Response to the Department for Business, Innovation and Skills discussion paper

Transparency and Trust: enhancing the transparency of UK company ownership and increasing the trust in UK business

Written evidence from R3, the insolvency trade body

Introduction

R3 represents 97% of UK Insolvency Practitioners (IPs) - the only professionals authorised to take insolvency cases. From senior partners at the 'Big Four' accountancy firms to practitioners who run their own micro-businesses, our members have extensive experience of both corporate and personal insolvency.

R3's expertise necessitates a broad response to Part A with more focus on specific questions as stated in the discussion document in Part B.

It is very encouraging to see Government seeking to address a number of issues which R3 has promoted for some time. This includes improving information stored by Government to combat fraud; and in particular, proposals to enhance the disqualification regime.

Executive Summary

- R3 believes the majority of the proposals contained within the discussion paper are well-intentioned and focus on the 'right' areas such as looking to introduce a compensation regime. R3 has, for some time, highlighted the importance of seeking redress from errant directors for the benefit of creditors.

- Our key concern relates to financial redress. Proposals contained in this paper are at odds with another Government Department (the Ministry of Justice) which plans to severely curtail the ability of creditors to seek financial redress. Insolvency Practitioners already have the means to pursue money taken by errant directors that rightfully belongs to creditors, including HMRC, and therefore the proposals outlined in the document regarding financial redress would not work as well as the current system. **R3 calls for a permanent exemption for insolvency from the Legal Aid, Sentencing and Punishment of Offenders (LASPO) Act to ensure that this important work can continue**.

- We support the proposals outlined in the paper regarding the education of disqualified directors. In addition, R3 calls for improving education for directors at the point at which an individual becomes a director; this preventative training should help reduce director misconduct.

PART A: ENHANCING THE TRANSPARENCY OF UK COMPANY OWNERSHIP

The majority of the proposals in Part A deal with equity, but there are many cases involving debt, where there is a lack of transparency. This particularly applies to bond-holders where the identity of stakeholders is opaque and, with the increasing market in selling distressed debt, can be a frequently changing constituency. Therefore, whilst the discussion paper seeks to address a significant amount of transparency issues in ownership, there is a whole area concerning 'debt' that has not been dealt with. As such, the scope of the paper to which we are responding, is limited.

<u>Beneficial ownership and a central registry</u>

As a result of R3's work to address fraudulent directors, we have developed proposals which relate to a number of themes raised within this section. Therefore, rather than answer the specific questions outlined in the discussion paper, R3 is providing comment based on our research and broader, but related issues which we believe should be considered by the department.

It would be a significant deterrent to fraud and make a significant difference when investigating fraud if directors had to provide KYC type identity documents when registering with Companies House/ a 'central registry'. At present it is easy for directors to have multiple registrations giving slightly different dates of birth, or slightly different spellings of names, or inconsistently using middle names. R3 believes the argument that providing identification stifles trade is specious as directors already need to provide such proof of identity if, for example, they wish to open a bank account. R3 also suggests that a fee should apply to every Form 288 when submitted, and that all or part of the fee go to a bond or fund to tackle fraudulent cases.

To help prevent disqualified directors from working behind the scenes as shadow directors or 'advisors' R3 believes that companies should be required to state on their annual return to Companies House/ a 'central registry' the names of all directors 'howsoever described' rather than just the appointed directors. R3 also proposes that the annual return form contains 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.

R3 also suggests that emphasis should be placed on improving education for directors with regard to their duties. For example, Insolvency Practitioners dealing with a failed company are often told by owners/ directors that they were advised to incorporate for tax reasons but not advised of their ensuing statutory duties. Whilst HMRC may send out leaflets explaining some of these duties, this is clearly not working as well as it should: ease of access to and engagement with information for directors is in need of improvement. BIS should explore the feasibility of a compulsory, annual on-line 'click through' tutorial video explaining directors' duties. The tutorial should require the director to confirm that he/she has understood what is required of them as a director.

This 'pre-education/ on-going education' of directors is arguably more important than post-education of directors of failed companies (which is covered in Part B of the discussion paper). However, it is vital that the UK maintains its position as one of the best places in the world to start and grow a business, so such proposals should be EU or G20 wide to avoid the UK suffering a competitive disadvantage.

PART B: INCREASING TRUST IN UK BUSINESS

<u>Clarifying the responsibilities of directors</u>

Q39. The merits of strengthening responsibilities of banking directors by amending the directors' duties in the CA06 to create a primary duty to promote financial stability over the interests of shareholders. This should be considered in the context of the banking regulation reforms the Government has already committed to and the further economy-wide measures set out in the rest of the paper.

R3 does not have any comments on this question.

<u>Allowing sectoral regulators to disqualify</u>

Q40. Whether, in certain circumstances, directors barred or prohibited from senior positions in key sectors should be considered for disqualification from acting as directors of any CA06 company?

Allowing sectoral regulators to disqualify is a good idea in principle. However, on greater inspection of the proposals, R3 fears that that there could be practical issues in application, which are outlined below.

Q41. Which sectoral regulators should have the ability to make an application to the Court for a disqualification order, or to accept a disqualification undertaking from a director?

R3 believes that disqualification should not be an automatic procedure as this would be unfair, as outlined below, and strict safeguards should be introduced.

Q42. The potential costs and benefits of this proposal.

Regulators are diverse with different levels of financial ability/ standing and with a level of inconsistency in their penalties and procedures. For example, there are Government regulators such as the FCA and Regulatory Bodies, such as ICAEW and ACCA who regulate accountants. There are two sets of distinct procedures at play – the Tribunal process is often an informal procedure with lay members on panels, sometimes a majority or even lay chair, for example, whereas Court (disqualification) is a very formal procedure with evidential and judicial protections.

Rather than sectoral regulators making an application to Court or accepting a disqualification undertaking from a director, R3 believes that the Insolvency Service should continue to be responsible for disqualification applications, including cases following on from sectoral sanction, as the Insolvency Service has expertise in this regard. The Insolvency Service maintaining its role would ensure consistency.

There should be the addition of an ability by the Court to disqualify directors at the conclusion of civil proceedings under the Insolvency Act 1986, or CA06 or for breach of duty under common law. This is presently the case in actions for wrongful and fraudulent trading under Sections 213 and 214 Insolvency Act 1986. In this way consistency would ensue and there should be the added benefit of an increase in the number of disqualifications.

<u>Factors to be taken into account when disqualifying</u>

Again, R3 supports expanding the factors to be taken into account when disqualifying in principle. However, on further investigation, we feel that there are a number of practical challenges regarding the proposals, which are outlined below. We feel that there are problems with adding to a ‘list’; by establishing a list this necessarily excludes issues and could, in fact, cause more problems than it seeks to address. A more inclusive approach is to identify broad issues by giving examples and explaining that they include, but are not limited to the examples outlined.

Q43. Whether Schedule 1 to the CDDA should be amended to provide that any breach of sectoral regulations is a matter of unfitness that may be taken into account by the court in disqualification proceedings?

No, R3 does not believe that Schedule 1 should be amended to include this specific factor. R3 believes that the Court already considers issues such as breaching sectoral regulations in disqualification proceedings, and therefore there is no need to amend the Schedule.

Q44. Whether Schedule 1 to the CDDA should be amended to provide that ‘wider social impact’ is a matter to be taken into account by the courts in disqualification proceedings?

The rationale to amend Schedule 1 to the CCDA is to ensure that the Courts should consider these issues. R3 understands that ‘wider social issues’ are already considered by IPs, the Insolvency Service and the Courts when taking forward a disqualification, and accordingly there should not be a need to amend Schedule 1. The following case illustrates the point:

Disqualification of a Director who ran a potato farm in York (case more than 10 years old)

The debt associated with the case was just £10,000, but this failure and the monies owed had a significant impact on the wider community locally and the case was pursued on that basis.

Q45. How wider social impact should be defined and whether a materiality test should be applied?

‘Wider social impact’ is very difficult to define and R3 anticipates a great deal of differing views regarding the factors that should be included and excluded. Thus seeking to amend the Schedule may cause more problems than it seeks to solve.

Q46. Whether, where unfitness meriting disqualification has been found against a director of a company that dealt with high volume deposits or otherwise vulnerable creditors, two tariffs of disqualification should be handed down (or agreed by way of undertaking):

- A tariff with respect to acting in the management of all companies; and
- An increased tariff with respect to acting in the management of any company dealing with high volume deposits or otherwise vulnerable creditors (or a company engaged in a business similar to that in relation to which he had been disqualified).

No, we do not agree that ‘two tariffs’ of disqualification should apply. R3 believes that the Courts already assess a multitude of issues, including the public interest, when deciding the terms of the disqualification.

Q47. Whether Schedule 1 to the CDDA should be amended to provide that failure to pay particular regard to the protection of deposits, pre-payments or otherwise vulnerable creditors once a company has become insolvent is a matter to be taken into account by the court when deciding whether a director is unfit and should be disqualified (or by the Secretary of State in deciding whether to accept a disqualification undertaking)?

No, we believe that the Courts already take these issues into account and therefore there is no need to amend the Schedule.

Q48. What account the court (and the Secretary of State when deciding whether to take action) should take of the track record of the director (including the number of failures a director has been involved in) when deciding whether or not to disqualify an individual and for how long?

As per R3's response to Q47, a director's previous failures are already taken into account where there is relevant evidence, such as several failures for the same reasons or with targeted creditor groups, which includes strong evidence of 'pheonixing'. We believe that it would be 'anti-entrepreneurial' to add and try to define previous failures.

Q49. Whether there should be a certain number of failures beyond which the presumption is that a director is unfit and should be disqualified. If so, what should that number be?

R3 does not agree with this proposal and believe each case should continue to be considered on its merits rather than an arbitrary number. There are many examples of situations which could 'explain' multiple failures with no evidence of wrongdoing: for example, an individual could be the director of a group of companies, or the director in question could encounter sheer bad luck. A limit to the number of failures permitted could deter entrepreneurs.

The 'remedy' to guard against this issue is to ensure that there is pre-education of directors and a robust system for disqualifying and prosecuting directors who have not performed their duties.

Improving financial redress for creditors

The proposals outlined in this section are laudable and welcomed: financial redress is vitally important. However, systems for financial redress are already in place – Insolvency Practitioners have the tools required at their disposal to pursue errant directors for the benefit of creditors. Despite this, Government (The Ministry of Justice) is currently seeking to curb these powers. It is extremely concerning, never mind totally inconsistent, that two differing Government departments are proposing contradictory policies. R3 calls for BIS to address this issue with the Ministry of Justice.

To outline this issue in further detail: The Legal Aid, Sentencing and Punishment of Offenders Act (LASPO), which was introduced in 2012, curbed the use of Conditional Fee Arrangements (CFAs) and After the Event Insurance (ATE) also known as 'no win, no fee' agreements. Insolvency Practitioners use CFAs and ATE to pursue money taken by errant directors. By doing so, they recover money that rightfully belongs to creditors, including HMRC.

R3 cautioned that these changes would severely restrict creditors' ability to recover money. Given that litigation of this kind returns a significant amount of money to HMRC, smaller businesses, as well as consumers, and the proposed reforms would effectively result in public money being retained by errant or fraudulent directors, Government granted an exemption for insolvency cases until 2015.

There had been no impact assessment on the changes in respect of insolvency and as such, R3 has commissioned independent research to provide this information. R3 has also been working with HMRC to look at alternative measures to a permanent exemption; however, due to the complex nature of insolvency, extensive meetings have so far failed to identify an alternative. It is R3's view that given the current economic situation and level of public debt, it is in Government's interest to protect a tool which not only returns taxpayers' money but also acts as a fraud deterrent.

Q50. How frequently the possibility of bringing wrongful and fraudulent trading claims arise, are pursued and what value the existing civil remedies for wrongful and fraudulent trading provide?

R3 members tell us that fraudulent trading claims are rare. Actions for wrongful trading are increasingly difficult to prove in terms of identifying the 'trigger date' when the directors ought to have known the company could not survive. In reality, there are often a number of 'trigger dates' which exist, but it is often only as the case progresses and information eventually 'drips' through that these dates can be clearly identified and evidence provided. As cases are rare, and the costs are prohibitive, IPs often pursue other causes of action, which includes trying to settle a case before it reaches Court.

Existing civil remedies provide good redress if pursued. However, because the company in question is often without funds it needs an Insolvency Practitioner to be appointed to investigate; this requires 50% of creditors who vote to approve the appointment, or the Insolvency Service's Official Receiver to make a rota appointment. There are a number of issues with the existing system which could be resolved by better communication between Government and Insolvency Practitioners. R3 would like to see more cases on the rota and HMRC, as the major unsecured creditor (other creditors are often smaller and do not participate in insolvency procedures) to approve more IP appointments. The cost to HMRC in increasing engagement would be negligible: all it requires is an email to the Official Receiver.[1]

Q51. Whether, if liquidators were able to sell or assign wrongful and fraudulent trading actions, more actions would be taken? If so, how many more?

R3 does not believe that wrongful and fraudulent trading actions should be assigned to a third party. IPs are Officers of the Court and under a duty to act in the best interests of creditors. IPs take on wrongful and fraudulent trading claim cases, ranging from say £50,000 upwards on a 'no win no fee' basis ensuring that recoveries can be distributed to creditors. The Insolvency Service itself takes on even smaller cases on this basis for the benefit of creditors.

The purchaser of an assigned claim is driven purely by profit. These firms typically take on cases no smaller than £1m+ for a small sum, for the majority of the recovery at the expense of creditors.

Q52. To what extent creditors would benefit from this proposal?

[1] This is in cases where the company has already been wound up by the Court; it does not include CVLs.

R3 finds it unlikely that creditors would benefit from the proposal as outlined in the consultation document.

Q53. What practical difficulties might prevent third parties pursuing claims and how these might be overcome?

The Liquidator has the powers of investigation which must be applied to see if the case is viable. If a third party buys the claim, they would probably preclude the Liquidator from using his/her investigative powers under the Insolvency Act as the intention to litigate may be assumed from the fact of the purchase. The same investigative rights cannot be given to a commercial purchaser.

Q54. Whether safeguards would need to be introduced to prevent certain parties acquiring such a claim? If so, who should they apply to and what form they should take?

The only single factor that should govern the sale is the best price for the claim.

R3 believes that the directors of the company under investigation, their associates, or debtors may see a benefit in setting up a company to purchase claims for limited sums and then abandoning the cases. It would be very difficult/ impossible to introduce a safeguard to prevent directors or connected parties from acquiring the claim. The Liquidator would have difficultly in identifying a connected party and they would have no power to pursue the identity post-assignment. The difficultly in providing a safeguard in this regard supports the case for non-assignment.

Q55. Whether this proposal would improve confidence in the insolvency regime?

R3 does not believe this proposal would increase confidence in the insolvency regime but rather the reverse. Claims would be removed from the control of an experienced licensed IP, who has a duty to all creditors, to a third party.

Q56. The benefits of giving courts the power to make compensatory awards against directors?

R3 welcomes the proposal of giving Courts the power to make compensatory awards in principle. It is very positive to see that Government are considering this important issue and proposing measures. R3 members work with businesses which have lost money at the hands of fraudulent directors and are well aware that a compensatory award would be welcomed.

However, R3 feels that there are some practical issues which need to be thought through: there would be difficultly in terms of timing/ information available to disqualify <u>and</u> make a compensatory order at the same time. It would also be difficult to establish the level of the compensation order that should be set and assess the ability of the director to pay the award. There is also the challenge that making a compensatory award would adversely impact on existing means to seek redress, as outlined below in further detail. We would very much welcome the opportunity to work with the Government to discuss how a compensation regime might work in the context of existing methods to seek redress.

Q57. The potential costs and drawbacks of this proposal?

There are a number of potential costs and drawbacks to this proposal. R3 is concerned that making a limited compensatory award could prejudice civil claims which should be brought against directors for the benefit of the insolvent estate. We fear that Insolvency Practitioners may be deterred from bringing a claim: there is a finite 'pot' of money available.

Directors are likely to defend more disqualification actions rather than agreeing undertakings (which currently take place in about 80% of cases). This would invariably stretch the Insolvency Service's already limited budget and may well see disqualification rates decrease.

Finally, we do not think that the Insolvency Service has the resource to provide the evidence required to ensure a fair compensatory award upon which the Court can rule. Therefore, the Service would need to build up this team and expertise, potentially moving vital resource from other important areas such as disqualification of directors.

Q58. Who should receive any monies recovered by action: should it be creditors generally or left to the court to determine?

No, these monies should be treated as a recovery in the Estate.

The Insolvency Service has suggested that they could distribute any surplus recoveries more efficiently than IPs. Whilst IPs will charge fees to distribute the monies for the work done, this would not be prohibitive. Whereas should the Insolvency Service seek to collect and distribute the monies, in effect duplicating the work already done by the Office Holder in establishing the creditors, the cost of doing this would be prohibitive. The Insolvency Service would be better focusing its resources on disqualifying more directors rather than seeking to take on new activities such as distributing monies, which is already preformed efficiently by Insolvency Practitioners.

Q59. Whether the IS (acting on behalf of the Secretary of State) should be able to request and agree a compensation award from a director when it accepts an undertaking from the director not to act in the management of a company for a certain number of years?

No, we do not believe that the Insolvency Service will not have all of the information necessary to agree an appropriate compensation. Please see our response to Q57.

Q60. Whether this proposal would improve confidence in the insolvency regime?

Insolvency Practitioners have, on an anecdotal basis, estimated that in approximately 80% of cases where the director could be targeted for monies, there is simply no money available from the director(s). If there is money to be extracted from directors for the benefit of creditors, then IPs have a duty and the existing means to do this. IPs agree that creditors want to see directors of failed companies 'pay' for their actions but in the majority of cases, this is not possible as there is simply no money in the estate.

R3 strongly calls for a permanent exemption for insolvency from LASPO to ensure that monies that can be taken from disqualified directors and rightfully distributed to creditors, can continue. There is no problem with the law as it stands and R3 believes that there is no need to introduce the proposals suggested given that the system currently 'works'. The exception to this is to develop proposals on compensation awards which can work alongside existing methods of redress.

Time limit

Q61. Whether the period within which disqualification proceedings under section 6 of the CDDA must be instituted should be extended beyond two years?

AND

Q62. If yes, should that period be five years, some other period, or no limit at all?

R3 believes that the period should remain at two years. The paper points out that in the majority of cases this is sufficient and as such, R3 considers that the extension as proposed is unnecessary. Five years is a long time for an investigation to 'hang' over an individual and there may be Human Rights issues concerning the rights to a fair trial in a reasonable amount of time.

However, we would suggest that the Insolvency Service should have the right to apply to Court for an extension. We would suggest that the Service could apply to Court, but without the need to have a finished case with full supporting evidence (as is the case under the current system), thus amending the existing "leave to issue out of time" process to make it easier to meet the evidential test required by the Courts. This would address the fact that the burden of proof now required, combined with directors prevaricating to try to exhaust the time limit, often makes the two year time limit very 'tight'.

Q63. How many directors are likely to be affected?

R3 does not have information in order to provide a response to this question.

Educating directors

Responses to the questions within this section should be viewed in the context of suggestions R3 made in Part A regarding pre-education and on-going education of directors of their duties, which is arguably more important than post-education of failed directors. However, it is vital that the UK maintains its position as one of the best places in the world to start and grow a business, so such pre-education proposals should be EU or G20 wide to avoid the UK suffering a competitive disadvantage.

Q64. Whether, if some form of director education were to be introduced, it would increase trust in the enforcement regime?

Director education has the potential to increase trust in the enforcement regime and R3 supports the proposals outlined in principle. Educating disqualified directors might actually encourage entrepreneurial activity with some directors deciding to set up a subsequent company.

Q65. What form the training should take and who should provide it?

R3 believe that the training should be comprehensive, lasting approximately 2-4 days and should involve taking and passing exams.

As well as training on areas such as directors' duties, ethics, tax, VAT and keeping accounts, R3 also feel that it would be important for directors to understand what action to take when things start to go wrong, which includes seeking advice and understanding the implications of wrongful trading.

Q66. What would be the likely cost of such training?

Comprehensive education may be quite costly, in the region of approximately £1,000. However, if this 'advance training' were taken up, it could have enhanced benefits for the business owner in terms of lower D&O insurance rates, and better access to finance, for example. Two levels of training could be introduced: more limited training could be cheaply provided for those seeking to reduce their tariff, with more comprehensive training reserved for directors who seek leave to act.

We are aware that the IOD suggest that 'basic' training could be provided at a cost of between £300-400 and the IOD have offered to work with the Government on the introduction of a scheme.

Q67. Whether successfully completing any such training should enable a reduced period of disqualification; or should be a pre-condition for any disqualified director wishing to seek leave of the court to run a company whilst disqualified?

A reduced tariff would provide an incentive to complete training. However, to safeguard against 'rogue' directors using this as an easy way to cut their tariff, we would suggest that the disqualification unit should put people forward as being appropriate for training. The most serious offenders would not be eligible for the course. It could also be argued that all directors should be required to undertake the training but only reduce the tariff if it is a low or middle bracket period. This issue will not be easy to resolve but it is important that training does not become the 'easy' route.

Q68. Whether there would be value in offering such training to all directors of failed companies – irrespective of whether they were disqualified - having regard to the fact that the director would need to cover the cost?

R3 believes there would be no harm in offering this training, if there is the appetite from directors of failed companies and they are prepared to pay the cost. Again, this training should be examined in the context of pre-training of directors regarding their duties.

Extending overseas restrictions

Q69. Whether regulations should be made using the powers in Part 40 of the CA06 to prevent persons who are subject to foreign restrictions (which fetter their freedoms to act in connection with the affairs of a company) being able to be directors or act in the management of companies in the UK?

Yes.

Q70. If yes, should the foreign restrictions be made to apply automatically in the UK, or should they require the Secretary of State to make an application to a court?

Whilst it would make sense for the restrictions to apply automatically in terms of reducing the administrative burden, R3 has concerns about the disparity between different regimes and how the restrictions are applied in the UK. Therefore, information and policing must be shared otherwise it would not work given the multitude of differing jurisdictions. R3 suggests that cases should be assessed on a case-by-case basis, overseen by the Insolvency Service.

Q71. If not, should a person subject to foreign restrictions be obliged to notify the Registrar of Companies if they act in the promotion, formation or management of a company in the UK?

Yes, a person subject to foreign restrictions should be obliged to notify the Registrar of Companies and it should be an offence if they fail to do so.

Q72. Whether the Secretary of State should have the power to bring disqualification proceedings against a person on the sole basis that that person has been convicted of a criminal offence overseas in connection with management of a company or business overseas?

Yes, it would seem sensible for the Secretary of State to have the power to bring disqualification proceedings against a person convicted of a criminal offence overseas in connection with managing a company. Again, as per our response to Q70., it is important for jurisdictions to share information given the differing procedures and for each case to be assessed on its own merits by the Insolvency Service.