a meeting may well in itself precipitate a financial crisis. The major loss of capital to which this provision refers is only loosely defined. There are many accounting issues to consider in deciding what assets to include and what to exclude from the balance sheet. For example, while the depreciation rate is arbitrary over the life of a fixed asset, it is permissible to reconsider the asset’s useful life and to write back past depreciation if that was thought to be excessive in the past. We agree with implication in the Report that the provision performs no useful function. It seems to have no role either in the context of solvency prediction, or for the protection of either creditors or shareholders.

3.2.13 The involvement of auditors is controversial, both in relation to existing rules concerned with creditors protection (published accounts, distributions, reduction of capital and purchase of shares out of capital) and our proposal in this report to require solvency certificates. It was noted in 2.8.1 earlier that: ‘Auditors’ legal liabilities have been debated at length in recent years, and CA 2006 ss532–8 sets out rules that permit companies to enter into liability limitation...
agreements with their auditors, with certain safeguards.’ The issue now is whether their involvement is needed in the context of solvency certification. The Report comments: ‘We accept the submissions made to us that, without some form of external verification, solvency certificates by directors have little information value, but even without auditor confirmation they would tend to concentrate the minds of the board on the process of cash forecasting that we see as central to solvency prediction. The Report accepts that, on balance, solvency certification would be adequate without the need for specific comment by the auditor’. (pp974–5) Those companies required by CA 2006 to publish a Business Review may, where relevant, include in their comments on financial risks any comments on future solvency. In any case, it is implicit in their going concern status. The auditors must review all such statements and comment if they are not consistent with the knowledge otherwise available to them in the course of the audit. Unaudited companies are of course excluded.

3.2.14 The 2008 KPMG review of Rickford, referred to in 2.7.11, 2.7.16 and 3.1.3 above, comments on the impact of the proposals in the Report for shareholders and creditors:

‘The position of shareholders and creditors is negatively affected by the fact that the distribution could also be made out of the contributions received from shareholders of the company if the solvency test allowed for this. The balance sheet test can be overruled. As a remedy, the Rickford proposal foresees an increased level of formalised solvency testing by the company’s management concerning both the company’s short-term liquidity and its viability in the long term. Both tests are linked to a system of sanctions at the centre of which is the personal liability of the directors. In implementing such a system, it would be crucial whether the threat of sanctions to directors serves as a means to discipline the management to act prudently. Under the envisaged format of the solvency test, the directors are partly required to make highly judgmental decisions about the prospects of the company. This may result in legal uncertainty for directors. Therefore, the actual design of the test and the format of the certification by the company’s directors will be decisive in determining the right balance between the legal uncertainty for the directors and the interests of stakeholders in a viable company.’ (KPMG 2008 pp288–9.)

3.2.15 There is also the question of whether there are any other occasions on which such a statement should be required. We doubt whether they should, although there is an argument that any event that involves a substantial outflow of funds from the company ought to be accompanied by a solvency statement. Thus, purchase of a major fixed asset undoubtedly reduces the level of funds available to meet external debts, just as a major loss of capital does (noted earlier in 2.4.12 and 3.2.12). Most respondents with whom we discussed this issue commented that there would be little useful information value in the solvency statement itself, but (as the Report notes) the need to issue a formal statement would concentrate the minds of directors on the issue. Such a measure would probably be of greater value in the context of private than public companies. Indeed, there is a strong case for making a solvency statement obligatory as a condition for granting a company exemption from the need to file accounts.

3.3 FEE DISCUSSION PAPER ON ALTERNATIVES TO CAPITAL MAINTENANCE REGIMES

3.3.1 This paper, published in September 2007, is a further statement in favour of a new solvency-based regime to protect creditors in the context of distributions in EU countries. Like Rickford’s Report, it addresses public companies and rejects the European Second Directive’s provisions for capital maintenance as being costly, unduly restrictive towards distributions, and ineffective in protecting creditors. It defines solvency as the ‘ability to pay debts in the ordinary course of business when they fall due (without selling premises etc.)’, and it states (p6 and p23) that the structure of any new solvency-based regime should aim to meet the following objectives:

• it should aim to prevent companies becoming insolvent or over-indebted as a direct or indirect result of making distributions;
• it should aim at protecting all stakeholders, especially creditors;
• it should aim to be flexible, simple, effective and efficient and not cause any unnecessary burden to companies;
• it should require companies to take into account, in making individual distribution decisions, both their short and long term obligations; and
it should incorporate the assumption that the longer the time horizon on which estimates of future solvency are based, the greater will be the level of uncertainty as to the reliability of such estimates.’

3.3.2 Like the Rickford Report, on which it draws, it comes to the view that solvency tests should be in two parts, a ‘snapshot’ test (based on the balance sheet or on net assets) and a ‘forward looking’ test (which involves the projection of cash flows). As in the case of the Report, we agree with the cash flow forecast test but we are less convinced about the ‘snapshot’ element, which the FEE paper argues (p7) is necessary to outweigh the inherent uncertainties of the forward-looking test. The snapshot test would use figures either taken from the published balance sheet or presented in an ad hoc statement prepared for the purpose, drawing upon whatever sources the directors thought appropriate. ‘There are different possible solutions regarding the question of which values should be taken for the snapshot test.’ (p26) The FEE paper would require the snapshot test to be carried out first, and only if it is passed (in that the assets exceed the liabilities) would the forward-looking test be carried out. If the liabilities exceed the assets, no distribution would be permitted. (This contrasts with the recommendations of the Report in that, under such circumstances, a distribution would be permitted, but the directors would have to explain why there was no threat of foreseeable insolvency.)

3.3.3 Given our concerns about the reliability of accounting numbers and the propensity to manipulate them in the face of perceived threats to solvency, we still hold to our view that the primary test should be to ensure that the company can meet its obligations as they fall due for settlement (and, hence, a cash flow test). Any test based on the balance sheet, or (more vaguely) upon ad hoc calculations of assets and liabilities and their values, might not only fail to ensure that funds are available to meet obligations as they fall due, but it could give spurious comfort both to external parties and to irresponsible directors. A company in difficulty may seek to ensure that assets are presented as being no less than liabilities, with ingenuity brought to bear on the challenge. We envisage that, in small companies in particular, the directors may react to the prospect of a deficit of assets over liabilities by valuing the premises upwards, which might improve the appearance of the statement but would do nothing to help cash flows. The FEE paper comments (p26) that:

‘No matter whether values derived from the balance sheet or values determined in the net asset test are used for the snapshot test, some kind of uncertainty remains due to the measurement methods applied by the directors or the availability of observable prices, valuation techniques etc. if other than historical cost bases are used.’

3.3.4 We agree. It should be added, of course, that creative thinking cannot be ascribed solely to the financial reporting process. Despite our preference for them, there is no doubt that cash flow forecasts are also amenable to wishful thinking, and indeed falsification. Our wish to stress the centrality of cash forecasts comes from our belief that this information is always of importance to the board, whereas the information in the accounts may or may not be the starting point for considering solvency.

3.3.5 The FEE paper presents an excellent analysis of the issues, in the context of distributions. In particular, it stresses the importance of the time horizon. ‘FEE’s view is that the proper length of the time horizon used for the forward-looking test cannot be determined with a “one size fits all” approach, but would have to be decided on a case by case basis’ (p8). It should in any case not be less than one year from the date when the distribution is authorised. The paper explicitly states that the tests need to be performed at the time of interim dividends as well as final dividends. We note, with interest, that the FEE paper discusses the current state of creditor protection in several other countries, drawing on the Report, and making reference to the US Model Business Corporations Act (and its Delaware and California variants), and also to Canada and New Zealand but not to Australia or to Massachusetts.

3.3.6 The FEE paper contains some very helpful discussion of the difficulties of preparing the forward-looking test. It accepts that the level of detail may need to vary depending on whether the company appears to be remote from financial strains or approaching insolvency. The company should not be obliged to publish sensitive data, details or underlying assumptions of the forward-looking test (p29), but there might be ‘several possible approaches to the need for dealing with directors’ judgments about solvency and going-concern’ (which we see as the same thing). There could be an ‘objective test with no specified underlying criteria’, or an ‘objective test with underlying criteria’ (p30). It presents the following list of matters which might need to be considered (p27):

’a) Profit and cash flow budgets (the latter including, where appropriate, any repayments of loans where no fixed repayment dates have been stipulated);
b) The ability to realise current assets, particularly inventories and receivables, and non-current assets which are held for sale;

c) The ability to comply with normal terms of credit;

d) The possible cancellation of financial support by major lenders;

e) The material effect of any contingent liabilities;

f) The ability to raise alternative forms of financing as far as they are reasonably reliable; or

g) Any funding for losses of subsidiaries.

We note that this list omits the question how far fixed assets can be pledged for loans.

3.3.7 The FEE paper also discusses assurance. It notes that IAASB standards already exist that address the matter of prospective information (particularly ISAE 3400, formerly ISA 810, and relevant parts of ISA 570 and ISA 545). In our view, the major problem of creditor protection arises with private companies, and these are subject neither to the Second Directive nor (in most cases) to audit. We understand why the FEE report would wish to put its snapshot test before the forward-looking test. The former arguably involves less subjective judgement than the latter. But we are concerned that a snapshot test which showed assets less than liabilities might lead to outright prohibition of a distribution, with no cash forecast, rather than requiring further justification. As noted earlier, some accounting provisions lead to conservative asset valuations (for example, the impairment test) and high liability totals (including convertible debentures as liabilities rather than equity, even when conversion looks highly likely – a matter that the IASB is discussing further at the time of writing).
4. LEGAL AND APPLICATION PROBLEMS IN APPLYING IA 1986 AND CDDA 1986

4.1 THE HISTORY

4.1.1 Insolvency law has a very long history, but there is no need to go back further than 1985 to find the main influences on current practice. CA 1985, as subsequently amended, determined the formation and operation of companies within the UK, and – as now stated in CA 2006 – similar principles still govern the regulations pertaining to accounts, capital maintenance, distributable profits and (in most respects) the reduction of capital. However, matters pertaining to insolvency and liquidation were transferred in 1986 from CA 1985 to IA 1986, supported by its several Schedules. This Act is augmented by CDDA 1986, and by detailed Insolvency Rules authorised by IA 1986 under the general supervision of The Insolvency Service (part of what was the Department of Trade and Industry, later called the Department for Business, Enterprise and Regulatory Reform, and now the Department for Business, Innovation and Skills). Statute law is supplemented, of course, by case law and common law. Moreover, further detailed insolvency practitioners’ rules serve to guide practitioners, issued mainly by the recognised professional bodies (RPBs) with respect to those of their own members whom they supervise. The rules (Statements of Insolvency Practice, or ‘SIPs’) are commissioned by the Joint Insolvency Committee, drafted by the Association of Business Recovery Professionals (R3), and adopted by the RPBs in order to produce common solutions to practising problems. Each SIP carries a statement as to its authority. ‘The purpose of SIPs is to set out basic principles and essential procedures with which insolvency practitioners are required to comply. Departure from the standard(s) set out in the SIP(s) is a matter that may be considered by a practitioner’s regulatory authority for the purposes of possible disciplinary or regulatory action.’

4.1.2 Formal insolvency procedures comprise insolvent liquidation, administration, administrative receivership and the company voluntary arrangement. We find few problems in the operation of the current law with respect to appointments to carry out these procedures, but we are aware that informal rescue procedures are widely used as an alternative to any formal process, and this seems to be sensible. Even in the case of insolvent companies, we have some doubts as to whether it is necessary for there to be four distinct forms of procedure, however. As noted below, in our recent study for the Insolvency Service (Katz and Mumford 2006) we suggested making administration the standard gateway for all companies entering formal insolvency, although liquidation is still the most commonly used route. EA 2002 brought about a marked shift away from receivership and toward administration as the main formal procedure for corporate recovery, but it insists that conditions must be satisfied in order to invoke administration rather than an immediate liquidation. We note some effects of the act below.

4.2 THE MAIN IMPACT OF EA 2002

4.2.1 The main change brought about by EA 2002 is that administrative receiverships are not available to the holders of new floating charges, although they can still be used in respect of such charges taken before 15 September 2003. Rather, the affairs of companies that become insolvent are now dealt with as a matter of routine either by liquidation or by administration (whether or not formally ordered by the court), rather than by receivers appointed by floating charge-holders. Part of the reasoning for the change was that receivership was seen to give too much power to charge-holders to benefit themselves at the expense of other classes of creditor, for example to liquidate businesses that might otherwise have been saved if recovery of the charge-holder’s debt had not been the ostensible criterion for action.

4.2.2 We have significant doubts as to whether, as a matter of fact, administrative receivership as a procedure typically operated in such a biased manner against the interests of the wider body of creditors. In Katz and Mumford (2003), we sampled 112 receiverships and 107 administrations appointed in 2002, and we found that only in a small minority of cases would it apparently have made a significant difference if a company that actually went into receivership had instead gone into administration – or, alternatively, if a company that actually went into administration had gone into receivership. There were some cases in which technical factors precluded the alternative course of action eg, the absence of a floating charge would rule out
the use of receivership, and some employment contracts favour the use of administration. Our method involved asking insolvency practitioners to estimate the amount by which recoveries would have been reduced if the alternative procedure had been adopted. Any bias felt when responding would have led them to exaggerate the benefits flowing from the procedure that was in fact followed, so we were all the more impressed at the fact that they reported that it usually would have made little difference. In those cases where technical factors did not impinge, they estimated the difference as being less than 2% in the amounts realised, all arising from higher costs rather than lower recoveries.

4.2.3 We doubt, then, whether EA 2002 has caused any significant harm by replacing administrative receiverships by administration, and we can well appreciate why, in principle, it would appear detrimental to other classes of creditor that the holders of floating charges had the power to instigate actions for their own exclusive benefit. A contrary argument is that this very power might also serve to increase the incentive of secured lenders with floating charges to monitor the behaviour and performance of the company. Most often the charge-holders were clearing banks. These can still bargain over the provision of confidential information by their corporate customers, observe their customers’ current bank transactions, and devote significant resources to corporate rescue and recovery even now that the EA has come into effect. In practice, these activities plausibly give incidental some protection to other creditors, although we are conscious of the warning given by Franks and Sussman (2000) as to the limits of this. (For information on lending protocols before the advent of EA 2002, see also Armour 2000.)

4.2.4 Reducing the power of floating charge-holders might have been seen as a blow to the security of clearing banks. But, in the event, EA 2002 was modified at the drafting stage to improve the banks’ position, including the ability for them to nominate the administrator, and it has been noted (eg, by Frisby 2006) that the banks seem to have lost little power in practice (even if that power is usually exercised out of sight).

4.2.5 One of the major worries that arose from the initial proposal to abolish receivership was that insolvency procedures would be slowed down and opportunities lost to recover assets at risk. In practice, the process of appointing an administrator has been streamlined, to the point that it seems to be rare for delays in appointment to put in jeopardy the collection and realisation of assets. On the other hand, we have some concern that creditors themselves, particular unsecured creditors, may have insufficient information or incentive to take part in the processes designed largely to protect their interests. Furthermore, measures apparently designed to discourage directors from acting dishonestly or carelessly (eg, by engaging in preferences or transactions at undervalue) are rarely implemented, in part due to problems of financing court actions potentially at the cost of unsecured creditors (discussed further in 4.6 and 4.8 below).

4.2.6 More recent work that we have undertaken for the Insolvency Service (Katz and Mumford 2006) shows how the number of administrations has been rising, both absolutely and as a proportion of insolvency cases, from a time well before EA 2002 came into force. While it remains true that the majority of failing companies go into liquidation (whether compulsory or voluntary), there has been a very marked shift both from receiverships and from liquidations to administrations. Our evidence suggests that there has been justification for using the process of administration in most of these cases, since the administrator reports that the company was capable of higher levels of recovery than an immediate liquidation would have achieved. Indeed, we believe that administration should be made the standard legal procedure for all failing companies, thus simplifying legal complexities and reducing decision making and administrative costs without giving rise to any significant disadvantages.

4.2.7 One of our few criticisms of EA 2002 is the ambiguity that arises over the interpretation of IA 1986 Schedule B1 paragraph 3 (as inserted in amended form by EA 2002), which purports to show the circumstances in which a company can properly be put into administration. We believe that unnecessary confusion is caused by this Paragraph. For convenience, it is shown below: A company can be put into administration for the following stated purposes:

‘3(1)(a) Rescuing the company as a going concern
3(1)(b) Achieving a better result for the company’s creditors as a whole than would be likely if the company were wound up
3(1)(c) Realising property in order to make a distribution to one or more secured or preferential creditors.’
4.2.8 It seems to us that (b) and (c), in particular, can be used to justify administration even if the benefits are trivial, either for creditors as a whole or for secured or preferential creditors (see also Katz and Mumford, 2006, p31 & 47). We are aware that the High Court has held that the absence of any clear benefits meant that administration orders would not be made (in Re Dollarland Manhattan Ltd [2005] EWHC 2861 (Ch) All ER (D) 371 Nov; and in Re AMCD (Property Holdings) Ltd [2004] All ER (D) 125 June). But we see little purpose in labouring the definitions in paragraph 3 to limit the circumstances when administration is permissible, rather than encouraging its use and making it the standard route in all cases.

4.2.9 We were aware of other research being undertaken for the Insolvency Service (eg, by Armour et al 2006 and Frisby 2006) on other effects of EA 2002, including the apparent opening up of the market for insolvency practitioners to take appointments, and the impact of the new procedures upon net recoveries for creditors. There is undoubtedly more to be written on the impact of EA 2002. In a field such as corporate insolvency, where many subtle interactions arise between institutional arrangements, it is difficult to trace exactly the consequences of new legislation. An important provision of EA 2002 was to end Crown preference, so that the Crown – particularly H M Revenue and Customs – became merely another unsecured creditor. It remains to be seen what the effects this change may have on the position of unsecured creditors generally. We refer below (4.10.16) to the views of an insolvency practitioner that EA 2002 may well result in less participation by unsecured creditors in creditors’ committees. The facts are worth tracing. It will also be useful to trace the trend of company voluntary arrangements – see Mocroft 2004. It is clear that the Insolvency Service intends to continue to monitor the EA’s effects (Insolvency Service 2005 and 2008).

4.3 OTHER ASPECTS OF IA 1986 AND CDDA 1986

4.3.1 We have little difficulty with the duties and powers of liquidators, administrators, and receivers to secure information under present law, but there are substantial practical difficulties in how they may successfully bring actions, particularly against directors whose conduct may render them liable to make a contribution to the insolvent estate. Practical difficulties exist also in the Secretary of State (by way of the Disqualification Unit) bringing successful disqualification actions under CDDA 1986 (which may result from an adverse report by the office-holder but are entirely separate from any proceedings that the office holder may bring).

4.3.2 In order successfully to bring an action for a contribution to the insolvent estate, the office-holder needs to prove a number of matters to the satisfaction of the court. In most cases, the required standard of proof is the civil standard (balance of probabilities), but where the allegation is of a fraudulent nature then the higher criminal standard of proof applies. Matters that the office-holder must prove may not be straightforward, and will involve both parties in obtaining expert legal advice and possibly expert evidence. They comprise the following (note that the third may be particularly hard to establish):

(a) That the alleged wrongdoing gives rise to a cause of action in law (eg, under IA 1986 ss212–216, 238 and 239), or under the Companies Act – say in relation to unapproved dividends, or common law (eg, theft) that generally does not require proof of insolvency.

(b) That the alleged transaction(s) occurred and the resulting claim led to a particular quantum of damage. For example, in the case of wrongful trading, it is necessary to establish that losses arose, and show a calculation of the losses since the relevant date – see also (c) below. In the case of an undervalue transaction, it must be shown that the transaction took place and show the amount of the undervalue, as is also the case in respect of a voidable preference (where it is also necessary to consider the rules on intention).

(c) That the company, in the case of most office-holder actions, was insolvent at the alleged date, which includes consideration of the earliest date from which the allegation must be proved.

4.3.3 Even if the office-holder considers that there is a good prospect of proving the case for a contribution, there are a number of practical considerations to be addressed before commencing proceedings. The first of these should be weighed up at a very early stage, since unless there is a satisfactory answer to it, there is no point in even assessing the legal merits of potential action:

(a) Whether the defendant is financially able to meet any judgment, including what may prove to be substantial costs.

(b) Litigation risk: even the most apparently straightforward actions (and cases that are advised to be very strong) will still involve risk, and cases of the nature under consideration are amongst the most complex and uncertain of all. One source of risk is that the insolvent estate, and in some cases the office-holder personally, may be liable for some or all of the costs incurred by both parties.
(c) Risks arising from other costs: even where the litigation is entirely successful and costs are awarded to the office-holder, the award will (because of the assessment – previously known as ‘taxation’ – of costs) cover only a proportion of the legal costs and none of the office-holder’s own time costs.

(d) Whether there are sufficient assets in the estate and the necessary consents to use them to fund the costs of litigation, including the risk of adverse cost orders.

(e) Whether there is some other acceptable source of funding.

4.3.4 We touch further upon these difficulties in the five sub-sections that follow, which address:

- The responsibilities of directors and officers.
- The question of the date when a company becomes insolvent.
- The possibility of recovering assets from directors and others: IA 1986 ss212–216, 238 and 239;
- The standard and burden of proof, and defences.
- Losses, costs and who bears them in the context of formal actions.

4.4 THE RESPONSIBILITIES OF DIRECTORS AND OFFICERS

4.4.1 The responsibilities of directors and officers under civil and criminal law have been altered by CA 2006, but it is not yet clear how far these changes will affect the conduct of insolvency cases. Several years’ of discussion and opinion-gathering preceded the Bill, with a wide range of views submitted for consideration. (It was noted in 3.2.8-9 above, for example, that ‘contractarian’ theorists of the law would urge rather different approaches from ‘communitarians’.) Pressure from some sources urged explicit recognition of a wider range of stakeholders towards whom the directors owe a responsibility, but such broadening tends to result in less precise definition of those duties.

4.4.2 There are provisions in CA 2006 addressing company directors and their duties (in Part 10, ss154–259), and spelling out their general duties (ss170–181). However, these duties are spelled out only in general terms. Section 174 goes further, in that it specifies the general duties of a director both in the objective and subjective terms that are familiar from IA 1986 s214(4) – namely in terms both of the ‘care, skill and diligence that would be exercised by a reasonably diligent person’ and also the ‘general knowledge, skill and experience that the director has’. (See also Davies, 2007.)

4.4.3 In the context of creditor protection, there was some debate when the Bill was being prepared over whether directors’ duties could be spelled out more explicitly to accord with the principle in West Mercia Safetywear Ltd v Dodd [1988] but it apparently proved impossible to find a suitable form of drafting. (This decision extends the duties of a director to creditors, rather than merely to shareholders, as the company nears insolvency and not merely after formal insolvency is instituted – see eg, Finch 2002 pp504–510.)

4.4.4 The 8th edition of Gower and Davies (Davies, 2008 p519-23, parenthesis added) discusses the dilemma facing the Steering Group of the Company Law Review:

‘It considered the proposition that directors should be required “where they know or ought to recognise that there is a substantial probability [which Davies says means more probable than not] of an insolvent liquidation”, to take such steps as they believe, in their good faith judgement, appropriate to reduce the risk, without undue caution and thus continuing also to have in mind the interests of members’.

4.4.5 Davies adds:

‘The qualified way in which this proposition is put indicates the lack of agreement among the members of the Steering Group of the CLR about the attractiveness of the idea. Those in favour thought the principle expressed simply what good directors ought to do; those against that fears of personal liability would lead to excessive caution on the part of the directors and induce premature decisions to end or scale down trading, especially as the trigger point for the new duty might well be difficult to identify. The Steering Group simply put the idea forward for further consideration by the relevant Government Department, which later, and probably rightly, rejected it as inconsistent with its policy of promoting a “rescue culture” for companies in financial difficulty.’

4.4.6 CA 2006 s172 specifies that a company director must act in good faith ‘to promote the success of the company for the benefit of its members as whole’, having regard to the long-term

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consequences and to a variety of named interest groups. Section 172 (3) adds the stipulation that: ‘The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company’ (emphasis added). Despite the reservations expressed by Davies (2008) above, the ‘circumstances’ under which this need arises remain somewhat less ‘certain’ than might be desired. The question of when the directors owe a duty to creditors rather than to members will continue for the time being to be a matter for the common law, rather than statute in the UK. Davies (loc cit) points out that: ‘As with most significant common-law developments in their early stages, there is considerable uncertainty about the conceptual boundaries of the new doctrine. For example, it is clear that creditor-regarding duties are being developed by extension of the traditional common law duties of directors. However, it is not always clear whether the duty being developed is a fiduciary duty of loyalty or a duty of care.’ The former, says Davies, is the more demanding duty. For the time being, it will be up to the courts to develop the law.

4.4.7 Insurance policies specifically designed to protect directors and officers (D&O) from legal action (eg, for negligence) became more widely available once CA 1985 s310 permitted such premiums to be paid by the company. (Previously, any such D&O policy premiums fell to be paid by the directors and officers in their personal capacity, and not by the company for their benefit.) It is unclear from published sources how far the individual responsibility of directors and officers has been assumed by the insurers who underwrite D&O policies. It is unusual for claims to be debated in open court; they are usually settled by negotiation between the insurer and the claimant out of court. The nature of such settlements tends to be highly confidential, and actors in this highly specialised market usually have no incentive to see them aired in open court.

4.4.8 CA 2006 clarifies some important features of insurance, however, in Part 10 Chapter 7 (ss232–239). In general, companies may not offer directors any provision that ‘purports to exempt a director of a company (to any extent) from any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relations to the company’ (s232). But s233 explicitly states that insurance may be provided. Section 234 also allows qualifying third party indemnity, but (by s234(3)(a)(ii)) directors cannot be protected by any such indemnity against fines or any ‘sum payable to a regulatory authority by way of penalty in respect of non-compliance with any requirement of a regulatory nature (however arising)’, nor against costs incurred in defending himself against any such charges that lead to judgment against him (including applications for relief, including those under CA 2006 s1157, formerly CA 1985 s727: see 4.7.2 and 5.1.14 below). Davies (2008 p592) observes that ‘the legislation is less strict in relation to insurance than in respect of the direct indemnity’. The legality of insurance cover does not mean, of course, that such cover will be commercially available.

4.5 THE QUESTION OF THE DATE WHEN A COMPANY BECOMES INSOLVENT

4.5.1 The question of the date when a company becomes insolvent is central to the concerns of this present report. Of course, a state of financial distress may arise in circumstances much more broadly defined than those leading to formal insolvency procedures. A company may encounter a dispute with an individual creditor, for example, which it resolves by selling some particular asset without jeopardising the well-being of the company as a whole. It is a matter of degree, then, to distinguish between this case and others in which all the assets, the whole company and the business are at stake. Even complete liquidation does not necessarily imply that a company has failed financially. Solvent liquidation presents no threat to creditors, and it can arise for a variety of sound commercial reasons. For example, a company may be taken over in a solvent state by another owner that sees it as a highly desirable set of assets to complement its own, whether followed by solvent liquidation or by continuing to run the acquired company as a subsidiary. Moreover, it is quite common for a company to sell off solvent parts of its business activities, or some of its assets, because these offer viable but less attractive prospects than other opportunities open to it. The difficulty for directors is to recognise the circumstances in which professional advice, from an insolvency practitioner for example, is worth buying as a precautionary measure in the interests of the company.

4.5.2 It is very difficult to estimate how many companies are at financial risk at any date. In many cases, even if a company is faced with financial pressures, contract terms may be renegotiated with bankers or major creditors in the normal course of business. Unforeseen cash shortages may perhaps be bridged by mutual agreement with external parties, or investment expenditure delayed. Merely rescheduling the repayment of a debt, even at a higher rate of interest, may be a sensible response to new demands for capital (either because the borrower has better or worse prospects than it previously expected – ie, more investment opportunities or lower cash receipts). It is hard to see such cases as constituting ‘distress’. However, Finch (2002: Chapter 4) might see them in this category, depending on whether the debtor is seen to have committed a ‘default’. Thus, she observes that (ss121–2):
‘Distressed companies are those that encounter financial crises that cannot be
resolved without a sizeable recasting of the firm’s operations or structures. Such
distress may be seen in terms of default, where the company has failed to make
a significant payment of principal or interest to a creditor. Alternatively, distress
can be seen in terms of financial ratios.’

4.5.3 The key word in this passage is ‘sizeable’. Once again, it is usually a matter of judgement
in any particular context whether or not the company is deemed to be in trouble. Matters are
not in fact resolved by examining the financial ratios that Finch refers to in the last sentence
quoted above. As noted in the discussion of ‘conventional liquidity ratios and ratio analysis’
in 2.6, balance sheet ratios do not suffice to show that a company is actually in distress in the
sense of being unable to pay its debts as they fall due. Neither would a test based on income
statement variables, such as short-term dividends. It is our contention that the only test that
matters is this solvency test, i.e., whether the company can actually meet its obligations.

4.5.4 But even this preferred solvency test has now to be seen in shades of grey, rather than
black and white. (The term ‘the twilight zone’ is used, for example in INSOL 2001 and 2005,
discussed below in 4.5.12 and 4.11.6 to describe the period between the date on which
insolvency arose and the date on which formal insolvency proceedings begin; see also Milman
2004.) What if a debt could not be met in accordance with the original terms under which it
was agreed, but the creditor is willing to amend those terms, with or without penalty to the
borrower? Within the UK, it has been common practice for companies to use overdraft facilities
as though these were part of long-term financing resources, despite the fact that they are
repayable on demand (and the banker often holds floating charges over the assets of the
company as well as personal guarantees from the directors). It might be the case that, if the
bank has doubts about a client’s financial stability, the usual overdraft facilities will not be
extended into the future and the company will become insolvent. But how are the directors to
know this? What evidence should they ensure they have on record to protect themselves against
any possible allegations at a later stage that they were complacent or negligent in the matter?

4.5.5 Informal measures to support their customers have been developed by the clearing banks
in the UK, which have specialist departments to deal with businesses that appear to be getting
into difficulties. Where more than one credit institution is involved, measures were developed
after 1970 to facilitate coordinated approaches to informal rescue, and the term ‘the London
approach’ was coined to describe such measures (see, for example, Armour and Deakin 2001;
and Finch 2002 pp219–229, which also analyse some of the practical problems with the
London approach, including the greater difficulties of achieving cooperation as the range of
stakeholders grows wider).

4.5.6 Although Finch writes in terms of ‘sizeable recasting of the firm’s operations or structures’,
formal insolvency can be put in train by quite simple acts by relatively few creditors, for example
the presentation to the court of a successful winding-up petition. Sealy and Milman (2007 , Vol.1
p150 et seq) discuss the term ‘inability to pay debts’ as set out in IA 1986 s123 in the context
of such winding-up petitions (which will only be made if the company is insolvent). It is striking
how severe these criteria are, in cold print. Under IA 1986 s123, six circumstances are specified
to show that a company is deemed unable to pay its debts in this context. By s123 (1):

(a) if a creditor (by assignment or otherwise) to whom the company is indebted
in a sum exceeding £750 then due has served on the company, by leaving
it at the company’s registered office, a written demand (in the prescribed
form) requiring the company to pay the sum so due and the company has
for 3 weeks thereafter neglected to pay the sum or compound for it to the
reasonable satisfaction of the creditor, or

(b) if, in England and Wales, execution or other process issued on a judgment,
decree or order of any court in favour of a creditor of the company is
returned unsatisfied in whole or in part, or

(c) if, in Scotland, the inducias of a charge for payment on an extract decree,
or an extract registered bond, or an extract registered protest, have expired
without payment being made, or

(d) if, in Northern Ireland, a certificate of unenforceability has been granted in
respect of a judgment against the company, or

(e) if it is proved to the satisfaction of the court that the company is unable to
pay its debts as they fall due.’

4.5.7 By s123 (2): ‘a company is also deemed unable to pay its debts if it is proved to the
satisfaction of the court that value of the company’s assets is less than the amount of its
liabilities, taking into account its contingent and prospective liabilities.’ We have already argued (eg, in 2.4.7–8) that such a formula is neither necessary nor sufficient to indicate insolvency in terms of ability to pay debts as they fall due, unless the court takes into account supplementary information on flows likely to arise in the course of trading, potential sources of credit and so on.

4.5.8 Sealy and Milman (2007) observe a number of qualifications to the s123 (1) criteria as stated above. Thus (Vol.1, p150) ‘a winding-up order will not be made on the basis of a debt which is genuinely disputed’ (except if the debt is for VAT); nor if there is a ‘genuine and serious’ cross-claim that brings the amount due to below £750. But (p152): ‘It has been held that failure to pay a debt which is due and not disputed is of itself evidence of insolvency under s.123 (1) (e), even though there is other evidence showing a substantial surplus of assets over liabilities (Cornhill Insurance plc v. Improvement Services Ltd [1986] 1 W.L.R.114).’

4.5.9 In short, a company will be formally insolvent (in compulsory liquidation) if one of its creditors successfully presents the court with a valid winding-up petition for an unpaid debt of as little as £750.

4.5.10 The need to establish whether or not a company is solvent is important in several respects. Thus, the members themselves can decide to liquidate the company (by a members’ voluntary winding-up) only if it is solvent (IA 1986 ss89–90). The directors have to make a statutory declaration of solvency for this purpose, which states that in their opinion the company is able to pay its debts in full within such period, not exceeding 12 months from the commencement of the winding-up, as may be specified in the declaration. (The penalty for making such a statement without having reasonable grounds is imprisonment or a fine or both.) Note that if the company in fact fails to meet its debts in full within the period, there is a presumption that the directors made their statement without reasonable grounds, and they will need to be able to demonstrate that this presumption is unfounded in order to avoid the consequences (Sealy and Milman 2007 Vol.1 p128). The company would also then have to be submitted to a meeting of creditors for them to consider a creditor’s voluntary liquidation; the winding-up can proceed only as a creditors’ voluntary winding-up or as a compulsory liquidation (ordered by the court).

4.5.11 A number of key decisions that need to be made by the liquidator, particularly in relation to the behaviour of the directors, depend on the date at which the company was (or should have been) seen to be insolvent. The period between the date on which insolvency is taken to have arisen and that on which any formal insolvency proceedings are instituted is known as the ‘twilight zone’, and it is important since during this period the duties of directors to act in the interests of the company have to be re-defined: rather than seeking the maximum benefit to the shareholders, they must seek to minimise losses to the creditors. They will be personally vulnerable to claw-back provisions for losses to creditors that they are deemed to have caused. This will be considered further below (in 4.6 and 4.7). Case law remains unclear on the matter, with some authorities declaring that a duty to creditors only arises when the company is clearly insolvent, while others hold that there is a duty that arises as soon as the company is in a precarious financial state. Keay (2007 Chapter13 ss199–220) discusses the issue at some length. He notes that some authorities take a ‘shareholder primacy’ view, whereas he suggests that it would be helpful if directors were guided to serve the interests of the company as an entity (see 4.10.3 below) (see also Keay 2005). A related issue is whether directors owe a duty to creditors as a group when the company is seen to approach insolvency, or whether a duty may be owed to individual creditors, even though others are not at risk. A balance has to be struck between inhibiting the commercial judgement of the directors and hazarding the legitimate claims of creditors, individually and as a class. It is as important feature of UK law that office holders defend the rights of unsecured creditors pari passu, and do not advance the claims of some over others.

4.5.12 INSOL International (2001, p127; also 2005) sets out the time periods specified in the IA 1986:

‘The various vulnerability periods for the English law claw-backs, being periods prior to the commencement of the formal insolvency, are as follows:

(a) preferences (e.g. security, charges) – 6 months, or two years if the preferred person is connected (S 239 and 240 (1)(b));

(b) avoidable floating charges – 12 months, or two years if the holder of the floating charge is connected (S 245(3));

(c) transactions at an undervalue (e.g. guarantees) – two years (S 238 and 240 (1)(a));

(d) extortionate credit bargains – three years (S 244(2));

(e) transactions defrauding creditors – no time limit (S 423);

(f) disposions after winding up petition – from date of petition (S 127).’
4.5.13 This list also serves to summarise the main headings under which directors may face the threat of having to contribute towards the assets of the company. The major headings are analysed further in the next section (4.6).

4.5.14 It has been established, then, that it can be very difficult to identify when a company is in a state of financial distress, and that it is even more difficult to identify the point of time at which it becomes insolvent. Yet this date can be critically important for deciding whether the company can be wound up by its members or by its creditors. It matters, too, in deciding whether the company’s accounts should be presented on a ‘going concern’ basis, and to whom directors should owe their prime duty of care, as in West Mercia Safetywear Ltd v Dodd. We understand that the rule in this case was considered for inclusion in the 2006 Companies Act, and was only omitted by reason of drafting difficulties. As Finch notes (2002, p504 et seq) the courts have left it unclear whether the directors owe a duty of care to creditors only once insolvency has been established, or when it appears likely to occur in future, or at all points of time. The issue of whether (and if so when) directors owe a duty to creditors has also exercised courts in the US over the years. Look (2005) discusses the matter as though the movement was towards earlier recognition of ‘deepening insolvency’, but McLaughlin (2007) analyses the 2006 judgment in Trenwick America Litig. Trust v Ernst & Young L.L.P. and expresses some relief that the trend has reversed (maintaining it caused uncertainties). Keay (2007 p215, parenthesis added) comments:

‘There is adequate authority for us to say that directors owe a duty [ie, to creditors] where they are aware or ought to be aware that their company is insolvent, near insolvency, at a risk of insolvency or in financial difficulties. But this does not tell us what is the earliest point when the duty will arise. Directors are still ‘in the dark’ on this issue. It is submitted here that the earliest point at which the duty is triggered is where the circumstances of the company are such that its directors know, or can reasonably expect, that the action upon which they are going to embark could lead to the insolvency of the company.’

4.5.15 Keay has an Australian background. (He was formerly Registrar of Companies for the State of Victoria.) He adds (loc cit): ‘The reason for taking this point is that companies that are not insolvent, or even close to it, can fall into that state quickly in some situations, and the suggested trigger is merely an attempt to cause the directors to think through the consequences of their decision-making’. This mirrors our views also.

4.5.16 Another context in which it is important to define when the company is insolvent is to prove wrongful trading. We noted earlier (in 2.4.11) that we doubted whether s214 (6) is actually a reference to the values as shown in the accounts (any more than is the case in the context of IA 1986 s123 (2), noted at the same place). Rather, it seeks to define a company as being in an insolvent liquidation if it goes into liquidation ‘at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of winding up’ (s214 (6)). This clearly refers to the values that can be realised, in relation to a set of estimated obligations, rather than to the figures that may appear in financial accounts at that date. We note, however, that Keay appears to argue the contrary in showing how IA 1986 currently defines insolvent liquidation.

‘According to S 214 (6), insolvent liquidation means that the company, at the time of winding up, was in a position where its debts and liabilities together with the expenses of winding up exceeded its assets. So, a balance sheet test is employed rather than a cash flow test. While the majority of liquidations involve insolvent companies, we must note that if a company was not insolvent within the meaning of S 214 (6), no proceedings could be brought. As balance sheet insolvency is the test, in determining whether the assets are outweighed by the liabilities a court is able to take into account contingent and prospective liabilities, but not contingent and prospective assets, so this potentially makes things easier for a liquidator in establishing insolvency.’ (Keay 2007 p87, emphasis added)

4.5.17 The trouble is that the court is not confronted by the need to compare balance sheet figures for assets and liabilities, but rather to assess whether the company would be able to meet obligations, some of which at least still lie in the future (including the winding up costs). This is not reflected in routine balance sheets, but in ad hoc cash forecasts. Clearly, unless cash flow statements have been prepared in past periods and preserved, a liquidator faces major problems in defining just when it was that the directors of the company should have realised that insolvent liquidation became inevitable. Whereas the company is obliged to prepare annual accounts, there is no specific legal requirement for it to prepare cash flow forecasts at all. (It is merely implied by the requirement to avoid wrongful trading. Of course, there
is no requirement for such cash flow forecasts to be published.) The balance sheet that Keay
describes above (including prospective liabilities) is not the familiar form of balance sheet filed
with the Registrar of Companies. If it is indeed the case that cash flow information is the critical
requirement for making solvency forecasts, then it is reasonable to require directors to prepare
cash flow forecasts periodically. They also need to consider them at board meetings, particularly
if and when the future solvency of the company begins to look uncertain. It will otherwise be
hard for directors to defend themselves from the accusation that they failed to take every step
needed to protect creditors’ interests. We are concerned if the court tests for insolvency under
s214 (6) solely by reference to the published balance sheet, as Keay appears to suggest. It has to
be an ad hoc balance sheet.

4.6 THE POSSIBILITy OF RECOVERING A CONTRIBUTION FROM DIRECTORS:
IA 1986 SS212–216, 238 AND 239

4.6.1 Several sections of IA 1986 present directors with the possibility of their becoming liable
to contribute towards the debts of the company, even though in normal circumstances neither
they (nor of course the shareholders) are responsible for paying the debts of limited companies.
The major liabilities fall upon directors from misfeasance generally (s212), or from fraudulent
trading (s213), wrongful trading (s214), and misuse of the name of a company that is failing or
has failed (s216). It may also arise that the directors are liable as recipients of the benefit where
the company has been transacting at undervalue (s238) or giving preference (s239). They are
considered in turn below.

a fuller list of actions potentially giving rise to liability for directors. Listed in IA 1986 Part IV
(winding up of companies registered under the Companies Acts) Chapter X (malpractice
before and during liquidation) are: ss212, 213, 214 and 216 above, and also s206 (fraud etc.
in anticipation of winding up), s207 (transactions in a fraud of creditors), s208 (misconduct in
course of winding up), s209 (falsification of company’s books), s210 (material omissions from
statement relating to company’s affairs) and s211 (false representations to creditors). Listed
in IA 1986 Part VI (miscellaneous provisions applying to companies which are insolvent or in
liquidation), as adjustments of prior transactions in administration and liquidation, are ss238
and 239 above, and also s244 (extortionate credit transactions). This list is still not exhaustive,
since eg, it excludes s423 (transactions defrauding creditors), which opens possibilities that go
beyond those in s207 above, for example in who can be held liable and who can bring actions,
but it indicates the sorts of grounds on which directors and officers can be held liable for actions
prejudicial to the interests of creditors.

4.6.3 Section 212 applies in the course of winding up, and holds an officer of the company
(including a liquidator or receiver) liable to repay assets or to contribute towards the company’s
assets if he has misapplied or retained assets or ‘been guilty of any misfeasance or breach of
any fiduciary or other duty in relation to the company’. The amount of such payment is at the
discretion of the court, but the effect is that payment is due to the company itself (rather than
to any individual who has been wronged). The scope of the section is clearly quite broad, which
may be helpful in mounting an action, and establishing the fact of a breach of duty may be
easier than proving intent (a problem with s213, as will be discussed below). Sealy and Milman
(2007 Vol.1 p229) observe that s212 does not ‘exclude the pursuit of common-law remedies
in contract and tort against the same person’, and we have been told that s212 actions are in
practice easier to bring than the other five headings discussed in this section.

4.6.4 Section 213 actions for fraudulent trading give rise to a claim for imposing personal liability
in winding up upon those concerned with carrying on any business of the company with the
intent to defraud or for any fraudulent purpose, continuing a tradition of making fraudulent
trading an offence that goes back to earlier companies acts. A related provision of CA 2006 s993
makes fraudulent trading a criminal offence, and provides that action can be brought under
this section whether or not the company has been or is being wound up. The major problem in
either case is the need to demonstrate actual dishonesty on the part of the accused (who need
not be an officer of the company). This problem is so severe that the section is rarely invoked,
particularly since the standard of proof under ss212 and 214 is somewhat less onerous.

4.6.5 Section 214 was introduced by IA 1986 to address directors engaged in wrongful trading.
It applies only when a company is being wound up, in relation to a person if:

(a) the company has gone into insolvent liquidation,

(b) at some time before the commencement of the winding up of the company,
that person knew or ought to have concluded that there was no reasonable
prospect that the company would avoid going into insolvent liquidation, and

(c) that person was a director of the company at that time’. (s214(2))
4.6.6 Sealy and Milman observe (2007 Vol. 1 p233) that the word ‘trading’ does not appear in the Act, so there is some lack of clarity over what actions are being described as wrongful, and they add that: ‘The section is singularly imprecise in defining just what conduct on the part of a director will bring him within its scope’. It is also clear that difficult judgements arise over determining the point of time at which directors knew or ought to have concluded that the company would go into insolvent liquidation at some future time, without some reasonable hope that the company could still trade its way out of difficulty or borrow to get over the worst. Action can only be brought at the instance of the liquidator, and there is a two-part test of the standard of care to be expected of the director, who should both exercise the care to be expected of a ‘reasonable’ director (the ‘objective’ criterion), and apply the knowledge, skills and experience that he himself possesses (the ‘subjective’ criterion), whichever is the higher of the two tests.

4.6.7 The issue of particular importance in the context of the present study is how to interpret s214 (b). What form of evidence is needed to establish that a director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation? How far do directors (including non-executives) differ in their responsibility towards this conclusion? In our contention, the key evidence includes cash flow forecasts, prepared at intervals that reflect the perceived seriousness of the company’s financial situation. Thus, for a company with no apparent threats to its cash inflows, and an apparent surplus of inflows over its expected outflows, the board of directors might only need to seek assurance from the finance director (or treasurer, if the company has one) that cash forecasts have been prepared to the planning horizon on reasonable assumptions, and that at no stage do these forecasts show cash flows that prevent the company from meeting its obligations as they fall due for payment. If there is reason to doubt solvency in these terms, the board should demand cash forecasts, examine them, and probe the basis of their preparation. Qualified accountants on the board will probably be held to a higher level of responsibility than others.

4.6.8 Note that there remains at law, as currently worded, a need for a test based on the balance sheet, despite the doubts expressed earlier in this report. The directors must examine how to meet any apparent cash deficiency by making the best use possible of funding sources open to them, and this will include a review of assets and liabilities listed in the balance sheet. But the need for perform such a test, including the construction of the relevant lists of assets and liabilities involved and their valuation under distress circumstances, follows after the cash forecast indicates the probability of insololvency. In the unusual event that the balance sheet shows a deficit of assets compared with liabilities, the company is often insolvent. But rarely will a balance sheet (even a forecast balance sheet) by itself reveal impending insololvency.

4.6.9 If there is cause for concern, however, the precision and frequency of cash forecasts must both be increased. The probable contingencies take on more significance, and possible alternative plans (such as deferring capital expenditure or dividend payments, and securing further lines of credit) need to be explored. Even with these procedures in operation, the essential element that minimises risk to the company’s future continues to be business judgement. Just as it was noted earlier that the nature of business is to take calculated risks in converting liquid assets into specialised project investments with a view to future cash flows, it remains the prime purpose of the board to seek out investments with positive (discounted) net present value and to invest in them – as long as sources of capital can be safely provided. The safest source remains retained profits, belonging to shareholders but lying largely within the control of the directors. And the control over the level that can be financed from available resources – in other words, a schedule of capital expenditure that over-runs available funds – and the situation where expected cash inflows fail to match up to expectations, even if the capital expenditure schedule is modest. The courts are reluctant to second-guess business judgements, but they can be persuaded that proper procedures were lacking where the board has failed to adapt to either set of conditions.

4.6.10 Developing a schedule of positive net present value investments is not sufficient for success. The projects have to be put into operation successfully, within budget and on time, and they require the attention of management as well as sufficient capital. Indeed, one of the most familiar sources of financial stress for a business is growth at too fast a rate – ‘over-trading’, in which cash expenditure precedes cash receipts (for the acquisition of working capital as well as for fixed assets). The term ‘wrongful trading’ describes both the over-rapid expansion of the business over the level that can be financed from available resources – in other words, a schedule of capital expenditure that over-runs available funds – and the position where expected cash inflows fail to match up to expectations, even if the capital expenditure schedule is modest. The courts are reluctant to second-guess business judgements, but they can be persuaded that proper procedures were lacking where the board has failed to adapt to either set of conditions.

4.6.11 Section 216 addresses the particular issue of the misuse of company names. It seeks to prevent directors from transferring businesses to ‘phoenix’ companies that take over an existing business after receivership, formal insolvency or voluntary liquidation, and continue it substantially in the same form, but shorn of its credit obligations. The problem is addressed in s216 by forbidding the use of similar or misleading business names, but the issue may be particularly important in the context of pre-packages (see 4.11 below).
4.6.12 Section 238 deals with another form of abuse of limited liability, namely transactions at undervalue, while s239 turns to forms of transaction where the counterparty has been given preferential treatment over other parties, in both cases restricted to circumstances where the company is either in liquidation or in administration. Sealy and Milman (2007, Vol.1 p263) point out that these matters may also be caught by IA 1986 s423 et seq even where the company is not insolvent (formally or otherwise); moreover under s423 there is no time limit and the action may be initiated by any ‘victim’ (not merely the office-holder). However, under s423 it is necessary to be able to show an intention to put assets out of reach of the creditors or to prejudice their interests. The aim in each case is to avoid the company from sequestering its assets in favour of some limited subset of the creditors (who may be the directors themselves).

4.6.13 Milman and Parry (1997) studied the operation of ss238 and 239 (as well as that of other transactional avoidance mechanisms under ss245 and 423). They report finding that in the experience of the 143 insolvency practitioners whom they questioned, the incidence of breaches of ss238 and 239 was ‘quite high’ – but that ‘the final account of successful avoidance actions (if one discounts the relatively high number of settlements) is very low in all cases’ (op cit p35). They go on to make recommendations for changes in the substantive law and in procedures offering greater success in prosecuting breaches.

4.6.14 Between them, these sections provide causes for action against directors who abuse their power over the company’s assets, but there remain serious obstacles in enforcing them, notably the difficulty of obtaining verifiable evidence and the costs involved in doing so. These are discussed in the next two sections.

4.7 THE STANDARD OF PROOF, AND DEFENCES

4.7.1 INSOL International (2001 and 2005) sets out a convenient, concise summary of the actions that can be brought, and their work is used as the basis for the synopses below.

4.7.2 Section 212: Misfeasance actions: Any officer of the company will incur liability ‘who has misapplied or retained or become accountable for, any money or other property of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company’. Misfeasance includes negligence (Re D’Jan of London [1993]) and any other act the direct consequences of which is misapplication or loss of assets of the company. Liability is civil, and it is not necessary that the company be in winding-up. The court has wide discretion as to penalties that might be imposed. Apart from directly refuting the facts as alleged, directors may seek to be excused under CA 2006 s1157 (formerly CA 1985 s727). This gives the court power to grant relief against proceedings for negligence, default, breach of duty or breach of trust, even if the person may be liable, if ‘he acted honestly and reasonably, and that having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused’ (CA 2006 s1157(1)).

4.7.3 Section 213: Fraudulent trading actions: The need is to establish that the company ‘has been carried on with intent to defraud creditors of the company or the creditors of any other person or for any fraudulent purpose’, and this is construed to involve dishonesty. Liability may be civil under IA 1986 s213, in which case only the liquidator can bring the action. It may also be criminal under CA 2006 s993 (formerly CA 1985 s458), which specifies that action may be brought under their provisions whether or not the company has been or is in the course of winding-up, in which cases the action will be brought by the Director of Public Prosecutions. In either case, the burden of proof is ‘beyond all reasonable doubt’. Action is not restricted to directors, but includes anyone who was ‘knowingly a party to the carrying on of the business’. Proving dishonesty (rather than, say, negligence or foolishness) is very difficult, and there have been few convictions. The court has wide discretion as to fines and penalties, and whether these include restitution or punishment or both.

4.7.4 Section 214: Wrongful trading actions: The need is to establish that the directors (including shadow directors) either knew or should have known at some point of time that there was no reasonable prospect of the company avoiding insolvent liquidation. Only the liquidator can bring an action, and even though liability is civil, it can be difficult to establish the culpability of the directors and the date when wrongful trading began. Consequences under CDDA 1986 (including disqualification) may accompany a wrongful trading action, so a higher standard of proof is usually demanded than a mere balance of probabilities. Defences available to the directors are that they could not have been expected to realise that there was no reasonable prospect of avoiding insolvent liquidation, or secondly that, if insolvency liquidation was the only reasonable prospect, from the moment of becoming aware of that likelihood the director took every step to minimise the potential loss to creditors. The extent of liability is the amount of loss caused to the creditors, rather than punishment.

On the other hand, Keay (2007, 109) observes that: ‘Clearly S 214 has both a private law and
a public law function’. He cites Re Brian D Pierson (Contractors) Ltd [2000], where the directors found culpable under s214 were also disqualified under CDDA 1986. Rubin v Gunner [2004] was pointed out to us as another (rare) example of a successful s214 prosecution.

4.7.5 Sections 216–7: Re-using a prohibited company name: Although this may appear a mere technicality, abuse of limited liability has in the past often involved liquidating a company to rid it of its debts and setting up another to take over its business substantially intact. These ‘phoenix’ companies have been particularly troublesome when used as a means to evade obligations under debts and warranties, owed for example by house-builders on completion of an estate of houses. The section prohibits the director from being concerned (ie, involved, directly or indirectly, in promotion, formation or management) in another company which uses the name of an insolvent company or another name similar to it so as to suggest an association with it. Liability may be civil or criminal, and the major effect is to make the person concerned personally liable to contribute towards the debts of the ‘new’ company.

4.7.6 Other criminal offences in the course of winding up: Actions may be brought against officers of the company (not only directors) under IA 1986 ss206, 207, 208, 209, 210 and 211, but these are criminal offences usually arising when the company is being wound up, and they are not discussed in the present context. Civil actions may also be brought under company law for general breaches of the director’s duty of care to the company, and under common law.

4.8 LOSSES, COSTS AND WHO BEARS THEM IN RELATION TO THE BRINGING OF ACTIONS

4.8.1 When it comes to creditor protection and office-holders’ fees, the insolvency office holder has an unusual role, and one that may well involve conflict. On the one hand he is charged with protecting creditors’ interests, but on the other hand his own commercial interests and the right to charge fees may be detrimental to creditors’ interests. There is a subtle balance to be struck, and whether creditors’ interests are being served depends crucially on how effectively the office holder may be called to account to demonstrate that his fees represent value for money. In this connection it must also be borne in mind that the office holder is required to perform certain statutory and administrative functions with a public interest dimension that may not directly assist in realising assets and making distributions to creditors, for example preparing the report to the Insolvency Service under IA 1986 s6 for CDDA 1986 purposes. Detailed consideration of insolvency fees is beyond the scope of this study. However, there are a number of pervasive issues.

4.8.2 In respect of charged assets, and in particular where substantial amounts are involved, the charge-holder will normally be proactive about fees and has effective means of protecting his interests because he has a strong negotiating position in relation to charged assets.

4.8.3 Generally where the interests of unsecured creditors may be at risk, they are able to appoint a creditors’ committee whose role, inter alia, includes a degree of oversight over the office holder and approval of the office holder’s fees. However, what is often called ‘creditor apathy’ means that creditors’ committees tend not to be appointed, other than on some of the larger and more complex cases. Reluctance on the part of creditors to take an active part on a creditors’ committee may often follow from a realistic assessment made by them of the value of the time involved. Members of the Institute of Credit Management (ICM) told us that they were often instructed by their own companies not to spend company time pursuing debts of dubious value. The effectiveness of such committees, where appointed, also depends on whether they perform their functions in an informed and diligent manner. In practice, committees often do not meet these criteria even where they exist. In the case of administrative receivership, while unsecured creditors are able to appoint a committee, this committee has much less extensive powers than in administration or liquidation. It is not obvious how to improve the functioning of creditors’ committees, although in principle modern technology should make communications cheaper and more efficient.

4.8.4 On smaller cases, it is not unusual for fees and costs to absorb a substantial proportion – or indeed all – of the realisations. This does not necessarily mean that the office holder has been inefficient or has failed to protect creditors’ interests, but there is always a risk that office holders may put their own interests ahead of those of the creditors. That said, there is an irreducible minimum of case administration to be incurred on any case, and in some cases it may be entirely legitimate to spend the available funds in attempting to identify and realise other potential assets. Two insolvency practitioners said that the courts are sometimes very unsympathetic to requests for office holder’s costs, particularly when contingent fees were involved, while we were told at the ICAEW, Insolvency Regulation that the DTI (as it then was) expected office holders, once appointed, to perform basic functions regardless of the prospects of recovering costs. Limits on costs are fully discussed by Sealy and Milman (2007, Vol. 1, pp257–61).
4.8.5 While there is legislation and professional guidance on how fees may be determined, these are primarily to set both the basis on which fees are to be calculated (for example, on a time basis or as a percentage of realisations and distributions) and also the disclosure requirements for reporting how much has accrued (Insolvency Rule 4.127 and Statement of Insolvency Practice (SIP) Number 9). Where a time basis is used, the law and professional rules provide for disclosure, but provide little – if any – effective control over the quantum either of the number of hours that are charged to the case, or over the rate of charge for those hours, especially if is no effective creditors’ committee.

4.8.6 There is legal provision for challenge to be made to office holder’s fees; only time ‘properly given’ should be charged (Baister 2006). There has been litigation on value for money and judgments intended to uphold creditors’ interests. In 1998, following his criticism of fees on part of the Maxwell insolvency that came to him for approval, Mr Justice Ferris published a report (Lord Chancellor 1998) recommending that fees should not be time-based but should reflect value to creditors (see also Finch 2002 pp152–3). However, in practice it is very difficult for an aggrieved creditor and also for professional regulators to mount an effective challenge that time spent was not properly given or that the rates were excessive if the office holder can support the charges from his time records (and in some cases even where he cannot). (We are aware of a case in which an IP was not held responsible, even though he was unable to supply time records when challenged.)

4.8.7 Putting to one side concerns as to whether office holders always put creditors’ interests ahead of their own, the law has not always been accommodating to office holders who may very properly wish to incur costs to bring recovery actions that have a good prospect of increasing the funds available to creditors. We suggest that the Insolvency Service explore the system of aid made available by the New Zealand Insolvency Service, which provides funding for cases which it believes are winnable (recovering the funds out of the proceeds of the action). We understand that most of the funds advanced under this arrangement have in practice been repaid.

4.8.8 In respect of certain actions there have been issues on whether office holders may raise finance and share the proceeds with a third party, although the position has been assisted by the introduction of conditional fee arrangements. There are also issues on whether costs of unsuccessful legal proceedings fall within the definition of recoverable expenses, although provisions in EA 2002 that came into effect in 2003 have resolved these issues following Re Floor Fourteen Limited, Lewis v IRC [2001], in which it was held that a liquidator’s costs in pursuing claims under IR 86 ss238, 239 and 214 were not payable out of the company’s assets. Thus, to quote Sealy and Milman (2007 Vol. 1 p145), the amended Rule 4.218: ‘now specifies as expenses of the liquidation expenses or costs which are properly chargeable or incurred by the official receiver or liquidator ‘relating to the conduct of any legal proceedings which he has power to bring or defend whether in his own name or the name of the company’. This puts beyond any doubt any contention that such expenses do not fall within S 115’ (this being the section that gives priority to all expenses properly incurred in a winding up) Thus, these expenses are to be included as liquidation costs payable out of the company’s assets in priority to all other claims.

4.8.9 The decision in Re Leyland DAF added to these difficulties while reducing the risk that the holder of a floating charge would have to meet the costs of an action – indeed potentially an action that might challenge the validity of the floating charge itself. The decision in Re Leyland DAF substantially limited the ability of a liquidator to use floating charge assets, whether to bring actions or indeed for any other purpose (Armour and Walters, 2006). However this judgment itself has now been reversed by the CA 2006 s1282, which restored the liquidator’s ability to bring actions that are properly approved (normally by a creditors’ committee). It remains to be seen how this will work in practice.

4.8.10 A major difficulty that arises in the analysis of insolvency, then, is how to identify the rights of the different parties over a set of assets that, by definition, is insufficient to meet all the claims. The way in which costs and benefits are divided has consequences for the amount of the assets that will be realised and available to be shared. It will require action by the liquidator, for instance, to secure payments into company funds by directors guilty of actionable misconduct, (see 4.6 above). Given the uncertainty of success in such actions, it makes a lot of difference who will pay for the costs of obtaining the necessary evidence and bringing the action to court and who will benefit from any positive result. There are potentially valuable new commercial sources of funding for actions, apart from general litigation financiers (who are reluctant to fund cases involving insolvent companies). For example Insolvency Management will fund, and underwrite funding risks and insure against adverse court orders, but only if it sees strong legal merits in the case (a probability of success greater than 70%) and a minimum claim size (usually of £200,000). Setting priorities between claimants is a matter for political judgment going beyond the scope of this report (see eg, Insolvency Intelligence, 2003).
4.9 CDDA S1A ‘UNDERTAKINGS’

4.9.1 Pressure arises from many directions to encourage directors to work in the best interests of the company. They will have a contract of employment, for one thing, although contracts of employment are of the nature of ‘incomplete’ or ‘relational’ contracts in which many day-to-day terms are unspecified (Kay 1995 pp55–7). Directors may be motivated to demonstrate their abilities to their peer group of directors and to the employees they work with. They will often be self-driven, as one of a cohort of exceptionally able and confident people occupying a prominent position of responsibility. Their work is also subject to criminal and civil law, and they hold duties towards the company by statute and common law (including the duties spelled out in CA 2006, noted earlier). Their activities are also often visible to external parties such as suppliers, customers and financial journalists.

4.9.2 Directors may also be aware of pressure from CDDA 1986, which is invoked following the insolvency of a company, whether this takes the form of winding-up or administration or receivership. In all such cases the office holder makes a confidential report to the Secretary of State (for Trade and Industry, later BERR and now BIS) on each director, specifically commenting upon whether in their opinion the director is unfit to service in such a capacity (CDDA 1986 s6). A special Disqualification Unit of the Insolvency Service is engaged in such investigations and carries out any subsequent negotiations (see below).

4.9.3 Disqualification is for a period of between two and fifteen years, with penalties arranged in three tiers depending on the seriousness of the charges. Finch (2002 pp521–40) discusses the role and operation of CDDA 1986, and she points out that it seeks a balance between two rather different strategic objectives. The ‘rights’ approach is somewhat different from the ‘privileges’ approach to the role of the company director. The former implies that directors should be able to take commercial risks without being second-guessed by the courts (or others); but if they demonstrate failure to exercise these rights responsibly, they should be deprived of them by a punitive process. The burden of proof is that required of a criminal action, although CDDA 1986 penalties are in fact civil rather than criminal. The alternative view, the ‘privilege’ view, is that directors are expected to exercise their power in the public interest, and failure to do so implies a need to withdraw the privileges in order to protect the public. There should be a need merely to prove a balance of probabilities, as in civil actions generally.

4.9.4 Disqualification formerly needed to be by order of the court. In the Carecraft case in 1993 (Re Carecraft Construction Co Ltd), rather than being formally disqualified, the director concerned gave an undertaking not to act, which the court accepted. IA 2000 added a new chapter 1A to IA 1986, to provide a faster and cheaper mechanism so that the Disqualification Unit can accept ‘disqualification undertakings’ in place of a court hearing to impose disqualification. The majority of cases each year now take the form of such an undertaking, agreed between the director and the Disqualification Unit.

4.9.5 Sealy and Milman (2007 Vol. 2 p1) comment that disqualification has been available to the courts as a measure for many years under the Companies Acts, but that it is only since 1986 that resources have been made available for investigation and enforcement. We understand that resources still do not permit systematic monitoring of disqualification orders (and undertakings) to ensure their compliance, although a breach of either an order or an undertaking constitutes a criminal offence (CDDA 1986 s13) and may involve further civil sanctions (CDDA 1986 s15).

4.9.6 Somewhat like the disciplinary procedures of a professional body, disqualification proceedings by the Disqualification Unit take on a dual function. They undoubtedly help protect the public from further questionable activities on the part of the director (since the directors cannot, for the time being, act as a director); but they also involve a degree of advice, support and mentoring to the person concerned. In disciplinary actions by professional bodies, it often becomes evident that unsatisfactory performance by the challenged practitioner arises because of some extraneous pressure, such as illness or family circumstances. Support may be more effective in restoring competency than punishment in such circumstances. It is then important that due process involves fairness to all parties, including those who have been harmed by the deficient actions that gave rise to the complaint. The Human Rights Act 1998 adds weight to the need for due process to be observed. Disqualification does not at present involve any provision for restitution, although we ask in Chapter 6 below whether a formal link should be made between disqualification and misfeasance actions against directors, and whether more monitoring resources should be made available to the Disqualification Unit to oversee compliance. A BBA member commented that IPs could put more pressure on directors than they do in this context, but noted that the provisions of the Human Rights Act 1998 have to be observed.
4.10 SOME BROADER POLICY ISSUES

4.10.1 Company law assumes that the company is run primarily in the interests of its shareholders as long as it is solvent. The CLRSG addressed the question of how to frame the duty of directors for their guidance. They accepted the existence of a wide spectrum of views on the matter, but concluded that the obligation of directors to serve the purposes of the company meant that the basic goal of directors was to seek the success of the company in the collective best interests of shareholders (Company Law Review Steering Committee, 2001, para 3.8, p41). Even so, in this Final Report the Steering Group specifically addressed the obligations facing directors when the company was ‘more likely than not to be unable to meet its debts’ and also where there was ‘no reasonable prospect of avoiding insolvent liquidation’. Annex C to the document (op cit pp343–356) sets out draft statements of the ‘special duties’ of the director under both sets of circumstances, thus seeking to establish clearer guidance in the light of West Mercia Safetywear Ltd v Dodd [1988] (which discussed the point at which directors need to take creditors interests into account, whether alongside or in preference to those of shareholders). In the event, CA 2006 incorporated most of the suggestions for stating directors’ duties, but did not include the ‘special duties’.

4.10.2 However, CA 2006 s172 goes some way towards recognising wider obligations upon the directors; they must ‘promote the success of the company for the benefit of its members as a whole’ but in doing so they must ‘have regard to the interests of the company’s employees’, and also ‘have regard to the need to foster the company’s business relationships with suppliers, customers and others’. However, the shareholders lose their primacy once insolvency arises, and (noted in 4.4) the directors must take increasing care to protect the interests of creditors as the company approaches financial difficulties (West Mercia Safetywear v Dodd [1988], Nicholson v Permakraft (1985)). Shareholders are said in finance textbooks (such as Brealey and Myers) to hold an option over the assets of the company, and once the expected value of external debts exceeds the value of the assets, the shareholders (protected by limited liability) are able to exercise their ‘put option’ on the assets and simply let the creditors take what is left. Brealey and Myers do not point out that there is also a ‘call option’ in the hands of the creditors once the assets are less than their claims. (They can, for example, take steps to put the company into administration.) It is not obvious who would want to exercise their option first; however, the textbooks put the matter, the shareholders could well be confronted with an obligation rather than an option in such a situation, given the capacity of debtors to anticipate financial failure. On the other hand, neither the shareholders nor the creditors may be in a good position to estimate realisable values for the assets. Once formal insolvency proceedings are instituted, it is rare that the shareholders receive anything back of the capital they have invested, but of course unsecured creditors often lose substantially too.

4.10.3 Keay (2007, pp241–6) recommends that the duties of directors should be directed towards the entity, rather than the shareholders, as noted in 4.5.11 above. He illustrates his point with a hypothetical case study (op cit, pp245–6). X Ltd has assets of £10m and debts of £8m.

‘The directors are presented with two ventures. The first is quite conservative, involving a £5m outlay of funds with a 90 per cent chance of reaping £6m and a 10 per cent chance of (the outcome) being worth £4m. This effectively means that the company has a 90 per cent chance of making a gain of £1m and a 10 per cent chance of losing £1m. The full amount of the gain would go to the shareholders, so the creditors would not be particularly supportive of the venture, especially as there is a 10 per cent chance that some or all of them will not receive full payment of their debts. The second venture is more risky. It requires an outlay of £10m. There is a 10 per cent chance of a £100m return (making a gain of £90m), but it has a 90 per cent chance of producing a £10m loss. The shareholders are likely to support this as they will get all of it and the benefits are substantial, and even if the venture fails they will only lose their equity in X, something which is, in total, likely to be in the region of £2m before the venture is taken on. The creditors would be the ones who bear most of the risk with the second venture. If the venture succeeds the creditors will be no better off and if it fails then they will get nothing. Directors following the entity maximising model would dismiss the second venture, but might reason that the former is worthwhile, given the high probability of a gain.’

4.10.4 The first venture offers the entity an expected value of £0.8m, whereas under the second version the plus £9m expected value for the shareholders is precisely offset by the minus £9m expected value to the creditors. One solution not noted would be to follow Hart (1995) and require the shareholders first to pay off the debts and then allow them to pursue whichever
venture they wished using their own money. This leads, of course, to the entity solution. The discussion also begs the question of whether, given the much greater probability of losing £10m than gaining £100m if the second project is pursued, the directors would find themselves challenged to defend their decision (alleging fraud, for example, under CA 2006 s993) or, in the event of subsequent liquidation of the company, wrongful trading (under IA 1986 s214).

4.10.5 Professor John Parkinson, a member of the CLRSG, addressed the question of how to interpret directors’ duties to the entity, rather than to shareholders or wider stakeholder groups. He comments:

‘The standard formulation of the duty of the directors in running the business is expressed not in terms of benefiting the members, but of benefiting the company. This does not, however, mean that the directors must use their powers to promote the welfare of the legal entity, though technically the duty is owed to the entity (this has important implications for enforceability). A requirement to benefit an artificial entity, as an end in itself, would be irrational and futile, since a non-real entity is incapable of experiencing well-being. Indeed, it is doubtful that an inanimate entity can be meaningfully be said to have interests, or if it could, what they would be.’ (Parkinson 1993 p76, emphasis in the original.)

4.10.6 While it is arguable that the entity seen as an inanimate object might well be viewed in this way, it might also be suggested that the entity as an organisation, as a distinctive social organism with its own culture and programme of activities, might quite well be viewed as an object for care and advancement. Schools have been put forward as suitable recipients of service and respect for generations. Moreover, finance theory can view the entity as a functioning organisation with its own assets and cash flows that can be analysed separately from the interests of its financial backers who fund it with equity or debt (as assumed in Keay’s example in 4.5.11 above). This is consistent with the idea of entity wealth maximisation regardless of how claims on that wealth are to be shared and distributed. Parkinson accepts that problems arise in any case in putting the concept of directors’ duties into operational form.

4.10.7 For some purposes it is convenient to divide the available assets into separate pools, over which specific creditors hold security or its equivalent. Leased assets and assets subject to valid reservation of title do not belong to the company in any case. In certain circumstances, the counterparty (eg, under a contract with reservation of title) can demand the assets to meet their debts. Similarly a mortgagee of property can require that particular property to be sold if the debt (or interest on the debt) is unpaid. In short, fixed charges – by definition – hold a charge over particular assets. Otherwise, by and large, there is a general pool of assets, and there is a general pool of liabilities. For the most part, it is not in fact possible to identify any particular assets with any particular source of capital used by the company to finance them. Once the priorities are determined amongst any unpaid creditors, the question is which assets to sell off first to meet the debts. In practice, it is likely that some assets can be sold off relatively easily and rapidly, such as stock in trade, but if trade is to continue there will probably be some assets needed, including fixed assets and work in progress, required for further use, some of which are already in existence and some of which are only ‘assets in prospect’ which require further work.

4.10.8 The creditors are the parties mainly interested in an insolvent company, and they may be divided into (i) those who have fixed charges; (ii) preferential creditors; (iii) those with floating charges; and (iv) unsecured creditors. The shareholders have a residual interest in anything that may remain once the other interests have been met. (‘Super-priority’ funding, available in several countries to facilitate the supply of credit once a company is in insolvency, is not allowed in the UK: see, for example, Finch 2002 p207.) Of course, it is likely that different members within each class will have different concerns and preferences, and thus have an interest in the powers (such as voting rights) that they hold to influence class decisions within their group as well as their rights vis-à-vis other classes. For example, an unsecured trade creditor with a small debt, hoping for further repeat business if only the company can be rescued, is in a very different position from the unpaid seller arising from a one-off transaction.

4.10.9 It also makes a difference whether creditors with higher priority are entitled to obtain payment before formal insolvency proceedings are instituted, and whether, after such proceedings begin, they are entitled to be paid in full or must share in costs and losses that materialise later. It might seem self-evidently fair that a class of creditors will only pay the costs incurred in order to secure discharge of their debts, but there are obvious difficulties with this (see Armour and Walters 2006). Some costs will be incurred jointly, whether before or after formal proceedings begin, and these costs are incurred to benefit all parties (whether or not they subsequently receive payment). Indeed, EA 2002 introduced (by a new s176A in IA 1986)
new provisions for a ‘prescribed part’ of recoveries under floating charges (to be set aside for the benefit of unsecured creditors where the company is in liquidation, administration or receivership), and this creates a link between the interests of secured and unsecured creditors. Some unsecured creditors may possess greater bargaining power than others. Thus, the repeated supplier of an important component may hold more sway than the incidental one-off supplier of goods off the shelf. **DLA Piper Rudnick Gray Cary** pointed out to us that problems will remain to be solved in the operation of the prescribed part, particularly over the need to engage unsecured creditors in framing strategies in which their interests are remote, and in securing unanimous decisions. **ICM** suggested that the principle of the prescribed part might be extended towards IPs costs – say, another 10% or 5% fund for investigations from the floating charge or from total realisations. On the other hand, **David Mond** expressed doubts about the value of prescribed parts. **Deloitte and Touche, Manchester** commented that very little has been raised so far, but there was a case for raising the £600,000 limit. **ICM** noted that directors sometimes fund creditors’ meetings.

4.10.10 In **Re Barleycorn Enterprises** (1970) the issue before the court was whether the holders of floating charges could demand that their debts be paid without contributing to liquidation expenses (Armour and Walters 2006). In this case, a firm of accountants had prepared a statement of affairs of value for the purposes of liquidation. The company had not paid for this work, and the only assets available proved to be worth less than the debenture loan. The court held that the cost of preparing the statements was a cost of liquidation that should be met out of assets otherwise payable to the debenture holder.

4.10.11 This principle was overturned in **Re Leyland DAF Ltd** (2004) (more properly known as **Buchler v Talbot; sub nom Re Leyland DAF Ltd**), in which it was held that ‘the company’s property’ was not to be defined to include assets required to meet a floating charge, and holders of the floating charge did not therefore have to contribute towards liquidation costs (except those incurred to realise the assets required to meet their debt) (see Sealy and Milman 2007 Vol.1 p139). As noted earlier, CA 2006 s1282 specifically overturned **Re Leyland DAF Ltd**. It remains to be seen, at the time of writing, how far holders of floating charges will in practice be called upon to contribute towards liquidation costs.

4.10.12 The rights of secured creditors were also central to another controversial recent case, **Spectrum Plus Ltd** (2004) (**National Westminster Bank plc v Spectrum Plus Ltd (in Creditors Voluntary Liquidation)**), which addressed the relative rights of holders of fixed and floating charges over book debts. The matter was important in relation to the rights of banks over such debts owed to their corporate clients. If the charge was interpreted as fixed, rather than floating, the bank could recover loans from funds as the company’s debtors paid them (although the House of Lords made stipulations as to how the bank was to treat such funds). The legal proceedings involved a decision in the High Court being overturned on appeal by the Appeal Court, and then re-instated by the House of Lords. There is no doubt that banks holding fixed charges claim ahead of preferential creditor, whilst floating charges rank after preferential creditors, but ahead of unsecured creditors. The banks will normally hold a floating charge over book debts, so rather than losing control over this source of funds they may prefer to factor the debts instead. Some commentators question the value of floating charges at all.

4.10.13 One major change brought about by EA 2002 was that Crown preference was abolished – debts owed to the state were no longer to be classed as preferential (most importantly, VAT tax, corporation tax and income tax collected from employees’ pay under the PAVE system). One result of this is that HM Revenue and Customs, now being included in the broad category of unsecured creditors, is a more watchful and powerful member of that general class, and in the course of enforcing its own rights this should in principle benefit other unsecured creditors.

4.10.14 The list of preferential debts is set out in IA 1986 Schedule 6, as amended. Preferential creditors now comprise mainly the employees with respect to certain (limited) entitlements to salaries and wages, holiday pay and pension contributions. These debts are paid in priority to debts secured by floating charges as well as other unsecured debts, although not before the liquidator. Liquidators have to take first call on the assets of the company to recover properly incurred costs of the liquidation, otherwise it will be impossible for them to take appointments.

4.10.15 An issue that has become much more prominent in recent years has been the rising interest on the part of some commercial firms in funding actions by office holders. **DLA Piper Rudnick Gray Cary** told us that s212 actions were easier to fund than other actions, although **Allen and Overy** saw lack of funding to be a major barrier to the effectiveness of s212. Concerns were expressed to us by several practitioners on the problem of funding insolvency cases. We are aware of new commercial sources of funding eg, from **Insolvency and Insolvency Management**, although these only take on cases that they estimated to offer odds of success.
better than 70%. BBA thought funding would increase further, particularly for actions against negligent professionals. Mediation is being used more often, as are contingent fee schemes. Some actions are funded by creditors, for which purpose the creditors’ committee plays a crucial role. While creditors’ committee can be very valuable when they work well, they often do not. ICM noted that there are occasions when none turn up for meetings, although the committees tend to work better in larger cases. BBA members told us that banks do not generally wish to pursue insolvency actions if they can avoid them, even if fraud is involved. Most of the problematic cases arise with smaller company insolvencies, where smaller amounts are at stake, resources are limited, and the incentive for creditors to take action is even less.

4.10.16 An insolvency practitioner commented that even in clear cut cases, such as where theft was evident, there were endless ways in which the defence could ‘play the system’ and the judge would accept this. He told us that, while the Disqualification Unit was getting better, the courts were worse at handling such cases. One effect of EA 2002 may well have been further to reduce the participation of unsecured creditors in insolvency proceedings, in which administrators are effectively appointed by directors at the behest of their secured creditors. We have been informed of the New Zealand insolvency service’s fund to assist appointees to bring recovery actions, repayable out of successful recoveries. We also note the existence of an Australian insolvency service fund to help with the costs of small investigations. Given the element of public interest in insolvency procedures, there seems to be a good argument for involving public funds in assisting office holders to bring actions, where these are justified, as well as aiding corporate recovery that may generate future taxes.

4.11 THE PARTICULAR DIFFICULTY OF ‘PRE-PACKAGED SALES’

4.11.1 There has been a marked rise in the use of ‘pre-packaged’ deals in recent years to address the rescue of failing businesses. Before the failing company gets into a formal insolvency procedure, the directors seek advice from an insolvency practitioner (probably with the encouragement of their secured lenders). This can only be applauded as sensible precautionary planning, anticipating possible difficulties. But it presents possible problems when it leads to deals over the future of the company being made out of sight of the general run of creditors.

4.11.2 At the heart of the matter is the conundrum that, according to a transaction cost economics (TCE) view of the firm, the management should possess particular advantage in making the best use of the set of (human and non-human) assets that comprise the enterprise. Even though some assets may have alternative uses to which they can readily be applied, the success of the company depends crucially on the way it can assemble a specific and specialised set of interdependent resources that it can exploit in a way that others will find it hard to replicate. Hart (1995 p87, taking a TCE view) notes that ‘if assets are strictly complementary then they should be under common ownership; and that if assets are independent, then they should be separately owned’. It may not be easy to explain in public the distinctive features of the firm’s assets, nor to encourage potential bidders to explore how to improve on the performance of the existing managers.

4.11.3 Kay (1995) identifies four types of asset in particular that explain the success of firms: organisational architecture, reputation, capacity for innovation, and strategic assets. Most of these are intangibles that are rarely reported in the financial accounts, and Kay points out that the management itself may not fully appreciate the distinctive capabilities that they confer upon their firm. A firm that is facing financial difficulties might be presumed to be in the hands of the wrong management team, but it does not follow that another team could do better. The great advantage held by the existing managers is familiarity with the existing business, with the people working for it and the strategic options open to it, and with its future potential. This makes is likely that if the company, or some significant part of it, is to succeed in future, some or all of the present management team will be in the best position to achieve this. But it is also obvious why there may be objections in principle to a bid by existing management simply to take over the company, shorn of its external loans. The negotiating process leading to a pre-pack simply cannot be supervised by the creditors who stand to lose most, nor by an insolvency practitioner (at the relevant time, at least, before any appointment) able to monitor the process on their behalf. In most instances, moreover, an IP engaged in setting up a pre-package is appointed at the request of the incumbent management, the very people with whom pre-pack deals are often struck. The potential scope for improper behaviour is clear, although, it must be stressed, not all pre-packs are to existing management.

4.11.4 The former chief executive of the Insolvency Service (Flynn 2006 p3) notes that: ‘Reforms made by the Enterprise Act 2002 have made it easier for pre-packs to be undertaken following the introduction of the streamlined system of without-court-order routes into administration and the simpler means of exiting.’ He goes on to point out the importance of having such arrangements in place promptly ‘where the value of a company’s business can be significantly
diminished very quickly, either due to damage to its reputation or the loss of key staff following a formal insolvency’ (loc cit). He adds that ‘it is largely down to the IP to ensure that the pre-pack procedure is undertaken in a fair manner from his or her first involvement in it’ (see also Finch 2006; also Lockerbie and Godfrey 2006; and Mason 2006).

4.11.5 One answer to the conundrum would appear to be strict documentation of the circumstances, negotiations and any conditions agreed before any pre-pack is accepted for recommendation to the subsequent creditors’ meeting. Thus, Stephen Davies (2006) has suggested that, for all pre-packs by an administrator and sales prior to a creditors’ meeting, a statement should be filed by the IP including information on: (i) the date when his firm was first instructed; (ii) the reasons for the pre-pack; (iii) the period of marketing (if any) or the reasons for no marketing; (iv) all valuations received and the process of deciding the sale price; (v) the material terms of the sale; and (vi) the total fees received by his firm and the source of those fees.’ (Davies 2006 p18) His point (iii) relates in particular to the obligation under IA 1986 para 3(1)(a) of Schedule B1 to make rescuing the company as a going concern the first priority, as noted in 4.2.7 earlier, but we have expressed our doubts (in 4.2.8 above) whether these provisions are useful.

The Institute of Directors noted the need for RPBs to have a code of practice. Since we submitted our draft paper in May 2008, SIP 16 has now gone a long way towards meeting the need for relevant disclosure.

4.11.6 There remains the difficulty of knowing just when an IP needs to become involved in the affairs of the company. The majority of takeovers do not involve insolvency at all. Negotiations take place between the bidder and the subject of the bid, and often a takeover offer is agreed between them and then reported to the members of the company for their endorsement. Even when the bid is contested, there are usually preliminary discussions between the parties beforehand. The importance consideration in the present context is whether there is a significant risk that the company being considered for the bid will prove unable to meet its obligations to its creditors, at any time before the bid is completed. In other words, the difference between a ‘normal’ commercial takeover and a pre-pack is that an IP is involved in the latter, for the reason that the company is thought to be in the ‘twilight zone’ between solvency and possible insolvency. It was noted earlier, in 4.5, that it is often difficult to know when a company gets into financial distress. As noted earlier, a robust definition of the rule in the West Mercia case was sought for inclusion in the 2006 Companies Bill (see 4.4.3 and 4.5.14 above), but it was impossible to frame one adequately, hence the wording of CA 2006 s172 (3).
5. WEIGHING UP THE PRACTICAL ISSUES IN THE PROTECTION OF CREDITORS

5.1.1 Most of the evidence has now been set down in the report. In our later interviews, we provided a list of our provisional recommendations and we sought comments on them. Interviewees often added their own comments on other related matters.

5.1.2 First, it will be helpful to summarise some of the major points from earlier in the report. It remains the fact that the major economic role of firms is to take in funds from investors and commit them to assets whose (immediate) net realisable values in the market are below – perhaps well below – their replacement cost. It is the specialised role of the management team to find projects with positive net present value, and to transform the assets so as to generate larger flows of funds in future. This is risky, but it remains the major challenge to business.

As long as the capital is provided by a homogeneous group of informed equity investors who are willing to bear the risk in the hope of future profits, the problems are relatively slight. It is when relative rights and obligations differ (between classes of shareholder, or more particularly between creditors and shareholders) that complexities increase. The privilege of limited liability increases these complexities further. The difficult judgement is to decide upon the balance between proper levels of risk and reward offered to investors by the company’s securities, and the distribution of those risks and rewards between stakeholder classes.

5.1.3 The essence of creditor protection is that the directors of companies with limited liability will only use loans and credit so long as those obligations can predictably be discharged when due (otherwise, equity capital needs to be used instead). The role of accounting data has been discussed at some length, since it has long been established practice to look to the accounts to help predict cash flows. Moreover, current law (as embodied in the European Second Directive and in legislation based on that Directive) sets out an extensive body of rules intended to secure capital maintenance and to prevent funds being disbursed to members at the expense of creditors.

It has been explained that these rules are costly, complex and, we believe, ineffectual for creditor protection. Accounting rules are themselves incomplete and in some respects ambiguous, and the valuation practices actually used in published accounts are rarely appropriate to the interests of creditors – even when the company is a going concern.

5.1.4 In our own interview with the BBA, we were told that even where they were audited, the accounts of corporate clients were often not of great value. They tended to appear too late, they were insufficient in terms of the details disclosed, and they were prepared on the ‘going concern’ assumption even when this was itself in doubt. As we noted in connection with the ICM above, the banks are knowledgeable lenders with professional staff and specialised departments to scrutinise corporate customers in financial difficulty. They are also usually able to form their own view of the company’s financial status by examining their customer’s various accounts held by their branches. To some extent, this means that unsecured creditors receive some protection from the monitoring activities of secured lenders, but their interests may also conflict.

5.1.5 We have no objection, of course, to external users using published accounting data in order to make predictions of cash flows. This is presumably how outside users of accounts already base their solvency projections. BVCA and R3 Technical Committee both told us that we may be underestimating the usefulness of published accounts, particularly for expert analysis of trends over three years or more. On the other hand, we are concerned that they may get spurious results based on inappropriate data. We note that financial reports represent only ‘general purpose’ reports, not suited to any specific purpose let alone the forecasting of insolvency. Concerns were also expressed to us (eg, by Lonsdale & Partners, BBA and BVCA) over the length of time it takes before accounts need to be filed, although CA 2006 s442 has made some improvement (reducing the time to nine months for private companies from the end of the relevant accounting reference period, and six months for public companies). BVCA also noted the low level of penalties for late filing.

5.1.6 In our interview with ICM, regrets were expressed that too few companies were filing full sets of accounts (850,000 non-dormant companies were not doing so). Audit exemption limits were also too high. This view was shared by the interviewees at ACCA, the Institute of
Directors and 100 Group of Finance Directors, although others such as the ICAEW disagree with this, and Lonsdale & Partners noted that the onset of IFRSs implied a need to lower exemption limits, rather than raising them, so that fewer companies would have to comply.

5.1.7 ICM thought too few creditors attended creditors’ meetings (although this was often at the insistence of the finance directors of the creditor companies, reluctant to devote resources to pursuing dubious debts even when individual ICM members working for the company were themselves keen to do so). Likewise, the information from the accounts was often of limited value to them, even when it was available. The view was also expressed that some credit reports were of little value. Of course, ICM members work for larger companies that have their own professional staff in charge of accounts receivable. Many smaller firms have to rely on credit reports, even if these are sometimes of questionable value.

5.1.8 We agree with the recommendations made by Rickford (2004) and by FEE (2007) that a solvency report is urgently required in place of the capital maintenance rules, even though this departs markedly from established practice throughout Europe. We differ from both reports in that we regard the highest priority as attaching to private companies, whose regulation mainly falls outside the terms of the Second Directive. We recommend that private companies that do not file audited accounts should file with the annual return a solvency statement by the directors, regardless of whether distributions are to be made. Even if these are published without attestation, such statements would require directors to pay attention to the solvency of the company for the coming year, and also, we suggest, require them to give assurance of solvency in more general terms for the foreseeable future after the end of the coming year. It is common ground that it is insolvency, rather than lack of profitability, that most often leads to the demise of companies, and this most often arises from inadequate cash planning. A member of ICAEW Insolvency Committee noted that it is possible for insolvency to arise with companies that are ‘asset rich but cash poor’, for example in companies suffering from over-trading.

5.1.9 Solvency statements rely upon cash forecasts. We are thus dealing with subjective estimates, rather than facts, based on confidential information. But evidence can and must be preserved of the procedures and facts used to form those estimates. The great majority of directors will never willfully seek to deprive creditors, but some may put them at risk through wishful thinking or negligence. It is dangerous for all concerned whenever directors get into denial over the threat of insolvency. Moreover, when they foresee the possibility of financial stringency, they may be tempted to deceive creditors over the soundness of the financial situation in order to enable the company to work its way out of difficulty. It is to encourage directors to address these matters that the law makes them personally liable to make legal redress to the company if it goes into liquidation under such circumstances where creditors’ interests have been neglected or put at undue risk.

5.1.10 We believe that most effective creditor protection at present comes from IA 1986 (particularly ss212, 213, 214, 238, and 239), from CDDA 1986, and from related measures. In practice, it is likely to be the threat of legal action under these headings that influences directors, rather than actions actually brought formally before the courts. But a credible threat means that action could plausibly be brought by the office holder, who in turn needs assurance that actions are likely to succeed and that sufficient funding is available.

5.1.11 Directors will not be deterred if they know that actions are unlikely to be brought – for example, if they have no assets to be seized even if action is brought against them. The question that arises is whether IA 1986 and CDDA 1986 provisions are as effective as they might be. These are issues which we have raised in our discussions with practitioners. Suggestions for improvement include improved funding arrangements and more active support from the Insolvency Service (given enhanced resources for the purpose), and linking restitution under IA 1986 with disqualification under CDDA 1986 (even though it must be recognised that the legal proceedings are separate at present). An academic lawyer pointed out to us that in Official Receiver v Doshi (2001), noted in 4.7.4 above), a wrongful trading action under s214 was linked with CDDA disqualification (as it was also in Re Brian D Pierson (2000), noted in 4.7.4 above).

5.1.12 It may seem relatively straightforward for the Disqualification Unit to take note of any restitution made by the directors in considering claims for reinstatement. We have been warned by two barristers, however, that it may be difficult in procedural terms to link the two. ICAEW, Insolvency Regulation saw merit in the principle of linking the two forms of action, particularly since the same proceedings could address both issues, but warned that directors must not be permitted to buy their way out of disqualification. We were told at ACCA that the Disqualification Unit already considers evidence of recoveries by the insolvency practitioner when initiating disqualifications, and this was confirmed by Dickinson Dees who carry out a lot of CDDA civil proceedings on behalf of the Department (BERR, now BIS). However, IPs themselves tend to wait for disqualification before pursuing recovery of debts from directors. There is thus a problem
of timing. Dickinson Dees noted that CDDA actions have to be initiated within two years of the insolvency, and regulators often cannot wait for the results of proceedings, or for decisions to be announced by the office holder. At present, monitoring compliance with CDDA undertakings (as far as it exists) tends to focus on procedural matters, such as whether filings had been completed by the due date. Most CDDA proceedings do not, in any case, involve recoverable assets but failure to deal with tax and VAT, late filings of returns and accounts, and deferment of Crown debts to the benefit of trade creditors and/or directors.

5.1.13 IPA also commented that CDDA 1986 is less concerned with restoration than with punishment. IPA commended the work of the Australian Securities and Investments Commission, which runs a team to investigate concerns about insolvency and impropriety and has authority to bring criminal proceedings and to petition for winding up. As noted earlier, Australian precedents seem to us to be worth examining closely as a model for the UK. BBA members commented that insolvency practitioners could themselves put more pressure on directors than they do in this context. The Institute of Directors urged more use of plea bargaining, by non-executive directors in particular (who are often disqualified despite their lack of access to financial information on their company).

5.1.14 As noted earlier, IA 1986 s214 and s213 together with CDDA 1986 already help to influence the behaviour of directors (as well as shadow directors and officers). But many points of interpretation of s214 are unclear, as evidenced in the fairly sparse number of cases heard under the section before the courts, and s213 cases are even rarer. On the other hand, many recommendations for disqualification are made under CDDA 1986, of which some thousands have been upheld. We heard from a barrister in chambers that actions are much easier to bring under s212 than under ss213 or 214 because s212 is directed towards the misfeasance of directors, and actions are easier to bring – partly because of the more general nature of the charges and partly because proof of misfeasance can be found more readily than evidence of directors’ intentions. Section 212 actions are also easier to fund. Even so, it is not easy to demonstrate misfeasance. Courts are understandably reluctant to penalise directors for mistakes that are made in good faith. In Re Wellab Engineers (1990), the court would not second guess the business judgment of the directors (although it was noted that the decision taken was finely balanced in the circumstances); it was also suggested that the directors would in any event have been protected by CA 1985 s727 (now CA 2006 s1157). Keay (2007, p123) notes that the court has full discretion over the amount that might be required from the director under s214, so a defence under s727 would be redundant if the court set the amount at zero.

5.1.15 A law scholar drew our attention to the rise in importance of actions under ss216 and 217 (concerning the misuse of business names), particularly now that these are being used more often by HMRC, leading to CDDA actions. While the ending of Crown preference under EA 2002 might suggest that HMRC would have become more active as a champion of unsecured creditors, and BBA members noted they were still being nominated to accept payment plans, we have been warned that HMRC is prevented from taking any other line than the recovery of its own debts. It does not lie in its power for HMRC to take action for the public benefit alone.

5.1.16 An academic/barrister observed to us that he found s212 actions easier to use than ss213 or 214 in part because they do not require the company to be insolvent, and also because actions could be brought not merely by a liquidator but also by a creditor. ICAEW Insolvency Regulation and The Institute of Directors both expressed doubts that allowing creditors to bring actions would add anything to existing rules. BRI Business Recovery and Insolvency agreed, commenting that creditor action made no sense when the company is solvent and that action needed in any case to be coordinated with the office holder when the company is insolvent. By contrast, a UK academic lawyer referred to creditor actions as one advantage of following the route taken in Australia, and Keay (2007, p278) suggests that CA 1985 s459 (now CA 2006 s994) could usefully be broadened to facilitate this. Creditors are always able to fund actions by office holders, but they may lack an incentive to do so if the benefits are shared amongst numerous ‘free-riders’. Keay (op cit p82) cites evidence that more than 40% of insolvent trading actions in Australia are brought by creditors (under s588BT(3)). IPA said that more work needed to be done on SIP 9 (on remuneration) to reassure unsecured creditors, and often there was no proper line of communication between them and the appointee. Creditors’ committees should be made more effective, for example by more use of email, websites, and conference telephone calls.

5.1.17 We agree with the Rickford Report that solvency certification is more significant as a protection for creditors (and perhaps shareholders) than legal limitations upon distributions, based as they are on capital maintenance rules that rely on notions of contributed capital. We do not agree that distribution is the major source of creditor protection, but the terms of reference were given to Rickford’s working party and thus lay outside its control. We submit it is even more important for directors to review solvency in deciding to trade for the coming
We believe trading losses are more significant a cause of losses to creditors than improper distributions, and we have had some confirmation of this from interviews. Lonsdale & Partners confirmed that cash flows undoubtedly represent the central problem; far more firms fail for lack of solvency than from lack of profitability. But formal cash flow forecasts differ from the informal picture, as obtained for instance by way of bank correspondence and reviewing the state of large contracts. Lonsdale & Partners commented that ‘solvency assessment is more of an art than a science’, with all parties seeking to protect themselves. The firm often provides financial advice to its (private company) clients. A member of the One Hundred Group also warned of unpredictable bank support, citing a case where a potentially recoverable group was put into liquidation at the insistence of one bank even when the four others were all prepared to continue with funding. The directors are not infallible, even when they try their hardest to form reliable forecasts. They must set out (and minute) the assumptions underlying the figures in their forecasts, and they must be in a position to explain how their solvency certificate relates to this analysis. The nearer the company seems to be to financial stress, the greater the thoroughness with which this process needs to be performed, and, as Allen and Overy commented, the more sensible it will be for directors to seek professional advice eg, when contemplating financial reconstruction or refinancing.

5.1.18 In our view, some form of directors’ declaration of solvency, preferably with external solvency ‘confirmation’, would be of great assistance, based upon cash forecasts to the planning horizon rather than just one year from the date of approval of the annual accounts. Confirmation would mean involving someone with direct access to management accounts as well as the published accounts. We are aware that New Zealand company law requires a solvency statement to accompany distributions, and this does not require attestation (see 2.8.11 above). We note that the professional accounting bodies are very sensitive to proposals to require accountants to report in any meaningful way on solvency reports, although special forms of assurance are already given by auditors on occasion and are regarded as valuable by bankers in particular (ICAEW Audit and Assurance Faculty 2006). ACCA suggested that if solvency reports were to become a legal requirement, some form of auditor confirmation might offer the potential for a new and valuable service for practising members to provide.

5.1.19 Allen and Overy, which usually act for lenders, pointed out to us that directors’ solvency certification was already a feature of covenants given in respect of high yield (loan) investments, and this was confirmed by BVCA members. These often require quarterly statements, covering the profit and loss account, the balance sheet and cash flow forecasts. Similar ad hoc statements were also demanded as part of the due diligence requirements of many securitisations. Whereas 10 to 15 years ago these would carry audit certificates, now the auditors do no more than confirm the officers’ certificates. The European High Yield Association is keen for further reform in this area, for example to bring in to Europe US-style stays of action along the lines of Chapter 11. On the other hand, from the viewpoint of this report these procedures are concerned almost entirely with large companies, where the involvement of auditors in published accounts and full directors’ reports already provides a major element of creditor protection. According to a member of ICAEW Company Law Committee, it would be perfectly feasible to demand listed companies to issue a solvency certificate, but it would be very costly (even without specific audit confirmation), particularly for groups with a lot of subsidiaries; furthermore, only in rare cases would such a certificate perform any useful function. BVCA shared this concern: ‘we have this in effect already; they cause a lot of cost in time and expense … My concern with certification for everybody is that it would hurt more innocent than guilty people.’ Moreover, businesses in their early stages would always have trouble making solvency statements. The Institute of Directors shared the concern about the costs for listed companies, and doubted whether it would be justified. (Individual members of the Institute of Directors tend to favour reducing burdens in their capacity of directors, but seek greater protection in their role as creditors!)

We note that The Director’s Handbook published by Institute of Directors includes advice on how directors must act ‘in the face of insolvency or financial difficulty’ (as does the Insolvency Service itself, of course, for example in its 2003 guide to compulsory liquidation).

5.1.20 A member of ICAEW Insolvency Committee commented that in the case of non-audited companies, the directors would have little idea in any case of what such a certificate would involve. We would see the major purpose as being to require them formally to consider the matter, and an insolvency practitioner we consulted agreed with this.

5.1.21 Unlike the Rickford Report, we would expect a formal certificate to be filed with the annual return for all private limited companies as a matter of course, in place of abbreviated accounts (as it is in Australia for all companies apart from small proprietary companies). This document would be filed whether or not a distribution was proposed. It would possibly also be valuable in other circumstances when substantial payments were authorised by the directors, but it seems impossible to frame an effective regulation to achieve this (for example, in the
context of major capital expenditure decisions, or when material losses are written off). As the ICAEW Company Law Committee commented, any regulation drafted to achieve such effects would need to involve some measure of what was meant by ‘major’ or ‘material’, which would mean getting back to accounts-based rules, using borrowing or gearing measures for creditor protection.

5.1.22 As for the time horizon, a difficult judgement is involved. Setting a one-year horizon makes matters somewhat easier for directors – a matter of great importance. An academic noted to us that SAS 130 (1994) specified the foreseeable future to extend one year from the date of approval of the financial statements. On the other hand, as the FEE paper quoted in 3.3 above noted, it seems perverse not to require solvency to be forecast indefinitely into the future. Without doubt, greater uncertainty arises as the forecasts extend into the future, but this would be acknowledged in the drafting of the regulations. There seems little logic in protecting creditors just for 12 months, and leaving them in limbo thereafter. Moreover, the nature of the business sometimes makes the arbitrary choice of 12 months inappropriate. A building concern undertakes projects planned for several years ahead, and needs to know that it will have a reasonable prospect of recovering the costs without leaving the creditors stranded. (Indeed, they already need such forecasts to comply with current accounting rules for incomplete contracts.) It is important to take reasonable care to avoid hazarding creditor claims whether they lie one or ten years ahead.

5.1.23 On the other hand, recognising the arguments in the FEE report, we accept that short-term projections are more reliable and easier to prepare than long-term projections. Even though we remain to be persuaded that a ‘snapshot’ test will provide assurance of the long-term ability of the company to meet its debts, we see the merit in making a procedural distinction between short and long-term projections. This, we suggest, can be achieved by making the one-year projection a matter for a positive statement by directors (that the company is able to meet its debts as they fall due), using the longer-term projection to state an opinion that in the view of the directors there is no evidence, after due consideration, that would lead them to doubt the ability of the company to meet its longer-term obligations, both those already incurred and those expected to be incurred in future, from funds available now or anticipated to be receivable in the course of expected business activities.

5.1.24 The CLRSG (February 1999 p82) noted that, where a company went to court for approval of a proposal to reduce its capital, the court typically required an ‘expensive bank guarantee to protect present and future claims regardless of the financial strength of the company’. They commented: ‘We do not regard this rule as efficient’. CA 2006 subsequently removed the need for private companies even to seek court approval for a reduction of capital, by ss641–644.

5.1.25 The provisions in CA 2006 ss641–4 (reduction of capital by a private company) and in ss709–723 ((redemption or purchase by of shares by a private company out of capital) both offer interesting points for consideration. Both require a solvency certificate by the directors and, in the case of redemption or purchase of shares, a statement by the company’s auditor (both quoted in 3.7.6–3.7.7). ICAs Research Committee recommended a formal ‘going concern’ declaration in the annual accounts, with suitable comments by the auditor (McInnes 1993). All annual accounts are published on this basis, but the going concern status is merely implied, with the auditor obliged to draw attention only if the going concern status is not regarded as justified. Problems still arise in the context of private companies, since the majority of these neither file their accounts nor have them audited.

5.1.26 Our research takes a UK focus, but we are aware that creditor protection is also an issue across national borders. We have not addressed the cross-border implications of creditor protection. We are aware that there are important developments, particularly within Europe following enactment in the national laws amongst some Member States of the European Union of the ‘Model Law on Cross-Border Insolvency’, adopted in 1997 by the United Nations Commission on International Trade Law. Similarly, there have been developments in the common law on the basis of some important decisions in the courts. To pursue these issues would fall outside the goals of this study.
6. RECOMMENDATIONS

A number of suggestions have been made in the course of this report. It will be helpful to bring these together in one place. They mainly rest upon a few basic principles that recur in the report, and are listed first.

(i) The first of these principles is that the interplay of unfettered market forces is insufficient to protect the interests of creditors, although these people can do a lot to avoid losses. Few people would dispute this proposition, but there is scope for debate over the most effective form of regulation. We accept that companies can signal their intentions, at least in part, by the way they exercise the choices available to them. Thus, small companies can decide whether to publish full sets of audited accounts, or unaudited accounts, or abbreviated accounts. They can also decide whether to present these to members at formal annual general meetings. We propose to extend a further measure of choice. Rather than filing abbreviated accounts, we would permit directors to file a solvency statement instead. This offers further scope for moral hazard (in that dishonest and negligent directors could make such a statement untruthfully), but we doubt that the present system affords great reassurance.

(ii) Current capital maintenance rules are complex and ineffective, as is the law on distributions. The European Commission doubts that the law as stated in the Second Directive entails substantial cash expense or limits dividend decisions. This seems to us to miss the point. Nothing but harm can come from spurious rules that fail to do what they purport to do. They create a fog of uncertainty that raises the cost of credit transactions and diverts attention from the issues that really matter. For example, there is no point in the rule that insists on a general meeting of the company if half its capital is lost.

(iii) One recurrent problem is how to know what debtor companies are doing with credit extended to them. It is hard to tell this in respect to a particular loan, and it is just as hard in respect of the overall trading results of the corporate borrower as reflected in published accounts. We have been very critical of financial reports as a source of information for creditors, particularly where small and medium-sized companies are involved. It is open to directors to improve communications with members and creditors, and it is clear that some companies choose to do so. This process is harmed, however, if the standard forms of communication are misleading.

(iv) There is an important role for solvency statements, in addition to the limited circumstances in which they are already required under company and insolvency law. We see them as having a valuable role in the context of public companies when they make distributions. It makes sense to extend this requirement also to large private companies. But many small and medium-sized companies do not make distributions. Solvency statements are particularly important for such companies, and we suggest they should be made by directors and filed their annual returns. Indeed, they could replace the need for abbreviated accounts to be filed, if companies wished.

(v) Solvency statements need to be made by directors on the basis of internal reports on cash flow forecasts, taking into consideration the main threats and opportunities open to the company. Directors need to document the evidence on which they base their statements. We accept that this offers scope for moral hazard. A rogue director will not hesitate to sign a solvency statement which is dishonest or negligent, but the process will be de-mystified. Practice will become established to guide directors as to what the statements require. No doubt, some will seek to justify their actions, if challenged, on the basis of fanciful cash flow forecasts. But there will no longer be any doubt as to the basis for the legal rule. It will also be important to develop further guidance on how to anticipate financial threats and how to respond to them.
(vi) As regards insolvency law, our main concern is that there is a marked mismatch at present between the public benefits served by actual and threatened formal actions and the way that costs are borne (mainly, by shareholders and unsecured creditors, and under some circumstances by office-holding insolvency practitioners). Current rules discourage participation in the formal recovery process, particularly by unsecured creditors. While rules to set aside a 'prescribed part' for their protection are intended to make it worth their while supporting creditors meetings, it appears that there is still too little incentive for unsecured creditors to do so. Indeed, secured creditors often see little point in doing so, either. Present incentives are often perverse in this respect both for creditors and also for office holders who must decide whether there are grounds to continue trading and also to investigate directors’ responsibilities.

We recommend:

R1. General purpose accounts: we have made some severe criticisms of published accounts for use in creditor protection (see 2.3, and in particular 2.3.20). Some of the people interviewed have suggested we were unduly critical, but they usually had in mind the more extensive disclosures made by public – and in particular, listed – companies. The term ‘general purpose’ implies that the accounts are not sufficient for any specific purpose, but will always need augmentation. Indeed, it is not obvious that the term ‘general purpose’ has any meaning at all. On the other hand, there seems to be wide agreement that creditor protection is one of the principal aims of published accounts. We doubt that they serve this purpose effectively. Accounting principles no doubt need further development; for example, we note that Canadian legislation seems to specify the use of (estimated) realisable values to test for solvency (2.7.8), which may not perform the task of the cash forecast but gets closer to it. Performance reporting seems to make quite different demands from creditor protection. The specific interests of shareholders diverge from those of creditors, depending to a great extent on how far the company is a going, rather than a ‘gone’, concern (noted in 2.4.4, 3.2.4 and 4.5.14).

R2. Companies need to publish accounts more generally: we find it alarming that important user groups, particularly the BBA and the ICM (2.2.14 and 2.2.15), are making less use of the accounts produced by small companies since thresholds were raised in 1994 and subsequently. It seems to us (and to some of those we interviewed) that the thresholds are now too high, so that too few companies are publishing meaningful financial statements.

R3. There is need for audit more generally: raising the disclosure threshold seems to be accompanied by a lowering of disclosure quality (judging from the 2006 POBA report, for example, cited in 2.2.15). There seems to us to be a strong case for lowering the threshold at which audit exemption is granted, as well as that for filing full accounts.

R4. We accept the recommendation in the Rickford Report that solvency certificates should be issued with distributions, rather than filed annually, by all public companies, and we would add large private companies that publish audited accounts (3.1.5).

R5. Solvency statements are needed in place of accounts/audit for private companies. Abbreviated accounts, in particular, convey little information (2.2.8 and 2.2.9). Political pressure for deregulation may prevent thresholds from being lowered, as we recommend in R3 above. In this case, a new trade-off could be established. Companies that do not publish and file a full set of audited accounts should be allowed to file a solvency statement in their place with the annual return (1.2, 2.8.6, 3.1.12, 3.2.7, 3.2.15, 5.1.8 and 5.1.18). Much has been written above in this report about the value of solvency statements issued by directors. We accept that they are judgemental, perhaps even more so than the accounts. Moreover, survey evidence was against the principle in Australia, where such statements are in force (3.2.6). On the other hand, these statements directly address the issue of creditor protection, and it is very important for directors to be aware of the need for cash forecasts. When creditors’ funds are used, this need is all the greater. We have made reference to several different uses for solvency certificates under current law (2.7.23). We go further (3.1.7, notwithstanding our reservations in 2.5.5 and 2.8.10), and recommend that it should be possible for similar certificates to be filed annually, not in the context of distributions, with their return to Companies House by all companies that do not publish audited accounts. It would be permissible for the solvency statement to replace abbreviated accounts.

R6. Cash flow forecasts: such forecasts lie at the heart of our recommendations. On the other hand, we recognise that they raise a list of further considerations as to what form they should take, how they need to be prepared, and how they are to be used by the board (3.3, particularly 3.3.6):
Recommendations

(a) how much to publish: it is taken for granted that the contents of the cash flow forecasts will be confidential and unsuitable for publication. Only the solvency statement would be published, and this would be based upon the detailed contents of the internal forecasts;

(b) what form the forecasts should take (weekly/monthly/quarterly cash flows): this depends on the nature of the business. In some firms, monthly details are suitable as a basis for analysis, whereas a merchant bank may need forecasts of cash movements on an hourly basis;

(c) how much detail: again, there may need to be some variation, depending on the nature of the business. Some firms have regular patterns of receipts and expenditure, with little variation from one month to the next. This will help to determine how many lines the cash flow grid will need, just as the number of columns will depend in part on whether weekly or monthly figures are forecast. A major issue is whether directors need statements that present single (most likely) values or, alternatively, a range of estimates. Any estimates that are presented with associated probabilities are much harder to form and to support with verifiable evidence. However, contingencies are by definition uncertain to arise (and may also be uncertain as to amount), and it may be that they are best dealt with by supplementary sheets to augment the schedule of ‘most likely’ values;

(d) time horizon: we suggest that directors need to offer positive assurance for at least one year ahead, that the company will be able to meet its debts as they fall due in the coming year. They should issue negative assurance for the further future, that they have considered the evidence and formed the view that there is no material reason to doubt the ability of the company to meet its future commitments as they fall due for payment, out of resources that are available or expected to become available. A public company would make a positive declaration at the time of a distribution, as suggested in the Rickford Report. The form of declaration in CA 2006 s714 (3) (quoted in 2.8.7) seems appropriate for the short-term declaration, referring to a distribution by a public/large private company, and (suitably re-worded) for a private/medium company’s annual declaration;

(e) auditor and/or other professional involvement: this is undoubtedly a controversial issue, particularly since the majority of the companies with which we are most concerned are private companies with no obligation for an audit under existing law. There may be sufficient incentive for directors to seek an assurance statement on a voluntary basis, as we note in section 2.8.14. We recommend that the solvency statement would need to be reviewed in the light of the cash forecasts placed before the board. We would prefer it to be accompanied (both for public and private companies) by audit confirmation of the form used in s714 (5) (quoted in 2.8.8), but we accept that this principle is more contentious. The forecasts themselves would not be published or filed with the Companies Registry. We believe that the involvement of a qualified accountant would greatly increase the value of the solvency statement, either in the form of an audit or in confirming the solvency statement alone. While it would clearly be less costly if the reporting accountant had conducted an audit, since the extra work would then centre on reviewing the evidence laid before the board as the basis for the directors’ statement on solvency, this need not be the case. Indeed, solvency reviews may offer a new practice specialism (just as due diligence reports are not necessarily carried out by the auditor);

(f) frequency of board review: while annual submission by a private company of a solvency statement would imply yearly board review, this would often be too infrequent for prudence: we would suggest that the board would need to consider a solvency report at least quarterly, with supporting cash forecasts tabled each year. If there is any cause for concern over solvency, the board will need to consider both documents at every board meeting, perhaps convening more frequent meetings for the purpose. Attendance will be expected of the person who prepares the forecasts, who may be a director, an employee, or perhaps an advisor from a professional firm;

(g) the process as a discipline on board: even without audit confirmation, the solvency statement would serve to remind the board of the key importance of cash flows to the survival of the company. This would justify making it a requirement.
R7. Modifying directors’ duties and behaviour: we have worked from first principles in this report, and on this basis we have recommended (as have other authoritative commentators) a move away from capital maintenance protection as set out currently in company law towards reliance upon solvency certification based upon cash flow forecasts. We accept that this presents company directors with a new challenge (as commented by KPMG (2008), quoted in 3.2.14). It will prove its success, however, if it provides better creditor protection in the form of reduced losses, particularly to unsecured creditors (which class, of course, now includes HMRC). Given the uneven and irregular progress of business cycles, it is difficult to test this with time series data. The efficacy of EA 2002 has also been difficult to test rigorously, but useful evidence has been produced (eg, in the Insolvency Service 2008 Evaluation Report, cited in 4.2.9).

R8. Directors’ duties need to be re-defined: 2006 CA s172 has recently redefined directors’ duties, and it is too early to be sure what effects this will have. We commend Keay’s (2007) recommendation (in 3.1.9 and 4.10.3 above) to phrase directors’ duties in terms of responsibility to the entity and its success. This is consistent with CA 2006. It may be more realistic than describing the prime obligation as being to shareholders, and expecting this to switch at a somewhat indefinite point of time to creditors in the event of insolvency.

R9. Objective versus subjective tests need revised burdens and standards of proof: one of the major difficulties in bringing actions under IA 1986 is meeting the standards of proof demanded by the court (4.3.2). The common law tradition is to avoid second guessing business judgements made in good faith, for obvious reasons. But this tends to mean that the court will find against the directors only where their culpability is obvious. There may be a need to reconsider the balance both of the standards of proof and the burden (with the presumptions that the court will bring to a set of circumstances). Arguably, the objective standard of proof is more justifiable than the subjective standard (although it is notable that the definition of directors’ duties in s174 CA 2006 has adopted the dual approach from the IA 1986 – taking the higher of objective and subjective criteria). It may seem harsh to penalise directors on the grounds that they have a particularly high level of experience or qualifications, but as against that they may well have had some years of involvement with the company, and they are expected to know its business.

R10. The timing of onset of insolvency needs clarifying – West Mercia extended the responsibilities of directors to creditors when the company is approaching insolvency. We have suggested that, following Keay (2007), directors’ duties should be directed towards the entity, regardless of who holds the beneficial interest in it. However, this does not resolve the question how, or when, to consult the stakeholders when insolvency appears to threaten. There will, for example, still be conflicts of interest between groups of shareholders, groups of creditors, and between both these categories of stakeholder. For example, there may need to be mediation between those who wish to liquidate the company and those who wish to rescue it. The timing at which the company is recognised as entering insolvency will inevitably continue to be a key issue in corporate rescue and liquidation, and it must be continue to be important to an incoming office holder (4.5). While it was not possible to incorporate the West Mercia judgement into CA 2006 (as noted in 4.4.3–6 and 4.5.14), we urge further consideration and clearer guidance on the matter, relying on forecast cash flows.

R11. Administration should be seen as the standard gateway to take on insolvency: this was a proposal that we (and Sandra Frisby) made to the Insolvency service, in order to reduce complexity and costs in dealing with companies at or near insolvency (4.1.2 and 4.2.6–8). There appears to be support for this view, but there are no doubt problems still to resolve to make this a convenient cost-effective and even-handed procedure, in comparison with immediate liquidation and administrative receivership.

R12. CDDA 1986 undertakings should be linked more closely with IA 1986 actions (4.9.6 and 5.1.11, despite the reservations in 5.1.12): we recognise that the regime that has followed the introduction of CDDA undertakings has produced a useful interaction between the IS Disqualification Unit and directors reported under IA 1986. We are conscious that the purposes of IA 1986 and CDDA 1986 are different (the former being concerned with recovery of assets and the latter with future protection of investors and others). The procedures are also brought by different people (the office-holder in the case of the IA, and the Secretary of State in the case of the CDDA, albeit with some input from the officeholder). The time scales also differ, as do the rules concerning disclosure. To some extent, defence lawyers can play off the two proceedings against one another, which present some issues of moral hazard. The rights of the directors (individually and collectively) must in any case be respected, despite the difficulties of the company they have been running. The Disqualification Unit is focussed on disqualification or an undertaking, while
the office-holder is trying to arrive at a settlement in the interests of the creditors. Even so, we recommend that further links be explored between IA 1986 and CDDA 1986, since they potentially involve substantial duplication of investigation even if the two cannot be combined into a single process.

R13. The Disqualification Unit should monitor compliance with undertakings: it seems unsatisfactory that the Disqualification Unit does not do this at present (or with orders under CDDA 1986), or exercise investigatory powers over compliance (4.9.5–6 and 5.1.12).

R14. We suggest that there may be scope to develop the role of the Insolvency Service, perhaps along the lines seen recently in Australia (3.1.12, 3.2.5, 4.10.16 and 5.1.13). Additional resources would no doubt be needed, but we suggest that the pursuit of public policy objectives may well justify this.

R15. We understand that the New Zealand insolvency service has resources for funding actions, on a repayable basis, where the prospects of success appear good (4.8.7). We commend such a resource for use in the UK. Other possibilities may also exist for a more pro-active approach by the Insolvency Service in Britain.

R16. We agree with the suggestion for a Europe-wide prohibition on wrongful-trading (2.7.10 and 3.1.10), although the view is widely held that a single European regulation is not the best way to pursue this objective.

R17. Funding is in certain cases available in support of actions taken under IA 1986 and CA 2006, including some from commercial sources. However, there seems to be something of a vicious circle. Difficult standards and burden of proof, added to uncertainties over the costs and outcomes of trials (and of settlements) all make it very difficult to mount actions, particularly for office holders, and to secure the backing of creditors. There is scope for measures to encourage arbitration, to assist in the bringing of actions and to discourage vexatious behaviour, so as to lessen the friction that inhibits IA actions at present. The cost and availability of commercial funding and insurance (including D&O cover) are affected by the considerations above (see also 4.8).

R18. Altering priorities in respect of benefits and costs: while the public policy priorities are not for us to determine, we can see arguments for adjusting the balance of protection towards unsecured creditors somewhat further than the prescribed part has achieved so far (4.10.8). There may be a case to revisit the case for ‘super-priority’, although we are aware that this is an area in which changing current arrangements could prove both costly to introduce and liable to unintended consequences.

R19. Prescribed part: this at present seems too insignificant a measure to offer any serious aid to unsecured creditors (4.10.9). The cap of £600,000, in particular, seems low in those cases (typically, the larger ones) in which it might prove more useful. We note that IA 1986 intends to monitor the effects of the prescribed part, as announced in its 2008 Evaluation Report (4.2.9); as in R18 above, this is an area for public policy decisions.

R20. Office holder’s costs and ability to recover them: there are risks faced at present by office holders that do not seem to be justified on the grounds of equity or public interest (4.8). For example, part of the work performed is of a public interest nature (such as the s6 report under CDDA 1986), but is usually subsidised by the limited assets available from the company. There is scope to clarify and improve recovery from the court, and arguably also from the prescribed part or from public funds (as in recommendation R18 above). Office holders may find themselves unable to recover their own time costs (where, for example, they are a party to a legal action), and unable to secure insurance for such risks. Wrongful trading and preference actions present important public policy issues, for example in deciding whether the burden of proof should be upon the directors to prove solvency, or upon the office-holder to prove insolvency (confronted by the need to trace hidden assets and establish what the board knew or should have known some time earlier).

R21. Some actions only by office holders and in formal insolvency: IA fraudulent and wrongful trading actions may only be brought by office holders, once the company is in formal insolvency. The law is complex in this area. Consistency needs to be improved between the main procedures, of liquidation and administration, as to which recovery actions may be brought and by whom. There is no reason why, for example, administrators should not be able to bring ss213 and 214 actions. There may be scope for rationalisation as between IA and CA procedures.
R22. It is also worth investigating whether creditors might take more of a role in bringing actions, as under insolvent trading actions in Australia (3.2.6 and 5.1.16), although we accept that creditors are already able to bring some actions eg, under IA 1986 s423 (see 4.16.2). The practical difficulty in doing so is high standard of criminal proof required to establish fraudulent conduct, including proving intention, when the creditors will rarely have access to the detailed workings of the board and its management. As Keay (2007) observes (see 5.1.16 above), giving power to creditors to bring actions may enable them to protect their own interests, but it can also lead to vexatious actions and attempts for some creditors to put pressure on the directors at the expense of others.

R23. Creditors’ committees: it is clear that a properly functioning creditors’ committee is of great benefit to a formal insolvency procedure. However, it is often difficult to get creditors to act (4.8.3, 4.8.5, 4.8.9, 4.10.15 and 5.1.16). They often have little incentive (rather as individual holders of small parcels of shares see little incentive to attend company meetings). There could be scope for making the convening and decision-making more friendly to the creditors, for example by making more use of websites, the internet and/or mobile phones.

R24. Pre-packaged sales (4.11): it is inherently difficult to establish a fair and comprehensive value for the company under consideration, either before or after formal procedures are instituted. There may well be few credible bidders for the entire company or for substantial parts of it, and little time in which to conduct a public auction without destroying what value there remains. Often, the sale will be to incumbent management, although we have been told of a case in which a group of companies was sold back to the vendors of the individual companies that comprised the group. We commend the suggestions made by Stephen Davies (2006) (see 4.11.5), but there will inevitably remain problems in involving the office-holder on arm’s length terms from the outset. We welcome SIP 16, published after our draft report was submitted in May 2008.

We are conscious, in concluding this study, that the field of creditor protection is broad and complex. There are issues that we have deliberately refrained from investigating, such as the extensive literature on the predictive powers of different configurations of accounting income; cross-border legal procedures and protocols, within and beyond the borders of the European Union; and many points of detail, such as the best form of wording that might be framed for solvency certificates to be issued by public companies in the context of distributions and by private companies in the context of annual returns.

For example, we briefly discuss (in 2.1.11, 2.4.13, 2.5.4. 2.5.7, 3.3 – especially 3.3.6, 4.5.17 and 5.1.9) the information needed to construct cash forecasts to be used as the basis for these solvency statements, but we do not enter into the question of what needs to follow if the directors are not able to declare that they are confident that the company will be able to meet its obligations in the coming year. There is obviously scope for different levels of confidence to be expressed: that, for example, the board is ‘satisfied that the company will be able to meet its debts as they fall due’; that the board ‘believes the company will be able to meet its debts as they fall due – provided that the principal bankers continue to extend credit facilities as in recent years’, or perhaps – ‘provided that the debtors continue to meet their obligations as in recent years’, or perhaps – ‘provided planned refinancing is successful’ – and so on. There is scope for a fuller range of messages than simply ‘yes, the company can meet its debts’ or ‘no, the company cannot’.

We hope that this report will stimulate interest in this fascinating area of accountancy and legal practice.
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