Insolvency and Corporate Governance Consultation
R3 response
June 2018

ABOUT R3

1. R3 is the trade association for the UK's insolvency, restructuring, advisory, and turnaround professionals. We represent licensed insolvency practitioners, lawyers, turnaround and restructuring experts, students, and others in the profession.

2. Our members work across the spectrum of the profession, from the global legal and accountancy firms through to smaller, local practices. Our members have direct experience of insolvencies and their impact on the UK economy and insolvent companies' stakeholders.

3. The insolvency, restructuring and turnaround profession is a vital part of the UK economy. The profession rescues businesses and jobs, creates the confidence to trade and lend by returning money fairly to creditors after insolvencies, investigates and disrupts fraud, and helps indebted individuals get back on their feet.

4. We have focused our response on those questions and themes in the consultation where we can provide answers based on our members' expertise, including their experience of dealing with directors and corporate governance issues.

5. R3 would be delighted to meet BEIS officials to discuss the points raised below in greater detail. If you would like to meet us or if you have any other queries, please contact R3's Public Affairs and Policy Officer, James Jeffreys, at james.jeffreys@r3.org.uk or on 020 7566 4220.

OVERVIEW

6. R3 welcomes the Government's focus on improving UK corporate governance and is pleased to have the opportunity to respond to this consultation.

7. While R3 supports some of the proposals within the Government's consultation document, including the proposal to allow the disqualification of directors of dissolved companies, R3 would caution the Government against introducing new legislative tools as opposed to fully examining the shortcomings and effectiveness of existing legislation and making changes and improvements, if necessary, to that instead. Introducing new tools on top of unchanged old ones will almost inevitably lead to confusion, inconsistency, unnecessary cost and overlap.

8. R3 is particularly concerned that the Government's consultation document contains reform proposals which would fundamentally change aspects of the UK corporate landscape and culture, undermining the "enterprise culture" the Government has promoted since before the turn of the century. It is not clear that the justification exists for these changes, and further consultation on the principles behind the suggested changes should take place with stakeholders before specific proposals are considered. Some of the proposals within the consultation could have a seriously negative impact on the UK's attractiveness as an environment for business rescue and investment relative to international peers.

9. The Government must also consider its corporate governance reform proposals in the context of other reform projects. In 2016, for example, the Insolvency Service launched a consultation on corporate insolvency reforms which could, if implemented, more effectively address the problems the Government is seeking to address than some of the proposals in this new consultation document. While R3 believes the specific details of the 2016 reforms could be improved and need further development[1], it is broadly supportive of the principles behind the proposals.

10. This consultation is one of a number published recently which relate to insolvency procedures and director roles and responsibilities. Other projects include (but are not limited to) the 2016 consultation on corporate insolvency framework reform, and the 2018 consultations on airline insolvencies and tax abuse. This year has also seen the publication of the Government's Defined Benefit Pensions White Paper ('Protecting Defined Benefit Pension Schemes') which included several proposals for new powers for The Pensions Regulator in relation to the directors of pension scheme sponsors. While the consultations share themes and identify some of the same issues, they do not obviously link together in their proposed solutions and this consultation has been launched before other reform proposals have made much progress. A more joined-up approach to policy-making would be welcomed by the insolvency and restructuring profession and wider business community. An ad hoc approach to policy making will undermine the effectiveness of the overall insolvency and restructuring framework.

11. The Government's consultation document touches on, but does not fully address, a number of much broader themes, including: the existing rescue options available to distressed companies; the existing powers available to office holders, and the effectiveness and use of these powers; director skillsets and director awareness of duties and responsibilities; and the funding available to companies in financial distress. Addressing these areas would help resolve the issues the Government is considering in this consultation but potentially without the same problematic consequences.

[1] R3 response to the 2016 call for evidence on corporate insolvency framework reform
https://www.r3.org.uk/media/Corporate_Insolvency_Consultation1.pdf

SALES OF BUSINESSES IN DISTRESS

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

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

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

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

Introduction

12. R3 understands the changes in director behaviour the Government is seeking via the ‘sales of businesses in distress’ proposal, but there are very serious concerns regarding the impact the proposal may have on UK business sales, investment, and rescue. The proposal would change director behaviour, but this may not have positive consequences for insolvent subsidiaries’ creditors or wider stakeholders. R3 would not support this proposal’s introduction.

13. If the Government is seeking to improve director accountability and ensure that stakeholder interests are protected in subsidiary sales, there are alternative measures which could be considered which would not have the same detrimental impact as the consultation proposal. The Government may wish to look at existing powers for redress available to office holders and review whether these are operating as effectively as possible. The Government should also push forward with the measures proposed in the Insolvency Service’s 2016 consultation, ‘A Review of the Corporate Insolvency Framework’. These proposals would increase the transparency and accountability of restructurings and insolvent subsidiary sales and could ensure that stakeholder interests are protected by the courts and insolvency practitioners. Additionally, the Government may wish to further explore ways to improve rescue funding beyond those ideas put forward in the 2016 consultation; reforms would improve the funding options available to financially distressed companies.

Concerns with the Proposal

14. Under this proposal, directors of a holding company which sells an ‘insolvent’ subsidiary that later enters an insolvency procedure may be required to contribute a sum towards their ex-subsidiary’s creditors and may be liable for disqualification. This would make directors personally liable for a business’s success or failure in a way they would not necessarily be if they ran the business, and in a way which challenges the concept of limited liability and the corporate veil. These new liabilities could have a serious impact on directors’ willingness to seek a sale for a struggling subsidiary, risking job losses, creditor losses and greater damage to stakeholder interests.

15. If the proposal were to be introduced, the new powers could prove difficult and costly to use in practice. In particular, it could be very difficult to demonstrate that the ‘selling’ director or

directors “could not have reasonably believed that the sale would lead to a better outcome for those creditors than placing [the subsidiary] into administration or liquidation.”

16. At the same time, aspects of the proposal are very broad: acting “unreasonably” and “harm caused to stakeholders from the sale” are hard to specify and could capture a range of actions or ‘harms’.

17. The potential scope of the wrongdoing and the potential difficulty in actually exercising the power would compound its problems: on the one hand, the risk of exposure to significant post-sale liabilities may prevent valid subsidiary sales outside of insolvency procedures; on the other, the power may end up bringing very little value into the estates of insolvent ex-subsidiaries.

18. Moreover, it would be possible for a particularly determined director to continue with the sale of a subsidiary outside of an insolvency procedure and still fall outside the scope of the proposed reform. A sale planned sufficiently in advance of any expected financial difficulties may see an ex-subsidiary enter an insolvency procedure outside of the two year period proposed by the Government.

19. Requiring a parent company’s directors to consider the future viability of a subsidiary creates a conflict for the directors between their responsibilities to the parent company’s creditors (whose position may be worsened by the failure to maximise the value of the sale of an insolvent subsidiary) and the interests of the subsidiary’s stakeholders, including those unknown parties who may not even have been a subsidiary’s stakeholder at the time of its sale.

How would the proposal change behaviour?

20. R3 understands that the purpose of this proposal is to change the behaviour of holding or parent company directors so that they consider the interests of stakeholders when a subsidiary is sold. This is a laudable goal but, while this particular proposal would be likely to change directors’ behaviour, it may not necessarily be positive for creditors, other stakeholders, or the wider UK business landscape. Consideration for wider stakeholders could come at considerable cost.

21. The introduction of the power would create a significant incentive for a parent company’s directors to close down an under-performing subsidiary rather than seek a sale outside of an insolvency procedure: the latter option would potentially lift the corporate veil, exposing the parent company and its directors to risk, which the former option avoids. R3 members have commented that this would be an important factor in the advice they give in such situations.

22. While the insolvency profession is well aware of the value of insolvency procedures and their use in distressed business rescue and for creditor protection, they are also very alert to the fact that these are not always the optimal solutions in every scenario. Alternatives to insolvency procedures as a means for achieving the sale of distressed subsidiaries should remain available to parent companies.

23. There are several downsides to forcing the use of insolvency procedures to deal with insolvent or near-insolvent subsidiaries, particularly where there is a chance the subsidiary could have been a post-sale success.

24. If the subsidiary were to close as a result of an insolvency procedure, there may be job losses and a significant negative impact on the subsidiary's supply chain. If the subsidiary's business were to be sold through an insolvency procedure, there is a risk that the act of placing the subsidiary into insolvency would undermine the business's goodwill sale value and the potential returns to creditors. There may be an increase in the use of 'pre-pack' administration sales as parent company shareholders and directors seek to avoid incurring the liabilities of a share sale of a subsidiary outside an insolvency procedure while seeking to minimise the impact of administration on the value of the subsidiary's business.

25. Additionally, there would also be the opportunity cost to the economy of not exploring the possibility of a sale outside of an insolvency procedure which may have given the subsidiary a better chance of succeeding.

26. By limiting options for selling subsidiaries, the proposal would not only make business rescue more difficult, but could also weaken appetite for investment and innovation. A key part of any investment plan is the exit route, but more difficult 'exiting' a subsidiary becomes for parent company shareholders and directors, the less likely it is that subsidiaries would be set up, invested in or acquired in the first place. This may make it more difficult for businesses to develop new products or manage risk, harming enterprise.

27. Under the proposal, sales through administration would create an inconsistency which may undermine the purpose of the reform in the first place. While a director selling a subsidiary by way of a share sale outside of administration would be liable for the subsidiary's future performance and there would be a requirement to consider the impact of the sale on stakeholders, this would not be the case in an insolvency procedure. Here, office holders are required to sell the subsidiary's business and assets in a manner which achieves the best possible deal for the subsidiary's body of creditors – without consideration for the future viability of the subsidiary's business.

28. While R3 does not believe the new measure should be introduced, it is worth noting that the proposed measure itself may also be seen as inconsistent: there is no reason why it should apply only to subsidiaries insolvent at the time of sale; 'inappropriate' sales may also occur with solvent sales.

Alternatives

29. Broadly, there are two alternatives to the measures proposed in the consultation. These alternatives would increase director accountability in a more proportionate way and would also increase scrutiny of proposed sales.

30. The first approach would be to review parts of the existing legislation. While the scope of the Government's proposal is too broad and would create too much risk for directors of parent companies, there are specific situations where the office holder for an insolvent former subsidiary may pursue a claim against a director or directors of the subsidiary's former parent company. These can include claims for wrongful trading or misfeasance, if, for example, the office holder can show that the parent company directors, acting as shadow or controlling directors of the subsidiary, caused detriment to creditors by failing to place the subsidiary into an insolvency procedure at the time of its sale. Office holders may also have the opportunity to explore non-Insolvency Act 1986 actions if, for example, the parent company directors misled the purchasers of the subsidiary as to the true state of the subsidiary's financial health.

31. Difficulties in exercising the existing powers are explored in more detail in paragraphs 49 to 63 below. If the Government were to review the existing powers, any changes must abide by the principle that a director is not responsible for the actions taken by a subsidiary once it has been sold.

32. The second approach would be to introduce the measures put forward in the May 2016 'Review of the Corporate Insolvency Framework' document, published by the Insolvency Service (subject to further development of these proposals). Among relevant measures in this call for evidence were plans for a business rescue moratorium and a court-based restructuring tool.

33. Both procedures would allow for a structured, transparent and, in the case of the proposed restructuring tool, court-sanctioned sale of an insolvent subsidiary. The added transparency and scrutiny provided by these procedures should help improve corporate governance in insolvency situations. The success of these tools would depend, in part, on them not being perceived as 'insolvency' procedures but as restructuring processes, thereby avoiding the value loss which can be associated with administration.

34. As per paragraphs 22 to 25, the difficulties in using existing insolvency procedures to achieve a successful sale of an insolvent company's business (outside of a pre-pack) emphasise the need for reform. R3 members have remarked that it is increasingly rare for there to be a successful 'traditional' trading administration as a result of factors including: increasing personal liability risks for office holders (from which directors are shielded pre-insolvency); the reputational or value impact of being in an insolvency procedure on the company and its business; and the difficulty in funding a business to trade through an insolvency procedure. While the Government was right not to take further the specific funding reforms outlined in its 2016 consultation, R3 would encourage the Government to continue to look into ways to improve the funding of insolvency procedures and rescue funding in general.

VALUE EXTRACTION SCHEMES

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

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

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

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

Introduction

35. R3 understands the Government's concerns and agrees that it can be frustrating when connected parties are not perceived to have experienced the same level of negative consequences from an insolvency as other stakeholders.

36. However, R3 members have expressed concerns that the powers outlined in the 'Value Extraction' proposal would have a negative effect on business rescue and investment. As with the 'Sales of Businesses in Distress' proposals, the new powers could be off-putting for rescue investors and could be hard to use in practice.

37. This proposal touches on a number of broad issues, such as funding for distressed companies, the fairness of the current system of distributing returns to creditors, and the effectiveness of the existing framework for challenging transactions and director behaviour post-insolvency. Singling out post-investment insolvencies and creating new powers on top of old ones could lead to confusion, inconsistency, and unnecessary overlaps – as well as damaging appetite for investment. This specific proposal would also do little to tackle the aforementioned underlying issues. Instead, it would be better for the Government to conduct reforms in a holistic manner: any changes should be consistent across the insolvency framework and made with reference to the broader challenges identified above.

38. For example, while the Government's proposal to remove the 'insolvency test' may be worth exploring, its removal in only some circumstances would create significant inconsistencies in the insolvency framework while making significant changes to the principles upon which the framework rests. Consideration would need to be given to whether the change could apply to other circumstances and what new threshold 'test' would need to be met for action to take place. Much more in-depth consultation is required so that the implications of any change can be understood.

39. Rather than proceeding with this proposal, the Government should instead update and improve existing parts of the insolvency and restructuring framework, and it should consider how the 2016 corporate insolvency framework reform proposals could address some of the concerns it is looking to resolve.

40. R3 believes that legitimate business rescue attempts, and the risks involved in these efforts, must be suitably rewarded. Management fees and similar payments can be examples of legitimate reward. The proposals contained within this consultation would be perceived by investors as increasing the risk and complexity of business rescue, and would thus make business rescue and related investment less likely. Even where an appetite to invest remained, added complexity would slow down the practical provision of financial support required by distressed companies in fast-moving situations, potentially leading to missed opportunities for rescue.

Key principles

41. When considering reforms to protect against illegitimate 'value extraction', the Government should bear in mind two key principles: genuine risk and value-added work must be rewarded; and secured lending to a company should be honoured, whether by a connected party or not, as per the protections offered to floating charges in S.245 of the Insolvency Act 1986 (although questions around the conversion of investment, debt, or unsecured loans to a secured loan could be further explored).

Concerns

42. Briefly, R3's key concerns with this proposal are that it would create significant added risk for the lenders and investors which are often the only option for financially distressed companies with a chance of survival and future success. This would increase the complexity and risk of lending and investing in distressed situations and would decrease the chances of business rescue (as outlined in paragraph 40).

43. Creating new powers which single out investors and those involved in business rescue may create a negative perception of the UK's friendliness to investment and business rescue.

44. Fully removing the 'insolvency test' in some circumstances would create inconsistency and would be a missed opportunity to explore ways to make improvements to the whole insolvency and restructuring framework which could be of benefit for creditors and other stakeholders (and which would avoid singling out investors for special treatment).

45. Many of the actions and behaviours which this part of the consultation is seeking to address are covered by existing legislation. Transactions at an under value, preferential treatment, or misfeasance following an investment are still transactions at an under value, preferential treatment or misfeasance whether they follow an investment or not. The problem is not that the existing legislation does not cover the issues identified in the consultation, but that the existing legislation can be difficult to use or has not been updated in line with changes to the business and funding landscape.

The existing framework and other challenges

46. As set out in the introduction to this section, the issue the Government is trying to address with this proposal (that some stakeholders are protected from the impact of an insolvency in a way other stakeholders are not) is a symptom of several different problems. Resolving any of these problems may go some way towards making 'value extraction' and instances of perceived 'unfairness' less likely, or may at least remove the perceived need for new powers to tackle these problems.

47. One key issue is the availability of funding for distressed companies. The relative lack of funding options means that directors often have little choice but to seek support from the sources of 'high cost' lending or investment the Government is seemingly targeting with this proposal (this is not to say that these sources of lending or investment are automatically problematic: they can be a very effective means of supporting and turning around a financially distressed company). Improving distressed funding options could reduce the costs associated with distressed borrowing.

48. The second key issue is the perception that the returns to 'value extractors' are unfair when compared to the returns to unsecured creditors, or that the impact of an insolvency is worse for other stakeholders than it is for investors. As above, it is important to recognise that those lending to or investing in distressed companies are taking a significant risk in providing new financial support and are an important part of the rescue landscape. As suggested in paragraphs 100 to 109, one option for managing the perception of 'unfairness' may be to increase the size of the Prescribed Part so that unsecured creditor repayments can be improved where possible (this may not be an option in all cases). Importantly, mechanisms for ensuring distributions to creditors are fair are already available in the existing framework. Rather than introducing new tools, the Government should examine why the existing tools may not be working as intended.

Alternatives to the proposal

49. Existing parts of the insolvency and restructuring framework which could help tackle 'value extraction' include (but are not limited to) S.212 (remedy against delinquent directors), S.238 (transactions at an undervalue), S.239 (preferences), S.423 (transactions defrauding creditors), and S.244 (extortionate credit transactions) of the 1986 Insolvency Act. R3 members have said that these powers are relatively under-used as a result of practical difficulties.

50. The key factors which can impede the use of the existing powers are: the 'insolvency test' where it applies, as this can be too high a hurdle to overcome; time limits and 'look back' periods where these apply, as transactions and restructurings can be arranged to avoid these; the funding available for making claims, particularly where there are no assets left in an insolvent company to pay for litigation; case law moving powers away from their original intention; the difficulty of applying these powers to 'new' features of the business landscape which have emerged since 1986; and the office holder's willingness and resources to litigate.

(a) *The 'insolvency test' and 'look back' periods*

51. The Government is right to note that the 'insolvency test' which applies for S.238 and S.239[2] could be an issue with regards its 'value extraction' proposals; resolving the 'insolvency test' is one of the key challenges in bringing *any* S.238 or S.239 claim. Rather than create a carve-out for one specific type of behaviour, it would be more worthwhile for the Government to examine ways to improve the use of insolvency practitioners' powers to tackle all types of misbehaviour and to improve returns to creditors. This would help improve both director behaviour and redress for creditors across the board.

52. Removing the 'insolvency test' from S.238 and S.239 would certainly make it easier to challenge any examples of 'value extraction' (such as management fees, interest payments,

[2] As outlined in S.240, the requirement to show that a transaction or preference contributed to an insolvency, or that the company was insolvent at the time of a transaction

and other charges), or other transactions at an under value, or preferences, without the need for new powers. The removal of the ‘insolvency test’ in administrations and liquidations would also bring the procedures into line with bankruptcy, where the ‘insolvency test’ only operates between two and five years before the insolvency, and where any transaction in the two years prior to the insolvency may be challenged without reference to the test.

53. However, removing or altering the ‘insolvency test’ would be a significant change to the insolvency and restructuring framework. In order to provide certainty for directors and investors, there must be a clear threshold ‘test’ which needs to be met before a challenge to directors’ actions can be made. While there is value in looking at ways to improve or update the ‘insolvency test’, any changes must be very carefully considered.

54. The ‘insolvency test’ cannot be reviewed without reference to the ‘look back’ provisions. R3 members have referred to cases where, even though a claim would otherwise have met the ‘insolvency test’, directors have taken an action or structured a payment or restructuring in such a way that they fall outside the ‘look back’ period. Removing or amending the ‘insolvency test’ may not make much difference if it is not done alongside a review of the ‘look back’ provisions.

(b) Updating existing provisions

55. It is worth noting that while parts of the Insolvency Act 1986 have seen relatively little change since they were introduced, the business and funding landscape in which the Act sits has developed significantly over three decades. For example, while S.244 (extortionate transactions) may deal effectively with ‘traditional’ bank lending, it may need to be adapted to take into consideration the new types of funding practices (from lending to investing) which have emerged since the 1980s. The section could be updated to better cover unjustified management or termination fees, for example.

56. Additionally, while the Act itself is little changed, case law over the past thirty years has gradually reduced the scope of some office holder powers or has moved powers away from their original intention. For example, cases such as *Re MC Bacon Ltd.* or *Re Ralls Builders Ltd.* have had a significant impact on the scope and ease of use of preferences and wrongful trading powers. The Government should consider reviewing the existing legislation in light of case law changes to make sure it remains fit for purpose.

(c) Funding issues

57. One reason given by R3 members for the under-use of their existing powers is that it can be difficult to fund claims. This issue would not be fixed by the ‘value extraction’ proposal and would remain a problem. Creditor representatives and R3 members have commented on the fact that while an office holder may be willing to pursue a claim, there may not be the support or funding from creditors to do so.

58. One potential reform which could help ease funding issues would be to restore the exemption for insolvency litigation from the Legal Aid, Sentencing and Punishment of Offenders Act 2012 (which ended in 2016). This exemption allowed successful litigants in insolvency cases to reclaim, in full, the costs of Conditional Fee Arrangement (CFA) uplifts and After-the-Event insurance premiums from losing defendants. This meant that litigation to retrieve money owed or belonging to an insolvent estate could be funded even when

there was no money in an estate to fund the claim to begin with. Without the exemption, and where value has been completely 'extracted' from a company, it can be more difficult to fund the use of office holders' powers.

59. R3 and others commissioned the University of Wolverhampton to investigate the use of CFA-backed litigation before the exemption ended. Published in April 2016, the research found that CFA-backed insolvency litigation pursued in 2014 involved claims whose value was likely to be in excess of £1bn, while the same type of litigation had realised approximately £500m for insolvent estates in the previous year.[3]

(d) Willingness to litigate

60. The use of office holder powers, assuming various tests and funding requirements can be met, depends on the willingness and ability of an office holder to use them and to conduct the investigations required to uncover the evidence needed to justify claims.

61. A significant proportion of insolvency cases each year are handled by the Official Receiver as the automatic trustee for compulsory liquidations and bankruptcies. While the Official Receiver may initiate a claim in its capacity as office holder, it may also appoint (on behalf of the Secretary of State) or agree to the appointment of an insolvency practitioner to act as liquidator instead. Increasing the rate at which insolvency practitioners are appointed to Official Receiver-held cases would significantly increase the capacity and resource available for the investigation of director conduct and pursuit of claims in response to misconduct. Helpfully, the insolvency profession is willing to undertake some investigatory work at its own cost (rather than at a cost to the taxpayer, as is the case with the Official Receiver) while insolvency practitioners are accountable to creditors and other stakeholders (fees must be approved by creditors, liquidator reports must be published regularly, and insolvency practitioners are regulated and licensed). In the period 2009-2015, the Official Receiver retained an average of 81% of new compulsory liquidations per year[4] – lowering this percentage would reduce pressure on the Official Receiver's own investigations resources while increasing the overall resources available for investigations work and the pursuit of claims.

62. As noted in the Insolvency Service's 2016-17 annual report[5], key risks for the organisation include an inability to recruit or retain staff in high importance roles (leading to the use of interim staff or contractors to fill gaps in "business-critical roles"), while cases were outsourced to allow resources to be dedicated to the BHS investigation. The appointment of insolvency practitioners to cases held by the Official Receiver could help manage any resource and staffing constraints (the 'outsourcing' of case work mentioned in the report is unlikely to involve the appointment of insolvency practitioners as office holders).

63. The appointment of insolvency practitioners to act as liquidators can be supported across government: government departments and agencies are often significant creditors in insolvency procedures and may be significant beneficiaries of any office holder claim against directors or others. As creditors, government departments and agencies should be

[3] 'Insolvency Litigation and the Jackson Reforms – An Update' – https://www.r3.org.uk/media/documents/policy/research_reports/bus_distress_index/Insolvency_Litigation_and_the_Jackson_Reforms_-_An_Update_April_2016_FINAL.pdf
[4] Insolvency Service FOIA Request 2286, 25 August 2016
[5] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/627605/annual_report_2016-2017_-_final-web.pdf, pgs. 40-41

encouraged to seek the appointment of an insolvency practitioner as an office holder where appropriate in compulsory liquidations (and bankruptcies).

Other Reforms

64. As noted elsewhere in this response, the Government should consider the proposed reforms in this consultation in the context of its 2016 consultation on corporate insolvency framework reform. A number of proposals within that consultation would boost the transparency of restructuring plans, in particular the new court-based restructuring tool, and would allow the validity of proposals to be assessed before they are put in place. This could help prevent restructurings or new investment which may later be seen as purely an opportunity for 'value extraction' rather than an attempt to support business rescue.

Other

65. While R3 does not support the specific proposal, it is important that any reforms do define key concepts such as 'unfair' and 'excessive' rather than leave definitions to the courts (as per question 8 of the consultation document). This would ensure a level playing field and reduce uncertainty once the reforms have been introduced without having to wait for precedent to be set.

DISSOLVED COMPANIES

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

Q10. Do you agree that director conduct in a dissolved company should be brought within the scope of the Secretary of State's investigatory powers? Do you have any other comments on the proposal?

Introduction

66. R3 welcomes the Government's attention to the use of dissolutions to avoid scrutiny and liabilities. R3 agrees that this is a problem.

67. R3 agrees that director conduct in a dissolved company should be brought within the scope of the Secretary of State's investigatory powers.

68. R3 does have concerns that increasing the number of directors brought within the scope of the Secretary of State's investigatory powers may create a resource challenge for the Insolvency Service. It is important that investigations into directors of dissolved companies do not come at the expense of investigations into directors of insolvent companies.

69. R3 believes there are several other ways in which the Government could make it harder to use dissolutions as a means of avoiding scrutiny, including making the restoration of a dissolved company to the Companies House register an administrative process rather than a court-based process.

70. R3 would urge the Government to consider how it can work with the insolvency and restructuring profession to investigate the conduct of directors of dissolved companies, and would welcome recognition by the Government of the profession's work in this area.

Increasing scrutiny of dissolutions

71. There are legitimate reasons why a company may be dissolved without having previously been through an insolvency procedure.

72. However, in the insolvency and restructuring profession's experience, dissolution can often be used by directors seeking to avoid the scrutiny of an insolvency procedure (or Members Voluntary Liquidation – MVL) and to avoid repaying liabilities.

73. Between April 2012 and the end of March 2017[6], there were 280 High Court orders for the restoration of a dissolved company to the register and its simultaneous liquidation. This does not include companies which were restored and liquidated in separate orders.

74. R3 does not believe that these 280 High Court orders constitute the full extent of companies which should have been put through an insolvency procedure before being dissolved: these are just the companies which have been picked up by the insolvency profession and creditors. There are likely to be many other companies which have escaped the scrutiny of an insolvency process, and there will be directors who have consequently escaped a review of their conduct.

[6] Ministry of Justice, FOIA Request 171020005, 16 November 2017

75. R3 believes that the introduction of the powers proposed in this section of the consultation would create an incentive for directors to use MVLs or Creditors Voluntary Liquidations (CVLs) to ensure their company's affairs are resolved in a transparent manner and to have their conduct checked by an insolvency practitioner. R3 welcomes this.

Other options for reform

76. While R3 supports the Government's proposal, this would only be a partial solution to the use of dissolutions to avoid scrutiny: a dissolved company's director may end up being disqualified, but creditors may still be left out of pocket in the absence of an insolvency procedure and a distribution of dividends (there may also be situations where a director's conduct merits disqualification but where an insolvency procedure may be inappropriate).

77. As well as introducing its proposed reform, the Government should also make it easier and less costly for creditors and the insolvency profession to restore a company so that it can be placed into an insolvency procedure and the company's assets realised for the benefit of creditors.

78. At the moment, there is a significant asymmetry between the cost to a director of avoiding scrutiny and the cost to the insolvency profession and creditors of putting things right. Whereas dissolution is an administrative process (it is either automatic following the failure to file accounts or can follow a £10 payment and the filing of a DS01 form by a director), restoration requires an application to court. This can be costly in terms of both time and money, and thus all too easily allows directors to create a significant barrier to investigating their conduct. While creditors have the opportunity to object to a dissolution and there are sanctions associated with misuse of the dissolution process or the failure to file accounts, R3 members report that these do not stop directors keen to avoid the spotlight.

79. To resolve this issue, the Government should remove the asymmetry described above and the restoration of a company should become an administrative process. This could be triggered by a company director or creditor once suitable requirements have been met (such as producing evidence of an unpaid debt or a commitment to petition for the winding-up of the restored company) and any fee for doing so should be similar to the cost of dissolving a company.

80. Where work has been carried out by an insolvency practitioner in preparation for the restoration of an insolvent dissolved company (for example, working with creditors to find evidence of unpaid debts), the insolvency practitioner should be appointed as the office holder in any subsequent insolvency procedure. The prospect of not being appointed as the office holder in an insolvency procedure can be a disincentive for insolvency practitioners to carry out preparatory investigations. Alternatively, once a company is shown to have been insolvent and is restored, its directors could be required to begin a Creditors Voluntary Liquidation.

81. The Government could also consider raising the costs or penalties associated with dissolving a company. Directors of a dissolved company later restored and liquidated (because of undeclared outstanding debts) could face automatic disqualification, for example, while fines and penalties for missed filings could be increased.

82. R3's General Technical Committee has been exploring ways to prevent the abuse of the dissolution process throughout 2018, and has been considering reforms to S.216 (restriction

on re-use of company names) and S.217 (personal liability for debts, following contravention of S.216) of the Insolvency Act 1986. R3 would welcome the opportunity to work with the Insolvency Service to develop these ideas further.

Concerns

83. As above, while R3 supports the Government's proposal, increasing the pool of directors who may be subject to investigations could potentially create extra workload for the Insolvency Service. This would need to be adequately resourced.

84. Without adequate resource, there is a risk that investigations into the conduct of directors of dissolved companies may come at the expense of investigations into directors of insolvent companies. This would not improve corporate governance in the UK, but would simply shift scrutiny from one type of corporate governance failure to another.

85. R3 members have already expressed concerns to R3 that the Insolvency Service's investigation work is resource-constrained. They note that the annual number of director disqualifications is remarkably consistent regardless of the annual number of insolvency procedures[7], and that directors whose conduct they believe is questionable are not investigated following the submission of director conduct reports.

86. The Insolvency Service should make clear how it will resource any extra investigations work, and how it will ensure this work does not come at the expense of existing investigations.

[7] Between 1,210 and 1,282 directors have been disqualified each year in the five years from 2013-14 to 2017-18 https://www.gov.uk/government/statistics/insolvency-service-enforcement-outcomes-201819

STRENGTHENING CORPORATE GOVERNANCE IN PRE-INSOLVENCY SITUATIONS

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

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

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

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

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

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

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

Introduction

87. As outlined in the 'Overview', a fundamental issue related to the behaviours this consultation is seeking to tackle is the skillsets of the UK's directors and their understanding of their duties and responsibilities.

88. The insolvency and restructuring profession's experience of director capabilities is mixed. While there are some very capable directors, there are others who are ill-equipped to run companies or who do not fully understand their myriad responsibilities and duties.

89. While developing policies to tackle the consequences of director misconduct is one approach (as adopted by this consultation), the Government must also pay attention to the root causes of misconduct and should consider ways to improve the skills and knowledge of UK directors. This focus on prevention rather than cure would limit the damage done to UK plc by corporate governance failures.

90. R3's response to this part of the consultation will focus on Q.14, Q.15, Q.16, and Q17.

Director duties

91. R3 believes that directors' knowledge of their duties can be poor, and that while directors are expected to be aware of limitations in their knowledge and to seek professional advice where appropriate, many do not. This is particularly true where a company enters the 'zone of insolvency'.

92. The insolvency and restructuring profession recognises that there needs to be a trade-off between promoting entrepreneurialism and imposing controls on directors and how they run a company. In the profession's experience, however, the balance struck is not always the right one.

93. Limited liability affords individuals significant protections from the financial risks and other liabilities a company may incur. This protection comes at a very low cost: a limited company can be created for as little as £12, with no requirement for new directors to provide identification, and little requirement for new directors to show their responsibilities are understood – until it is too late and those responsibilities are breached. The protection on offer to entrepreneurs is welcome, but there is a question about whether this protection is too easy to obtain – and therefore too easy to abuse.

94. Where a company's financial problems have been long in the making, R3's members often report that company directors seek advice from an insolvency professional too late, or that advice isn't sought at all. A number of factors explain why this might be so, including (but not limited to):

    a. Directors may simply be unaware of their options or the true state of a company's finances;

    b. Directors are overly optimistic and believe that they can resolve a company's problems themselves; and

    c. Directors may be worried that speaking to an insolvency practitioner or restructuring expert may see them lose control of a company; they may be worried about the personal consequences of corporate insolvency (disqualification or potentially personal financial troubles); and they may also be worried about how a company's entry into an insolvency procedure might be perceived by colleagues, contacts, or friends and family.

95. In the profession's experience, the earlier advice is sought, the more options a company has and the more likely it is that it can avoid insolvency and the consequent creditor losses and negative impact on the company's supply chain, employees, and other stakeholders.

96. The existing provisions against wrongful trading may act as a trigger for directors to seek advice, although this advice may only be sought at the last moment. To improve the chances of early advice being sought, the Government may wish to look at the impact of some of the new approaches to corporate governance being taken overseas and consider whether they might be appropriate in the UK. Among overseas reforms, for example, legislative changes in South Africa have seen directors' duties broadened so that evidential rescue efforts must begin if insolvency is reasonably likely within the next six months. While R3 would not recommend introducing this change in the UK without fully assessing its impact in South Africa, it may be a useful case study.

97. The Government's own 2016 corporate insolvency framework reform proposals may also help incentivise directors to seek early advice. As above, directors may delay seeking advice because they worry about losing control of a company; under the Government's proposals for a moratorium, directors would retain control of a company while they seek advice and put a rescue plan together.

98. As the consultation notes, directors are already expected to consider whether they need to use professional advice, but they may not be aware of this expectation or they may not be aware they are at a point where advice is needed. The Government must explore ways to improve director awareness and education, and R3 would be happy to work with the Government to do this. One option could be to use directors' regular statutory interactions with Companies House as an opportunity to provide directors with information and reminders of their duties.

99. Finally, while director awareness of their duties and responsibilities to stakeholders and creditors should be improved, director awareness of their own responsibility for assessing the risk of trading with other companies could be improved, too. Commercial counterparties should take adequate measures to consider risk before providing services or goods on credit. An increased awareness of the risks of extending credit could help reduce the impact of insolvencies on other companies – and their creditors. Suppliers should always seek to understand exactly what exposure they are taking on when they supply goods or services on credit.

Smaller creditors and the Prescribed Part

100. While R3 would caution against making changes to the hierarchy of creditor repayments to specifically recognise SMEs (because of the risk of unintended consequences, including reducing returns to other unsecured creditors such as employees or the taxpayer), R3 does agree that the Government should consider reforming the Prescribed Part.

101. The Prescribed Part recognises an important principle that while secured creditors take priority, other creditors should see at least some money back.

102. The problem with the Prescribed Part is its lack of scaleability. In many cases, the Prescribed Part's £600,000 cap (and indeed the Prescribed Part itself) is irrelevant: there simply isn't enough money available to reach the cap or to make any sort of distribution to unsecured creditors. However, in those rarer cases where there are hundreds of thousands of pounds – if not millions – available to creditors, the Prescribed Part seems insubstantial. The cap is easily reached and money goes back to the floating charge holders, but still little is then available for the unsecured creditors after that.

103. Outcomes like these have a negative impact on the perception of the UK's insolvency and restructuring framework. It's true that, in order to encourage lending, floating charge holders should occupy a higher position in the order of priority than others. But it can be questioned whether that high position should come so far at the expense of unsecured creditors. Even a little bit of extra money back for an unsecured creditor – whether a small business or a consumer – is probably worth proportionately more than it would be for a floating charge holder.

104. There are other arguments in favour of, at the very least, increasing the Prescribed Part cap. Inflation is one example. Set at £600,000 since 2003, the Prescribed Part cap has not increased since. Had the cap been tied to inflation, it would be over £900,000 today.

105. However, a simple inflationary increase would not address the arbitrary nature of the Prescribed Part: there would still be a sudden cut-off in those cases where the cap is easily reached.

106. The Government must also avoid making changes to the Prescribed Part which would be seriously detrimental to floating change holders.

107. Rather than maintaining a fixed cap, the Government could consider introducing a tapered one. Under such a system, the value of the Prescribed Part would remain low in proportion to the total money available to floating charge holders, but proportionately higher compared to what could otherwise be repaid to unsecured creditors. While increasing the Prescribed Part would mean less money back to floating charge holders, the relative loss would be low.

108. For example, the Prescribed Part could be amended so that, subject to the total assets available for the Prescribed Part exceeding £25,000, the Prescribed Part would be worth 50% of the first £25,000 of net floating charge realisations; then a further 25% on realisations between £25,000 and £3,000,000; then 10% on realisations between £3,000,000 and £6,000,000; then 5% on any remainder. Under this scenario, a taper would mean, in very large cases, a Prescribed Part several times higher than it is now, but still a relatively low proportion of the money available to floating charge holders.

109. The Government should consult further on any changes to the Prescribed Part, especially with those creditors likely to be left worse off by any changes. An empirical analysis of the use of the Prescribed Part would help. R3 would be pleased to discuss any proposals with officials.

Other areas for improvement – fraud

110. Where there is a breakdown in corporate governance and directors are guilty of negligence or misfeasance, the insolvency and restructuring profession can play a significant role in investigating conduct, seeking redress for creditors, and disrupting further attempts at wrongdoing.

111. The insolvency profession has a significant toolkit of powers for tackling fraud, in particular.

112. Under the Insolvency Act 1986 and supporting legislation, insolvency practitioners have extensive powers to investigate and, under civil litigation, to prosecute those involved in or assisting in fraud. Insolvency practitioners' powers include the ability to interview under compulsion; search and seize property associated with fraud; obtain freezing orders against assets of those involved; overturn transfers to third parties; apply for passport orders (where the individual is ordered to surrender their passport to prevent them leaving the country); order for the delivery up of records; and hold private and public examinations before the court and recover assets for the benefit of victims. All of these powers can prove invaluable in detecting, investigating and disrupting fraudulent activity and in making

recoveries for victims. Insolvency practitioners also benefit from extensive international recognition powers to enable them to pursue fraudsters and their assets internationally.

113. R3 believes that the insolvency and restructuring profession can provide the much needed extra capacity and powers required to boost the fight against fraud and improve UK corporate governance.

114. As well as using the insolvency profession's powers and skillsets – by, for example, ensuring insolvency practitioners are appointed to complex insolvency cases which might otherwise be held by the Government's Official Receiver as the liquidator of first resort in compulsory liquidations – the Government should also consider introducing a number of measures outlined in R3's 2015 paper, 'The Fraud Landscape: Insolvency and the Fight Against Fraud'.[8]

115. Aside from some proposals in the paper already covered elsewhere in this consultation response, proposals in this paper included, but are not limited to:

a. Companies should be required to state on their annual return to Companies House the names of all directors 'howsoever described' rather than just the appointed directors.

b. The annual return form and Form 288 to Companies House should contain a 'health warning' of what may happen to directors who break the terms of their disqualification order and other directors who are complicit in allowing disqualified directors to be involved with the management of a company.

c. The Secretary of State should be able to issue petitions to make individuals bankrupt in the public interest in order to provide a further method via which returns can be made to creditors and victims of fraud, unincorporated entities trading to the detriment of the public can be shut down, and the ability of dishonest traders to set up new businesses in future is reduced.

d. Directors of companies wound up in the public interest should face automatic individual public interest petitions for their bankruptcy and/or disqualification from acting as a director.

e. Government should take steps to reintroduce the courts' power to impose criminal bankruptcy orders on defendants as a further means to tackle fraud, disrupt fraudulent activities and increase recoveries for victims.

[8] https://www.r3.org.uk/media/documents/policy/policy_papers/Fraud/R3_Fraud_Landscape_Paper.pdf