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By e-mail: insolvencyandcorporategovernance@beis.gov.uk

11th June 2018

Dear Sir/Madam,

Department for Business, Energy and Industrial Strategy (BEIS) consultation on Insolvency and Corporate Governance (the "Consultation")

This response has been prepared by the Company Law Committee of the City of London Law Society (CLLS). The CLLS represents approximately 17,000 City lawyers through individual and corporate membership, including some of the largest international law firms. These law firms advise a variety of clients from multinational companies and financial institutions to government departments, often in relation to complex, multijurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its nineteen specialist committees. The membership of the committee can be seen on its website herewith http://www.citysolicitors.org.uk/index.php?option=com_content&view=category&id=115&Itemid=469

Overview

In their report of the joint inquiry into the collapse of Carillion, the Work and Pensions Committee and Business, Energy & Industrial Strategy Committee acknowledged that *"companies collapse [and corporate failure] is an inevitable part of the business cycle"*. Before concluding that the recent high-profile corporate failures of BHS and Carillion have exposed an urgent need to change the law, ongoing investigations and enforcement actions against directors and auditors should be allowed to run their course. There is a significant risk that the understandable anger and frustration resulting from these high-profile failures results in the problem being misdiagnosed as a problem with the substantive law itself, when it may in fact be attributable to the ability and incentives of regulators (and, where appropriate, private actors such as creditors and shareholders) effectively to enforce the substantive law as it already exists. The independent review of the Financial Reporting Council (FRC) and the greater powers given to The Pensions Regulator, are important steps in this regard.

On the whole, we believe that the UK's company and insolvency laws work in harmony to promote high standards of business conduct while also encouraging investment and entrepreneurship. Although the Consultation raises some legitimate concerns that we agree could be addressed, many of its proposals would have far-reaching consequences that would tend to undermine foundational principles of UK corporate law (such as limited liability and the duty of undivided loyalty that directors owe to their company) and certainty of contract, while having other unintended and adverse effects, including for creditors and employees in the UK. In our view the proposals will be likely to have a chilling effect that will result in genuine opportunities to turn failing business around, not being pursued.

We would observe that the general approach of UK law has been to allow those creditors who are able to adjust the terms on which they lend (i.e., financial creditors) to use contract and insolvency law to protect their own interests as they think best. Where it is thought that employees, pensioners, suppliers and other stakeholders are deserving of greater protection, this can be regulated for specifically, if necessary by reducing the powers or entitlements of shareholders or financial creditors. A primary function of corporate law is to establish the ends to which the directors should devote their efforts and for which they may exercise their powers, and to secure the loyal exercise of those powers within the constraints imposed by regulation and the consequences that may follow from breaking the company's contracts. There is a limit to the purposes that can be served by corporate and insolvency law, and by the 'soft' law on corporate governance, before it is undermined by internal inconsistencies.

Any proposed reforms of corporate and insolvency laws also need to be evaluated in their wider context. Aspects of the current law and practice in relation to financial and narrative reporting, corporate governance, executive remuneration and labour law, as well as tax policy, interact with corporate and insolvency laws to create a framework of incentives that affect the likelihood and severity of any corporate failure.

As the Consultation itself notes, there are already impending changes to the corporate governance regime, including requirements for directors to explain how they have complied with their duty under section 172 of the Companies Act 2006; mechanisms to facilitate more meaningful stakeholder engagement, and new corporate governance principles for unlisted companies. The excellent work done by the Financial Reporting Lab under the aegis of the FRC in relation to risk and viability reporting is an example of how sharing and developing best practice in this area can make a real difference to the way that boards think about these important matters. All these developments will help to change the environment in which the corporate failures that provide the background to the Consultation arose.

We would also observe that, during May 2016, the Government published a consultation seeking views on measures to update the UK's corporate insolvency laws. The Insolvency Service then published a summary of responses to this consultation during September 2016. However, this Consultation does not reference that earlier consultation. In our view, the proposals in this Consultation need to be considered together with that earlier, more wide-ranging consultation.

<u>Sales of Businesses in Distress</u>

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

No.

In the large majority of cases, sales of distressed subsidiaries are undertaken for legitimate reasons. Typically, the parties genuinely and honestly believe that, under new ownership, a business in need of additional capital, or a more skilled or more focussed management team, can be turned around and rescued. But sometimes distressed subsidiaries will ultimately fail despite a change of ownership and despite the new owner's best efforts. The question should therefore be whether the prospect of personal liability being imposed on the directors of the holding company, in the given circumstances, is more likely to result in a better outcome for the subsidiary's creditors (and, potentially, other stakeholders) than would be the case under the current regime, where there is no such liability. Relatedly, could imposing a duty of this nature on the directors of the holding company be expected to have other undesirable effects (e.g. on shareholders, creditors or employees of the holding company, or on the wider community)?[1]

Most problematically, the proposed duty would conflict with, and undermine, the core duty of loyalty which the directors of the holding company owe to the holding company itself. If the holding company is a UK company and not itself financially distressed, this core duty is the duty of the directors to exercise their powers in the way they consider in good faith to be most likely to promote the success of the holding company for the benefit of its shareholders, having regard to, among other things, the interests of other creditors and employees. What is in the interests of such a holding company (and its shareholders and other stakeholders) will often be diametrically opposed to what is in the interests of the creditors of a distressed subsidiary. If the directors of the holding company have an opportunity to recover some value on the investment in the distressed subsidiary by selling it to a third party and withdrawing the holding company's financial

[1] We refer in this submission to the proposed new 'duty' on the part of the directors of the holding company. In circumstances where liability is imposed as a result of a person's having acted (or failed to act) in a particular way in particular circumstances, in the light of the knowledge he or she had or ought to have had and the alternative courses of action he or she could otherwise have taken, it is apt to describe that liability as arising consequent upon a breach of a duty.

supports (which actions would be in the best interests of the holding company and its stakeholders), but they have a reasonable suspicion that the buyer of the subsidiary may be over-optimistic in evaluating the prospects for a turnaround, or unable successfully to execute that turnaround, is it in fact right that the holding company should forego the opportunity to recover that value through sale, and instead put the distressed subsidiary into liquidation or administration (which, almost inevitably in the UK, would lead to its demise)? If such a duty were to be imposed, the effect would be that the interests of the holding company (which subsume the interests of its own shareholders, creditors, employees and other stakeholders) end up being practically 'subordinated' to the interests of the subsidiary's creditors.

This situation becomes even more intractable where the holding company itself is financially distressed and where the sale of the relevant subsidiary may be critical to the survival of the holding company. In such a situation, the primary duty of the directors of the holding company may well be owed to its creditors, meaning that the 'subordination' to the interests of the subsidiary's creditors noted above would be particularly stark. Creditors can and do lend to different group companies, taking security over different assets and shares in other group companies, with full knowledge not only of the potential risks but also of the 'rules of the road' in circumstances of financial distress. It would upend settled principles of law if the creditors of a holding company were to face the prospect that the powers of the holding company's board (or, if displaced by an insolvency officer, the liquidator or administrator) would in certain circumstances require to be exercised in a manner adverse to the interests of the holding company to which they have lent. This is potentially enough to make normal group financing structures untenable and could significantly impair the value of existing credits, which could in turn give rise to challenges under human rights law (e.g. under Article 1 of Protocol 1 to the European Convention on Human Rights). It could also raise the cost of credit for UK companies generally, because one effect of the duty will be to require holding companies to bear greater losses than they would otherwise have to bear. Whether there would be any off-setting reduction in the cost of credit extended to subsidiaries seems to us to be doubtful: we believe that the fissure created by this novel exception to the principle of limited liability will have the preponderant effect.

Another potential source of conflict arises from the fact that, under the articles of association of most UK companies, the directors are required to take (or refrain from taking) specified action set out in a special resolution passed by the shareholders of that company. That could include a direction to sell a particular subsidiary: which course of action (that prescribed by shareholders or that dictated by the proposed new duty to put the distressed subsidiary into liquidation or administration) would the directors be required to follow?

In short, the proposal seeks to impose a duty of care on the directors of a holding company that is directly opposed to the duties which they owe to the holding company and its own shareholders, creditors and other stakeholders. And it is on the basis of a settled understanding of those fiduciary duties that people have invested in, and lent to, companies.

The new duty would in any event replicate existing duties to which the directors *of the distressed subsidiary* are already subject, but in a different and distorted way. To comply with the new duty, the directors of the holding company would be required to conclude that the sale would lead to a better outcome for the creditors of the subsidiary than placing it into liquidation or administration, whereas the directors of the subsidiary would be required to conclude (in order to avoid liability under section 214 of the Insolvency Act 1986) that, despite the sale, there is (still) a reasonable prospect of avoiding insolvent liquidation. These are different standards, so it is conceivable that the new duty imposed on the directors of the holding company could be breached in circumstances where the existing duty owed by the directors of the distressed subsidiary had not been.

It is not obvious that the existing duty of the directors of the subsidiary under section 214 is not appropriately calibrated. As noted above, it currently requires those directors to consider, on a continuing basis, including at the time of and after any sale of the subsidiary, whether there is (still) a reasonable prospect of avoiding insolvent liquidation. In our view, the issue is not that the existing law is inadequate but rather that it is potentially not being effectively applied or enforced. Guidance given to directors at the time of their appointment could make it clear that there is a greater risk of personal liability where a company is in financial difficulty and that in certain circumstances they may have a duty to put the company into administration to avoid further loss to creditors.

We also do not believe that the directors of the holding company are in a better position than are the directors of the subsidiary, to decide whether the subsidiary should or should not enter liquidation or administration. In any event, under existing law, liability under section 214 can be imposed on shadow directors and de facto directors, including (in appropriate circumstances) a holding company. The concept of the shadow director was developed precisely in order to *deter* third parties from usurping the role and responsibilities of the actual directors. It ensures that the right individuals are held to account. Yet the proposed duty actively encourages the directors of the holding company to override the directors of the distressed subsidiary.

If the directors of the subsidiary have carefully and honestly formed the view that a sale offers the best chance of a successful turnaround, but the directors of the holding company – with one eye to their personal liability – conclude that it is safer for them to put the subsidiary into liquidation or administration, the outcome is likely to be worse for the stakeholders of the distressed subsidiary, who could rightly have complained that it would have been a breach of duty for the directors of the subsidiary to put it into administration rather than facilitating a sale.

Even if these problems relating to conflicting duties could be satisfactorily resolved, which we doubt, further difficulties arise. What degree of confidence would the directors of the holding company need to have in order to avoid liability on the basis that they 'could reasonably have believed' that a sale was the better outcome? This is not a question about reasonable belief as to existing facts, but rather about what it is reasonable to believe about possible future states of the world. Looking into the future and ascribing probabilities to various outcomes is an inherently uncertain exercise, worryingly susceptible to hindsight bias. Faced with this uncertainty and the prospect of personal liability, who could blame directors for resolving that uncertainty by putting the distressed subsidiary into liquidation or administration? In turn, that must increase the risk that potentially viable turn-around opportunities will not be taken, to the detriment of the subsidiary's stakeholders.

It is important that directors should be clear as to what steps they are expected to take to avoid liability, particularly as it is suggested that they would need to do more than just asking questions and accepting assurances. This could have significant cost implications if directors of holding companies have to arrange some form of financial and commercial due diligence on the prospective buyer's plans and capabilities. For obvious reasons, prospective buyers (and the directors they appoint to the board of the subsidiary) are unlikely to be willing to share their commercial and financial plans with the seller and its directors.

The new duty would appear to require directors of the holding company to consider the interests of creditors of the subsidiary at the time that the sale was entered into. However, for some stakeholders of the subsidiary, such as employees (who may continue to be employed after the sale, as opposed to the situation if the relevant company immediately went into an insolvency process) and even for creditors who will be repaid in the intervening period between the sale and the commencement of the insolvency process (e.g. from the proceeds of new equity or finance injected by the purchaser), the sale might provide a better outcome than if the company immediately entered into an insolvency process. The sale could therefore harm some creditors while benefitting others. How should the directors of the holding company weigh the distribution of pain in various possible future states of the world? Should the directors give different weight to the interests of those creditors who choose to give further credit to the company despite its distressed state and/or after new security is granted, compared to those who extended credit in a time of financial health?

What relevance and weight would be given to the fact that the holding company (or another of its subsidiaries) may have provided support or assistance as part of the sale arrangement, which it would have no legal obligation to provide had that not been contractually agreed with the purchaser? For example, the selling group may waive some or all of outstanding intra-group debt, allow the relevant company continued use of a valuable trade mark for less than market rate, or provide transitional services at cost.

The new duty also raises a concern that directors may not pursue genuine opportunities for a business rescue by a sale of shares, due to fears that they may become personally liable. Directors may therefore decide to pursue a sale in conjunction with a standard insolvency process, including a pre-packaged sale. This course of action may disadvantage, in value terms, creditors, employees and other stakeholders.

It is not clear from the consultation whether the duty would apply only to the directors of UK holding companies, or also to non-UK holding companies, or to the equivalent officers of any ultimate controlling entity or even the ultimate beneficial owner. The basis for imposing, and practical enforcement of, any such duty against the directors of a remote, non-UK holding company, is also fraught with difficulty. Would this consideration encourage the formation of offshore holding companies for UK trading subsidiaries? Similarly, would the regime apply to the directors of a UK holding company that sold a non-UK subsidiary which subsequently entered an insolvency process outside the UK? Would it matter if the large majority of the employees or creditors of the subsidiary were within or outside the UK? It is not clear whether it is only UK financial creditors or UK-based suppliers (if such a categorisation is meaningful) or UK-based employees who are intended to be protected by these proposals.

Other difficulties that would need to be resolved would include the question of how to treat 'indirect' sales (i.e. a sale by the ultimate holding company of a solvent intermediate holding company, which in turn holds the shares in the distressed subsidiary) and the possibility that transactions could be structured differently so as to fall out of scope (e.g. through an issue of new shares and cancellation or repurchase of existing shares, instead of a sale of shares). The proposal that the duty would apply only in relation to 'large' subsidiaries would also seem to invite the possibility that the employees and business of an insolvent subsidiary might be divided into a number of smaller subsidiaries before the sale.

In our view, there should be extreme caution regarding the introduction of legislation that imposes a significantly higher degree of risk for directors of holding companies than other jurisdictions unless the rationale for the legislation can be clearly justified (which we do not consider to be the case with the current proposals), as the result will inevitably be that businesses will incorporate in other jurisdictions and look less favourably on investing and operating in the UK.

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?

For the reasons outlined above, we do not support the introduction of the proposed new duty. If it were to be extended to apply to other measures in addition to sales of shares, this would exacerbate the problems we have identified. For example, there is a risk that it could require a holding company to continue providing financial support or other resources (e.g. access to know-how or intellectual property, central functions) to its distressed subsidiaries, even if there is little or no commercial justification in doing so and where this prejudices the rest of the group. If that were to be the case, it will discourage holding companies from providing such support to their subsidiaries in the first place, undermining the undoubted benefits of conducting business through subsidiaries and making it more difficult to rescue distressed businesses in the first place. We see this as a critical point, because the provision of financial support and other intra-group arrangements within corporate groups is commonplace and, in many situations, will help the recipient to return to financial health.

More generally, it would be undesirable for the directors of a solvent holding company to have to consider whether each and every act which might or might not be done by them in that capacity, would be likely to operate to the prejudice of the creditors of the subsidiary in a hypothetical future insolvency of that subsidiary. Should the interests of the creditors of an immaterial subsidiary be able to dictate the behaviour of its much larger holding company or fellow subsidiary? We think that they should not.

Our comments in relation to Q1 above take up the problem of material conflicts.

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

We do not consider the proposal to be appropriate or required. In our view, for as long as our corporate law is based upon the fundamental precepts of limited liability and separate legal personality, with delegated management under a board of directors, it is those directors (including, importantly, shadow directors and de facto directors) alone who should be held responsible. To make parent company directors personally responsible for a sale focusses on the wrong 'target' and would place those directors in intractable conflict situations.

If one were to look for others to 'target', one should keep in mind that there are many situations in which creditors themselves, through their own self-interest and focus on short-term returns, culminating in their unwillingness to agree to a restructuring, could be seen as being as much to 'blame' for the failure of the borrower-subsidiary, as are the directors of the holding company. Indeed, it could be argued that large financial creditors are uniquely well-placed to monitor their borrowers and spot early signs of distress.

Separately, the footnote on page 10 of the Consultation is vague and potentially very broad. Who are persons 'connected with' a director? There is no basis in law for imposing a duty of care on a person who cannot bear culpability – in any meaningful sense – for the bad outcomes which the duty seeks to prevent given that they are not able, practically, to influence the future conduct of the entity that has been sold or the decision to sell. Such people may have no way, in practice, to influence or prevent the behaviour targeted. Ordinary principles of accessory liability (which require a degree of knowledge and some act or omission that contributed causally to the bad outcome) are appropriate. No-fault liability for corporate failure, simply by virtue of being 'connected' to a director, would be a novel and inappropriate development.

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?

In our view, it will not be possible to ensure that there is no impact on sales which genuinely seek to rescue distressed businesses, because the number of such sales that are attempted in the first place will inevitably be reduced due to the incentive that holding company directors would have to place the distressed subsidiary into an insolvency process.

The proposal also does not take into account the legitimate interests of potential purchasers. We have already noted above that purchasers will be highly unlikely to be willing to divulge details of their turnaround plan. It may also require diligence on the purchaser's sources of financing (see below) which may also be unwelcome, requiring disclosure of sensitive financial information to the selling holding company or its advisers. A seller board may go further and require binding obligations on the purchaser which will, in practice, be very difficult for a purchaser to agree to. A purchaser will not commit a "blank cheque" to achieving a successful turn-around of the target company and even committing to a multi-year turn-around plan may be difficult. The underlying business will be vulnerable to wider market forces (e.g. level of consumer demand, interest rates etc.) meaning that the turn-around may fail despite the best efforts of the purchaser and the company. In such a situation, the purchaser will want the flexibility to change approach, including ceasing to inject additional capital and instead commencing an insolvency process. The net effect is that the proposed new duty risks deterring purchasers with valid business plans and good intentions from acquiring distressed assets.

One possibility we considered was whether it would be feasible to provide for a safe harbour that would protect the holding company directors against liability if they could demonstrate that they had received reasonably satisfactory evidence that the buyer had sufficient financial resources to support the business's working capital requirements for at least the next 12 months, assuming forbearance by other creditors. One difficulty with this, however, is that assuming such forbearance may be an unrealistic counterfactual. The distressed subsidiary may foreseeably require a financial restructuring after the sale, such that its survival may be dependent not only on the actions and capabilities of the buyer in running the business, but also in negotiating a restructuring, and on decisions made by the subsidiary's creditors after the sale, who may well be different persons. There would obviously be a cost in having to provide such evidence and there would still be a question as to whether the evidence provided was reasonably satisfactory or not.

<u>Value Extraction Schemes</u>

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?

No.

On page 14, the Consultation suggests that existing rules may be insufficiently robust to counter sophisticated modern transactions which unfairly strip value from a distressed company. However, we consider that existing rules in relation to directors' duties under the Companies Act 2006 and the avoidance of transactions under the Insolvency Act 1986 are already largely sufficient to address this type of behaviour. For instance, the example given on page 15 of the Consultation would arguably fall foul of the directors' duty to promote the success of the relevant company under section 172 of the

Companies Act 2006, as well as the rules against extortionate credit transactions in section 244 of the Insolvency Act 1986. Similarly, references in the Consultation to a transaction not 'adding value' raises the possibility that the envisaged transactions could be undervalue transactions for the purposes of section 238 of the Insolvency Act 1986. In particular, we note that section 172(3) of the Companies Act 2006 establishes a duty on directors to consider the interests of the company's creditors when the company is in financial difficulty. This duty already requires directors in the scenarios envisaged to consider the interests of the company's creditors and, in particular, whether they would be better off if the company entered into the relevant arrangement or if it entered into an insolvency process instead.

It should also be borne in mind that voiding otherwise valid contracts between sophisticated parties on the basis that they were 'unfair' or 'commercially unreasonable' and entered into in circumstances of financial distress, would undermine the freedom and sanctity of contract for which English law is rightly held in high regard. While it is true that contractual terms can be invalidated under the Consumer Rights Act 2015 (in consumer contracts) and under the Unfair Contract Terms Act 1977, the techniques deployed in this legislation generally are to invalidate certain clauses per se, and not to invalidate or re-write essential terms such as price. To use concepts such as 'fairness' and 'commercial reasonableness' to re-write the parties' bargain, or invalidate their bargain entirely (presumably leaving them only with an unsecured claim in unjust enrichment to the extent that consideration has passed) should require the strongest justification.

If measures in this area are to be introduced on the basis of the Consultation, they should ideally develop the rules already in existence. For example, section 244 of the Insolvency Act 1986 (regarding extortionate credit transactions) could potentially be amended slightly to address some of the concerns highlighted in this section of the Consultation so that it referred to disproportionate or commercially unreasonable transactions, which would help to focus on the matters raised in the Consultation without introducing sweeping changes to the legislation. Any measures introduced would need to be responsive to the fact that it is difficult for the court to make judgements about what is and what is not reasonable or fair in a market context without clear legislative guidance. It is also important for any measures to provide sufficient certainty as to the tests that would be applied to determine fairness for potential investors and companies to be able to decide that their proposals fall on the right side of the "fairness" dividing line. Otherwise, they will not be willing to invest.

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?

No.

Transactions in distressed situations almost by definition take place in extreme or unique circumstances. In many cases, the proposal for new investment may be the company's only alternative to entering into an insolvency process. In such a scenario, it may be difficult to determine whether or not the terms of the investment are fair or market standard, since there is no established market in relation to that particular investment. This will create challenges both for the company and investors concerned and whoever brings a claim under these proposed rules. In cases where a company is in financial distress, any investor providing new funds is likely to want to be treated ‘better’ than existing creditors, as it is taking risk at a time when there is an increased risk to the funds provided. If the test is whether they will be in a better position that other creditors, this will almost inevitably be the case because, for example, they will want some preference or security to reflect the risk they are taking. The issue we think the Government is seeking to address is whether the degree of preference is “unfair” in some way.

If ‘new money’ is taken by a company on terms and in circumstances where no reasonable board of directors could have believed that so doing would be in the best interests of the company, then a claim will prima facie lie against the directors for breach of duty. A claim may also lie against the relevant creditor as an accessory to such breach, or potentially also under the existing avoidance provisions of the Insolvency Act 1986. However, to revise the standard of review in such cases to one that requires the directors and an unconnected third party creditor, dealing with each other at arm’s length, both to be confident that the transaction will pass some objective test of ‘fairness’ when judged with the benefit of hindsight, will throw our corporate laws into a state of great confusion and uncertainty and either raise the cost of credit or reduce its availability.

Again, we think that the issue is not the inadequacy of existing law but potentially inadequate enforcement powers. “Value extraction schemes” are difficult to define because they rely on subjective concepts about what is “fair” or “reasonable” or “market practice”. The trigger would need to be clear, not a hindsight test which creates real uncertainties. If the trigger can be clearly and objectively defined, then it could be made subject to a solvency statement test similar to the s643 CA 2006 solvency statement – with liability determined by whether the directors had reasonable grounds at the time for making the statement. The merits of this test is that it is already well understood and is already used to cover one type of value extraction i.e. capital reductions for private companies.

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?

An inevitable consequence of these proposals is that they would create uncertainty for investors as to the security of their investments and the confidence they could place in their expectations. It seems that the risk potential investors could face could exceed the amount of new money invested and the amounts received from the company in which the investment is made. Other things being equal, this would be expected to make investors reluctant to provide investment that may help rescue distressed businesses. It is also likely to lead to such investments becoming more expensive for distressed companies, since investors will price this uncertainty into their investments.

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?

It would be helpful to ensure that the relevant concepts are defined as specifically as possible in order to provide the maximum amount of certainty for companies and investors. This is particularly so given that courts are understandably reluctant to make judgements about commercial reasonableness.

In particular, it would be helpful to provide safe harbours for the many types of transaction in this arena that may be legitimate, such as:

- director remuneration – newly appointed directors in a distressed scenario will be operating in a challenging and stressful environment. Accordingly, directors may require sufficient remuneration in order to assume the extensive responsibilities that are incumbent upon directors in distressed scenarios;
- limited options available for the company – it is often the case that a company has limited options for new investment in distressed scenarios. The wrongful trading provisions in section 214 of the Insolvency Act 1986 give directors a powerful reference point in order to decide whether entering into the relevant transaction is appropriate. Accordingly, companies should not be discouraged from pursuing their only available lifeline, even where this lifeline may be deemed excessive in other contexts; and
- management fees – management fees are often structured so as to provide a return on investment. Payments in those scenarios may be viewed as more sinister than they actually are, when looked at in hindsight and in the round.

More generally, investors specialising in distressed situations structure their investments in order to address the inherent significant downside risks in these contexts. This usually results in higher interest rates, senior ranking security packages and tighter financial covenants and information rights than might be found in an investment grade context. However, it is important to bear in mind that these provisions may be proportionate in distressed circumstances in order to protect investors from downside risk. Any new restrictions imposed in this area could have the unintended consequence of reducing the availability of rescue finance in distressed scenarios.

We would also reiterate the point we made in our answer to Q6 above, namely that it is difficult to conclude what should be considered 'market standard' or 'fair' (or, at least, not 'unfair' or 'excessive') for these purposes, since the circumstances around a particular investment are often fact specific. We see particular difficulty in formulating a test as to whether the interests of other creditors are unfairly harmed or not.

Where it is objectively reasonable for directors to believe, based on the facts available to them at the time, that the proposed arrangement would benefit the company (or its creditors depending on the relevant circumstances) then the relevant arrangement should not be made more vulnerable to challenge than is currently the case even where, with the benefit of hindsight it becomes apparent that arrangement did not deliver the anticipated benefits.

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?

We agree and welcome this proposal, other than to suggest that there should be guidance around the circumstances and timetable in which the Secretary of State would seek to utilise these powers.

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?

We agree. We are not clear whether there would be any time limit on how far back the Secretary of State should be able to go. We think there should be a limited time period (except in cases of fraud) after which the Secretary of State would not exercise these powers.

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?

We note that many of the concerns in this area are already addressed by existing rules and practice, including under the Companies Act 2006, the Listing Rules and related disclosure regimes (including under the Market Abuse Regulation) and the UK Corporate Governance Code. In particular, poor record keeping is already a breach of duty. Failure to file the requisite returns at Companies House is in some cases a criminal offence. These failings would also be taken into account in disqualification proceedings against directors.

We would suggest that any measures adopted should be on the basis of best practice guidance rather than formal legislation. For example, it could be considered whether guidance already given to new directors by Companies House could include a section on good corporate record-keeping, some examples of scenarios where separate legal personality within corporate groups will be relevant, and an overview of directors' duties when companies are in financial difficulty.

Any more wide ranging reform in this area would also need to be capable of addressing the multinational dimension of many corporate groups, in order to ensure appropriate oversight and control.

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?

Shareholders and directors have access to different information and face different incentives. The structure of modern capital markets (diversified, internationalised, and increasingly either entirely passive or trading with high frequency) makes it difficult to require shareholders positively to take steps to engage with the companies in which they have invested. At best, obstacles to those willing and able to engage should be removed. Some steps have been taken in this direction already. For example, the Takeover Panel has clarified that shareholders will not be presumed to have formed a control-seeking concert party by reason only that they join together in order to engage with management on matters which concern them. The Kay Review has also seen the advent of the Investor Forum, which applies collective (and, in some cases, public) pressure on companies. Transparency in financial and narrative reporting has enabled problems to be uncovered (sometimes by the media or by short sellers) sooner than would otherwise have been the case. Say-on-pay has resulted in real change that often goes unremarked because it happens behind the scenes. Shareholders often owe duties to third parties for the decisions they take on their behalf. It might be helpful to encourage those third parties to take more action to encourage shareholders and other intermediaries who advise them to take an active role in stewardship.

We agree that inquiries into the failure of large or high-profile companies (whether public or private) can provide useful lessons, provided that they are conducted fairly.

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?

In our view, there may be some benefit in requiring public companies to disclose the amount of their distributable profits in their audited accounts. However, we also caution that some companies' share prices will be dependent on the assumption of a regular dividend payment, and that these companies may decide to 'create' distributable profits in a perfectly legitimate manner by upstreaming cash only immediately before they authorise the dividend. Accordingly, any such rule would need to allow companies to clarify whether they are able to 'create' distributable profits in order to pay dividends. Moreover, many older companies with substantial distributable profits fully adequate to cover dividends cannot calculate the precise amount of their distributable profits. Any disclosure requirement would need to take this into account.

Distributable profits are only part of the picture, however, as there are circumstances where the existence of distributable profits may not mean that the dividend is lawful. For example, the case of *BTI 2014 LLC* v *Sequana SA* [2016] EWHC 1686 established that the payment of a dividend can constitute a transaction defrauding creditors for the purposes of section 423 of the Insolvency Act 1986, even where there are sufficient distributable profits available to justify the dividend, depending on the purpose for which it was paid. In addition, the common law rule against paying dividends out of capital remains unaffected.

It could be explored whether there are alternative or additional measures that could be applied to control the payment of dividends given the complexity inherent in the current regime which involves consideration of interacting statutory, common law and accounting issues. The current rules, based on the Second Company Law Directive, are quite complicated and this is compounded by the complexity of the technical guidance issued by the ICAEW on realised profits. Instead of requiring distributable profits, for example, some jurisdictions impose a forward-looking solvency test. However, these rules potentially come with their own difficulties, such as in relation to the consideration of contingent liabilities and the degree of judgment involved in predicting how matters may in future unfold. If changes in this area are to be considered, they should be the subject of a separate and properly-considered consultation.

We note that the example on page 23 of the Consultation specifies that the company continued to make large dividend payments despite having a significant defined benefit pension fund deficit. We would caution against making any rules against paying a dividend in such circumstances. This is because it is possible for a company to manage its pension deficit and comply with its deficit recovery obligations whilst still being able to pay a dividend. Furthermore, as noted above, many companies' share prices are dependent on the payment of regular dividends. Preventing companies from doing so, even where they have sufficient distributable profits to justify paying the dividend, could significantly reduce their share price, which could also have an impact on their solvency or ability to sustain or grow their businesses, for example if it made it more difficult for them to raise capital.

The existing statutory rules in relation to dividends are derived from EU law. Accordingly, any significant reform in this area, at least for public companies, may have to wait until after the UK withdraws from the EU.

We recognise the tension inherent in the claims and expectations that creditors, pension schemes and shareholders make on a solvent company's cash flows. Generally speaking, solvent and profitable companies operate with a mix of permanent debt and equity funding, which requires periodic payments to be made to the providers of both, in the form of interest and dividends (or share buybacks). Companies must be run with a high degree of confidence that they will be able to meet their actual and contingent financial commitments, and that they will prosper in the long run. Stopping dividend payments until a pension deficit has been cleared would make the UK a very unattractive place to raise equity capital. For existing companies, it could be especially counterproductive by making it more difficult to raise new equity when it is most urgently needed. We do, however, believe that disclosure of the details of a deficit reduction plan would provide stakeholders with more information with which to hold management to account for decisions on pay-out policy. The Financial Reporting Lab's recent work on dividend disclosures also calls for greater transparency as to how the board has decided to allocate available cash between re-investment in the business, pension contributions, remuneration and dividends.

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?

It is important to recognise that directors will often need to obtain professional advice in order to comply with their duties. Indeed, case law recognises that the failure to obtain appropriate professional advice can itself constitute a breach of duty. It is not our experience that directors are unaware of their duties or of the benefits of obtaining appropriate professional advice. The duty on directors to exercise independent judgement does not conflict with (and is often complemented by) consulting professional advisers and, indeed, acting with due regard to that advice. Furthermore, in our experience, advisers often remind directors of their duty to consider the issues and to come to an independent decision. Frequently, obtaining specialist advice at an earlier time will lead to a better outcome in circumstances of financial distress. However, it is also the case that the directors of a distressed company will often be experiencing a situation of that nature for the first time. They may well be on unfamiliar ground and – not unfairly – more reliant on the advice of professionals than would normally be the case.

We are also conscious that the UK's model of 'enlightened shareholder value' – which is enshrined in the duties of the directors set out in the Companies Act 2006 – has been subject to recent criticism. There is a growing emphasis on what might be described as 'stakeholder governance'. While we welcome (subject to some reservations) the steps taken towards facilitating more meaningful engagement with stakeholders, we would also caution that confusion about the ends that the directors of a distressed company should be pursuing, and the permissible means to those ends, would be harmful to all stakeholders. Maximising returns to shareholders, maximising the value of the company, minimising losses to financial creditors, minimising losses to suppliers, and minimising losses to employees, are all different objectives. There is unlikely to be a single course of action that solves optimally for all of them. While directors should be encouraged (and are indeed required) to 'exercise independent judgment', this should not be taken as a licence to disregard what their duties require of them, particularly where the company is financially distressed.

The best option in this area may be to add to the guidance already given to directors by Companies House and/or bodies such as ICSA. This guidance should clarify that, whilst it is recommended that directors seek professional advice in certain circumstances, they still have a duty to make their own independent decisions (that is, not to allow decisions to be ‘taken’ for them by third parties, including advisers) and to challenge and test advice where appropriate. This guidance could say that whenever the directors become aware that the company may be about to experience financial difficulties, they should take advice from a professional, but also that ultimate responsibility rests with them.

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.

We do not express any views on this question.

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?

We do not express any views on this question.

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?

We believe that the current corporate governance framework does achieve the right balance.

In our view, the proposals in the Consultation should be considered within the context of the responses to the May 2016 consultation on the UK’s corporate insolvency regime. In particular, we note that approximately two thirds of respondents to that consultation agreed in principle that the introduction of a pre-insolvency temporary moratorium would facilitate business rescue. Similarly, we believe that measures should be introduced in accordance with the Consultation only if there is a clear ‘gap’ to address and they will further the aim of facilitating a culture of corporate rescue.

We note that one of the general aims of the proposals in the Consultation is to improve corporate transparency, particularly in distressed scenarios. Accordingly, to the extent that it is determined that action is required, we would suggest utilising and developing the rules that are already in place. For example, the Listing Rules require companies with a premium listing of equity shares to include in their annual report (i) statements by directors on the appropriateness of adopting the going concern basis of accounting and (ii) the viability statement, which sets out the directors’ assessment of the company’s prospects. Similar rules could be extended to large unlisted companies in order to increase transparency in a way that the market is already familiar with.

If you have any queries, please do not hesitate to contact me.

Yours faithfully

David Pudge
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