A Culture of Fear or Rescue? - Consultation on Insolvency and Corporate Governance

26 March 2018

The Government has issued a Consultation on proposals designed to reduce the risk of major company failures and to strengthen the responsibilities of directors in the context of actual or threatened insolvency.

The principal specific proposals are:

- directors of a holding company that sells an insolvent subsidiary to be required to take into account the interests of the creditors of that subsidiary and possibly its other stakeholders
- the unwinding of transactions that have "unfairly removed value" from a company that becomes insolvent.

The Consultation also invites comments on more open ended questions on strengthening corporate governance in pre-insolvency situations, including:

- The governance of group structures
- Whether anything can be done to increase stewardship responsibilities of investors
- Whether the rules on dividends be reviewed
- Whether directors understand and are fulfilling their responsibilities in relation to professional advice

The Consultation also includes some more technical proposals relating to increased powers of investigation of the conduct of directors of dissolved companies and to protect the supply chain of companies that become insolvent.

Some of these proposals appear to have been prompted by the BHS failure. Others, by the failure of Carillion. Although this is not stated (anonymised examples are offered instead) there is no analysis of what failings in the existing regime may have contributed to those situations. BHS and Carillion involved very different fact patterns with the former involving a distressed sale which was heavily scrutinised and the latter involving a company that could not obtain ongoing financial support from its stakeholders to implement a restructuring. It is disappointing that there is no indication of how the new consultation is intended to interact with The Insolvency Service's 2016 consultation on the UK corporate insolvency framework and options for reform. The 2016 consultation appears to have stalled due to Brexit but in the meantime Europe is pushing ahead with its restructuring reform agenda.

The UK needs to ensure that it remains competitive to help avoid unnecessary corporate failure. It is time to re-examine whether any features of Chapter 11 would be appropriate (such as an automatic stay to prevent the termination of contracts and

making it easier to raise rescue finance) to ensure that the UK has the right toolkit to cope with increasingly complex corporate groups and capital structures rather than just focussing on corporate governance and director liability issues in isolation.

Specific proposals

Seller director responsibilities

Directors of a holding company would be held accountable (by director disqualification and personal liability) for decisions to sell a subsidiary that is insolvent (or solvent only by virtue of support from the selling group) unless they reasonably believed that the sale would be more beneficial to the creditors of the subsidiary than placing it into an insolvency process. This accountability will only arise if (i) the subsidiary concerned enters administration within two years after sale and (ii) between sale and that event the interests of those creditors have been "adversely affected". There are many details to be clarified (How is insolvency to be assessed at the time of sale? What does "adversely affected" mean?) but the main question is whether directors of holding companies should be made subject to any additional responsibility of this kind. To do so would be an important deviation from the principle of limited liability and separate corporate existence and the wider implications of that need to be assessed carefully.

The proposal is limited to directors of holding companies that are incorporated in the UK. It does not include individual shareholders or companies incorporated outside the UK.

The Consultation recognises that this change could make it more difficult to sell companies in a genuine effort to rescue distressed businesses (although it is not clear whether the Government is concerned about the company being sold or the company that is selling) and suggestions are invited on how to ensure that does not occur.

Unwinding value extraction schemes

The Consultation suggests that the existing regime to protect creditors by unwinding transactions that extract value prior to an insolvency process being commenced (antecedent recovery powers) is inadequate. It proposes that, in addition to transactions at an undervalue and preferences (which are already caught) it should be possible for the administrator or liquidator of a company to apply to court to unwind a transaction that has "unfairly removed value" from the company. It will not be necessary that the company concerned was insolvent at the time of the transaction (as is the case with the existing antecedent recovery powers). The potential scope of transactions that could be considered unfair is broad: management fees, excessive interest on loans, charges over property, excessive directors' pay and sale and leaseback of assets are mentioned. The Government intends legislation to be broadly formulated in order that the ingenuity of those who wish to extract value inappropriately will be defeated.

It appears that the Government has in mind three conditions for the unwinding to be ordered. Two are straightforward: (i) there has been an investment in the company and (ii) the company enters formal insolvency. There is more difficulty over the third

"unfairness" condition: that value is extracted by the investor without adding value to the company. It is not clear whether the value contributed through the initial investment would be taken into account but hard to see why it would not be. A transaction that extracts value for nothing in return would be an undervalue transaction that is covered by the existing rules. It is, however, suggested that "commercial reasonableness" is the real test of whether the transaction is unfair.

The Government is awake to the risk of limiting the availability of finance to distressed companies and invites suggestions for how investors could be protected.

Broader questions on strengthening corporate governance

The governance of group structures

The Consultation asks whether stronger corporate governance and transparency measures are required in relation to the oversight and control of complex group structures but it does not explain what the problem is that needs to be addressed. Groups organise themselves in different ways but it is not uncommon for little heed to be paid to strict legal boundaries while the group is operating solvently, an approach that is justified on the basis of business efficiency. It is not clear why this needs to change and there are risks if directors of individual companies feel obliged to take steps to conserve cash or take other actions prematurely.

Enhanced stewardship

The Consultation asks what could be done to promote more active monitoring of risk by investors as part of their stewardship responsibilities. Investors will no doubt have views on this, including the costs involved. The suggestion that there may be a role for the Investor Forum is not well considered.

Review of rules on dividends

A review of the technical rules on dividends and other distributions is to be welcomed, although given that the existing statutory rules are derived from EU requirements, significant reform may have to wait until after Brexit. It is not obvious that any changes to the governance framework are required, or what those might be. In 2017 the Financial Reporting Lab produced a useful report on disclosures around dividends.

The Consultation suggests that directors may not be aware of their duties with regard to commissioning and using professional advice but does not provide any evidence of why that is thought to be the case. The nuances of how Section 172 of the Companies Act (duty to promote the success of the company) interacts with the duty to act in the interests of creditors when a company is in financial difficulty also does not appear to be recognised in the Consultation. There is already a risk of personal liability for directors for wrongful trading and the issues for the board to weigh up when deciding whether to continue trading will always be very fact specific. Whilst directors should clearly debate and challenge professional advice when taking decisions, they should

not feel that it is inappropriate to rely on specialist advice in distressed situations.

Conclusion

The questions that are raised by the Consultation will require very careful thought in order to strike the right balance. This is why it is essential to consider this Consultation in conjunction with a broader review of the corporate insolvency framework in the UK. Stakeholders as a whole, including employees and pensioners, are more likely to be benefit from an environment in which directors have the ability to preserve and maximise value rather than an environment in which they are paralysed by fear or become forced to make decisions more quickly which have a negative impact on value. We will also need to ensure that investors are encouraged to support and fund viable businesses that are in difficulty rather than deterred from doing so.

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