



RESPONSE TO  
CONSULTATION ON  
INSOLVENCY AND CORPORATE GOVERNANCE

DEPARTMENT FOR BUSINESS ENERGY & INDUSTRIAL STRATEGY

11 June 2018

## Introduction

- 1 The Institute of Chartered Accountants of Scotland (ICAS) is the oldest professional body of accountants and represents over 21,000 members who advise and lead business across the UK and in almost 100 countries across the world. ICAS is a Recognised Professional Body (RPB) which regulates insolvency practitioners (IPs) who can take appointments throughout the UK. We have an in-depth knowledge and expertise of insolvency law and procedure.
- 2 ICAS's Charter requires it to primarily act in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and protect their interests. On the rare occasion that these are at odds with the public interest, it is the public interest that must be paramount.
- 3 ICAS is interested in securing that any changes to legislation and procedure are made based on a comprehensive review of all of the implications and that alleged failings within the process are supported by evidence.
- 4 ICAS is pleased to have the opportunity to submit its views in response to the Department for Business, Energy & Industrial Strategy (BEIS) consultation on insolvency and corporate governance. We shall be pleased to discuss in further detail with BEIS any of the matters raised within this response.

## Response

- 5 We welcome the publication of the consultation and support the efforts of Government to take appropriate steps to deter and deal with abuses of insolvency processes and reduce the risk of major company failures.
- 6 The consultation is one of a few consultations and discussion documents<sup>1</sup> issued in recent months by the UK Government which relate to insolvency. We consider that while each of these consider distinct areas, there is a synergy and benefit in considering aspects of each alongside each other. In addition to commenting on the discussion document, we therefore make some general comments below in relation to the totality of the proposals across Government consultations.
- 7 As several our comments do not fall directly within the questions contained in the discussion paper we have not responded directly to the questions asked within the consultation.

## General

- 8 The UK has a highly respected insolvency and restructuring regime. It currently ranks 14<sup>th</sup> in the World Bank Resolving Insolvency Index. The insolvency regime is part of a wider macro economic system for an effective and functioning economy and contributes towards a country's economic growth. We therefore wish to ensure that any future steps which may impact on the insolvency regime will not unduly harm the UK and hinder economic growth.
- 9 The Government acknowledge that the vast majority of insolvencies in the UK are for genuine reasons and there is little suggestion that there are widespread issues with the insolvency regime in the UK. This is an assessment with which we would agree. Future changes should therefore be targeted where there are specific issues identified to be addressed.
- 10 One of the areas seeking to be tackled is phoenixism. While this may be broadly referred to as a concept, in reality it is difficult to define. There is no legal definition in the UK of phoenixism and what may well be referred to as phoenixism may also, in certain circumstances, describe

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<sup>1</sup> In addition to this consultation the other consultations are: Tax abuse and insolvency, HMRC; and Extension of the existing security deposit legislation to include CT and CIS deductions, HMRC.

serial entrepreneurship. Often what is referred to as a phoenix operation will have resulted from a business or asset sale which maximises the return to creditors out of an insolvent situation – the primary responsibility of an insolvency practitioner. It may also maximise the preservation of employment. A distinction requires to be made between abusive phoenixism and other forms of phoenixism.

- 11 The UK promotes entrepreneurialism and a rescue culture for financially distressed businesses. Any proposed actions therefore should consider the potential detriment to placing limitations or barriers to a rescue environment. We are concerned that the potential for increased personal liability may act as a significant barrier to both entrepreneurship and the business rescue culture.
- 12 The consultation appears to be predicated on a small number of corporate failures which have attracted significant attention in recent months. A blanket market response to the failures of a small minority is unhelpful. We are concerned that the proposals being considered appear to be a reaction to what are perceived as public scandals without adequate reflection, investigation into the underlying issues or indication of wider harm or deficiencies.
- 13 The consultation paper uses a mixture of terminology throughout which may or may not be meant to refer to the same thing. For example, in places it refers to holding companies in the same way also referring to parent companies. There is also for instance reference to large subsidiaries when describing a problem but does not qualify the proposition as relating only to that cohort. It has therefore been extremely difficult to fully understand from the consultation what the proposals are and the extent of their proposed application.

#### Devolved issues

- 14 The territorial extent of the consultation is England, Wales and Scotland although it is noted the exception in relation to parts of the sale of distressed business and value extraction schemes relating to company liquidations in Scotland is devolved and the group structures, professional advisers, dividends and shareholder stewardship sections which would also apply in Northern Ireland.
- 15 The underlying framework for both the regulation of business entities and insolvency of business entities applies largely UK wide. Business within the UK on a practical basis operates across the devolved boundaries with significant levels of trade being undertaken across borders.
- 16 Should there be a requirement to make further legislative changes then we would strongly advocate and support consistency across the devolved territories in all aspects.

#### Sale of business in distress

- 17 The proposals appear to fundamentally change the philosophy and framework upon which an entrepreneurial economy operates. In the UK, this is set out primarily through the duty of a director to promote the success of the company, narrated in legislation in section 172 of the Companies Act 2006.
- 18 Legislation requires the director(s) to act in the best interests of the company members, subject to a situation where the director is required to act in the interests of creditors. Section 172(1) requires directors to have regard to several other factors while acting in the best interests of members. Illustrations of good practice application or case studies would be helpful.
- 19 In a large and complex group situation, the responsibility in relation to the parent/holding company is to its members. This can at times be in direct conflict with the responsibilities which a director in a financially distressed subsidiary may have. It may be that the focus of responsibility in a subsidiary is that of the creditors rather than the members. We believe that this is a correct interpretation of the directors' duties.
- 20 In many situations, the insolvency of a subsidiary may meet the test for being in the best interests of the parent/holding company members. For example, it may help protect more jobs and suppliers across the wider group if one subsidiary can be placed into administration without adversely affecting the viability of the wider group. Unless express support of a subsidiary has been legally provided there is no obligation on the parent to support the subsidiary.

- 21 The proposals to hold a director of a parent/holding company liable for loss or harm by creditors of a subsidiary, which could in many situations be several layers removed, in our view fundamentally changes and is contrary to the requirements of section 172.
- 22 We have concerns that the proposals for director accountability as set out in the consultation would act as a significant barrier to legitimate restructuring opportunities. For example, it is likely that substantial due diligence would be required to be carried out by the selling company on any proposed purchaser, adding additional delay and cost in a distressed restructuring situation.
- 23 The policy may also result in an advancement of administrations or liquidations as directors may wish to avoid potential sales or restructuring due to increased risk. Where there is financial distress then the more favourable approach would be to deflect such risk and place the entity into an insolvency process. Any sale could then be carried out by the office holder without the same risks attaching to the directors. However, that approach may not achieve the best outcome for the subsidiary, its creditors suppliers and employees.
- 24 Such a policy is also likely to result in reduced returns to creditors from financially distressed companies through increased costs or reduced recoveries arising from an insolvency process.
- 25 Insolvency legislation already provides for challenges to the conduct of directors and other office holders. The consultation sets out that the problem lies with the directors of parent/holding companies and who decide and dictate the actions relating to the sale of the subsidiary. Powers exist under existing legislation to challenge such actions either of a director, defacto director or shadow director where appropriate.

#### Value extraction schemes

- 26 We do not agree with the statement that existing legal protections are insufficient to allow insolvency practitioners to un-pick value extraction schemes. We consider that existing provisions within insolvency legislation such as those provided under section 212, section 239 (England & Wales) and section 243 (Scotland) are sufficient to allow value extraction schemes to be challenged where they are undertaken inappropriately.
- 27 The barrier to insolvency practitioners is not the lack of power to challenge but balancing the risk and reward of a challenge together with funding a challenge. While litigation funding has become more prominent in the market over the last few years, the Jackson reforms enacted through The Legal Aid, Sentencing and Punishment of Offenders Act 2012 (LASPO) have also had an effect on the ability of an insolvency practitioner to initiate litigation.
- 28 Obtaining a return on investment as quickly as possible is not inherently wrong. This is part of an entrepreneurial society. We agree that it is undesirable to promote this above the medium to longer term objectives associated with promoting the success of the company.
- 29 Where an investor is exposed to future risk this will reduce their appetite for investment or require an adjustment to the price payable. The changes being consulted upon are likely to result in an increase in risk exposure for those contemplating a company rescue resulting in a reduced market appetite and lower prices being paid. This is likely to frustrate rescue processes and result in reduced recovery for creditors.
- 30 Should such provisions be taken forward and be introduced, we consider that the success of such provisions may be limited. As has been noted in the consultation, such schemes are undertaken within a complex structure. The costs and time to challenge such a scheme is likely to be high and with a significant degree of risk on whether it would be successful or not. Any litigation can expect to be robustly challenged and defended. The sums involved would require to be significant to warrant challenge. All of these factors limit the prospect of actions being raised.

#### Investigation into the actions of dissolved companies

- 31 We support the proposals set out to tackle the investigation of directors who avoid the current investigation regime through having the company dissolved at Companies House rather than through an insolvency process.

- 32 While we support such a measure, this will only result in success if the Insolvency Service have appropriate resources to carry out such investigations and pursue disqualification undertakings or disqualification orders.

#### Strengthening corporate governance in pre-insolvency situations

- 33 We are not convinced that there is a requirement to differentiate between corporate governance and transparency measures in relation to complex group structures over other forms. Complexity of the corporate structure is normally related to the business model and only becomes a concern if the organisation becomes unmanageable and where funders/ investors lose confidence. Complexity is therefore more a question for funders and lenders rather than for further legislative intervention.
- 34 In general, in large and complex group situations there are knowledgeable and experienced directors in situ who carry out their responsibilities with diligence. A governance gap is more likely to exist in small or medium sized companies.

#### Dividends

- 35 It is widely acknowledged that the process for determining distributable profits is complex, not easily understandable and the focus on profit as a driver of returning cash to shareholders that is in excess of the needs of the business may promote the wrong behaviours.
- 36 There are other issues which should be considered aside from the accounting profit. Importantly a longer term perspective when considering dividend policy is good practice. It would be helpful to have further guidance on the solvency considerations to be undertaken when declaring a dividend to help encourage wider consideration of longer term creditors (see more below) and inform the decision on whether the dividend should be paid or constrained. We would also encourage boards to disclose their thinking on this.
- 37 Dividends must take into account a variety of factors including the perceived future cash needs of the company, balance sheet liabilities, capital position, the business plan, significant capital expenditure issues and longer-term viabilities as well as the assumptions on which the business would be successful/viable. Companies and boards should do more to ensure that the longer-term plans are sensible.
- 38 Dividend policy must also reflect the price of obtaining equity. Without some element of regular financial return (dividend) it may not be possible to raise capital of this nature. For earlier stage companies, the risks of creditors, staff and shareholders have to be carefully balanced in what may sometimes be highly risky circumstances. Creating a strong board is vital but there is no single solution for this. We have to rely on boards and shareholders to pay appropriate dividends. Ethical behaviour is fundamental.
- 39 Decisions to approve dividend payments need to take a holistic perspective and include long term impacts. Where actions are taken that reduce the asset base of the sponsoring company, such as a major change of dividend policy, a major return of capital or share buybacks etc., it may be appropriate to consider what impact this could have longer term. It raises the question of whether it would be more prudent to consult the pension trustees in circumstances where there is a long term pension fund deficit. Our understanding is that certain companies have taken the broader perspective and consulted their pension trustees in particular situations e.g. on a takeover or a return of capital. We see this as good practice and 'doing the right thing' but are not convinced that this approach is consistent.
- 40 We suggest that it is timely to review whether the existing framework and current rules for distributable profits are still fit for purpose. This is also increasingly pertinent in light of accounting changes which may make it even more complex for directors to identify distributable and undistributable reserves as more fair value gains/losses are charged to the P&L. This increases the risk of illegal dividends. If the objective is to afford some protection to creditors, in our view, distributable reserves are not especially effective. It is also a system which is less transparent to users of the accounts.
- 41 A new mechanism could involve moving away from distributions being subject to an accounting/legal test of distributable reserves to a new framework where the onus is on

directors to assess solvency/liquidity perhaps through a new solvency statement and reduce the complexity inherent in the current framework.

#### Directors' duties and the roles of professional advisers

- 42 We do not believe that for larger corporates there is a general culture where directors are unaware of their duties regarding commissioning and using professional advice but agree that it is more likely for smaller companies. It is also expected that accountants, Insolvency Practitioners and lawyers would have the broader understanding of professional and directors' responsibilities when they are approached for advice. Boards and professional advisers are acutely aware that ultimately it is for directors to make any final decision on a matter where they have taken advice. There may be a lack of awareness across smaller corporates (particularly of broader duties under section 172) but when a business is losing money, our experience is that the vast majority understand their position and do not show a reckless disregard for creditors.

#### Protection of companies in the supply chain

- 43 We agree that it is poor practice for companies not to pay timeously and use suppliers as a "bank" to assist their cash flow. Promoting and raising awareness of good practice where payment terms are lengthy, or payment is at risk would be useful for example, banks offer an early payment facility to protect suppliers and some protection for the smallest creditors exists through credit insurance.
- 44 An expectation to keep your supplier and customer chain in one organisation (rather than across different entities in the group) would be helpful as differences between those purchasing and arranging payment can create unnecessary complexity and suggests a potential risk for suppliers payments.
- 45 We would suggest that any consideration relating to an increase in the prescribed part limits should only be undertaken should this be shown to be of benefit following appropriate research. We are not aware of any statistics currently available relating to how often the prescribed part limit is reached or how often the prescribed part is disapplied.
- 46 Carrying on business comes with an inherent risk attached to it. It is a commercial activity with associated commercial risks. Experience from changes in other insolvency areas, such as the voluntary measures introduced in relation to pre pack administrations, suggests that creditor behaviour is driven by many factors with risk of loss being only one. For example, despite a relatively small number of pre pack deals being referred to the pre pack pool, there is little evidence that creditors have adjusted their behaviour on continued trading with the new entity.

#### Other issues

- 47 While we consider that the current framework is broadly appropriate, it should be subject to on-going evaluation and improvement. We support the approach of comply or explain and principles not rules and the combination of legislation, good practice codes and developing guidance/ sharing good practice on values, ethics, behavioural standards and organisational culture. Our preference is for minimal statutory intervention unless there is evidenced need that no other option is feasible.
- 48 The Stewardship Code also needs to be subject to regular review and improvement to embed good practice more widely across asset managers as well as business and to maintain a similar pace of reform as the UK Corporate Governance Code has achieved.
- 49 Long-term success of companies should be measured in broader terms than just for shareholders. To embed good practice more effectively, we suggest that guidance is provided which encourages directors to report how they have considered and discharged their broader duties under section 172 and their approach to fair and balanced decision making which gives effect to this.
- 50 We note that whilst comply or explain is not intended to be used as a tick box exercise, there are some investors/ agencies who approach their company analysis in a binary way which expects full compliance. Managing this needs further consideration.

- 51 In our view, the volume of enforcements for corporate law breaches is low. We suggest that a more consistent approach to corporate enforcement would be beneficial. Whilst we support the preventative approach and increasing transparency, on its own this approach lacks teeth. We need a combined preventative and detective approach to police the current system with enforcement action to reduce corporate law breaches.
- 52 Ultimately it is the directors who are responsible for ensuring how well they discharge their duties bearing in mind the wider expectations and perceptions. This is the starting point and whilst it is important to identify and remove any barriers or obstacles to assist those with accountability and scrutiny duties, a preventative based approach is better than a complex system of multiple checks and balances.