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Insolvency and Corporate Governance

Thank you for giving the Institute of Directors (IoD) the opportunity to provide written evidence in response to your consultation on Insolvency and Corporate Governance. This consultation is of considerable interest to the IoD, its membership and the wider community of board members, and we are therefore pleased to present our views in respect of your proposals.

About the IoD

The IoD was founded in 1903 and obtained a Royal Charter in 1906. It is an independent, non-party political organisation of approximately 33,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. 49% of FTSE 100 companies and 45% of FTSE 350 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises (SMEs), ranging from long-established businesses to start-up companies. IoD members' organisations are entrepreneurial and growth-orientated, and more than half (61%) export goods and services internationally.

The IoD has long been an advocate of high standards of corporate governance. According to our Royal Charter, one of the IoD's key objectives is "to promote the study, research and development of the law and practice of corporate governance, and to share findings." We strongly believe that an effective system of corporate governance is a key underpinning of UK economic performance and business legitimacy.

Summary of our view

- We accept that holding company directors should be accountable for decisions made about the sale of insolvent or near-insolvent subsidiaries (e.g. to sell to a third party or to place directly into an insolvency procedure). Although holding companies and subsidiaries may be separate legal entities, the holding company board will, in most cases, be responsible for making the key decisions concerning the subsidiary.
- However, we do not agree that holding company directors should be held personally liable for what happens at companies that are no longer under their influence or control, i.e. after the insolvent subsidiary has been sold to a third party for a period of up to two years. This would be neither equitable nor supportive of proper accountability.
- Furthermore, we do not see how holding company directors can, in practice, be held liable for harm that could be "reasonably foreseen" at the time of the sale of the insolvent subsidiary. Directors do not have a crystal ball. How can they realistically predict if the sale of a financially-distressed subsidiary to a third party will ultimately harm or improve the position of creditors or other stakeholders?

- In our view, the best way for directors to fulfil an appropriate duty of care is for boards to consult with relevant stakeholders at the time of the potential sale. If other stakeholders are broadly supportive of a sale, then directors should face no ongoing post-sale liability.
- We broadly support Government proposals to provide insolvency office holders with more power to reverse transactions that unfairly remove value from a company, to the detriment of other creditors, suppliers and other stakeholders.
- We also support proposals aimed at permitting investigation of directors of dissolved companies.
- In order to enhance the accountability of boards within Corporate Groups, we propose that each Group should define and disclose a Group Governance Framework, which delineates the relative roles and responsibilities of holding company and subsidiary boards.
- We advocate a much greater emphasis on director education and professional development as a means of increasing board-level awareness of directors' duties under the Companies Act, Insolvency Act and other regulatory requirements.
- In addition, we propose the establishment of a newly-defined corporate form – the Public Service Corporation – through which the outsourcing of public services and related activities could be delivered. Such a legal entity would be constructed in order to ensure that the board maintains a balance between the interests of shareholders and other stakeholders – such as creditors, employees, suppliers and the pension fund.
- Finally, we advocate enhancing director accountability and competence by establishing a more explicit framework of professional conduct for directors of significant corporate entities. This could involve a commitment to a Code of Conduct for directors and, in cases where behaviour falls short of these defined standards, directors could be publicly censured by their peers. In order to achieve a significant enhancement in director competencies and awareness of director duties, this framework could also incorporate commitments from individual directors to undertake tailored programmes of continuing professional development.
- We believe that such a framework could play a significant role in increasing the accountability of boards of directors of significant corporate entities. It would also drive the evolution of the director role from that of "gifted amateur" to competent professional with a clear understanding of fiduciary duties and responsibilities.

<u>Specific responses to Consultation Questions</u>

Sales of Businesses in Distress

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

We agree that more needs to be done to take account of the interests of stakeholders when a holding company sells a distressed subsidiary. The scenario described in the consultation document is obviously akin to the circumstances surrounding the sale of BHS (controlled by Arcadia Group) to Retail Acquisitions (controlled by Dominic Chappell) in 2015. The subsequent collapse of BHS negatively affected a large number of stakeholders – including BHS employees, pensioners, creditors and suppliers – and was also damaging to the reputation of the wider UK business community.

However, although we accept the need for improvements to the current insolvency regime, we have concerns with the details of what is being proposed. Our observations relate to two areas.

Firstly, although we agree that holding company directors should accept accountability for what happens to the stakeholders of subsidiary entities (despite the fact that, strictly speaking, the holding company and the subsidiary company are two separate legal entities), we feel that it is problematic for directors to be held liable for companies that are no longer under their influence or control. According to the proposals, holding company directors could remain personally liable for losses incurred up to two years after the subsidiary has been sold to a third party. In our view, this is neither equitable nor supportive of proper board accountability.

Furthermore, we do not imagine that many holding company directors would be prepared to expose themselves to that kind of risk. As a result, the unintended consequence of the proposals would be for holding companies to play safe - by immediately placing financially distressed subsidiaries into an insolvency procedure rather than selling to a third party. In many cases, this could give rise to a worse outcome for creditors and other stakeholders than might be possible if they were to be rescued by another corporate buyer.

Secondly, we are concerned with the proposal that holding company directors should be held liable for harm that could be "reasonably foreseen" at the time of the sale. This gives rise to a question: on what basis should a holding company director determine if a potential buyer of a distressed subsidiary is suitable? The consultation document does not provide much guidance on this question.

Hindsight is a wonderful thing. However, in real time it will always be difficult to predict if a potential buyer will ultimately harm or save an insolvent company. Even in the case of BHS, it was not initially obvious that its acquisition by Retail Acquisitions would inevitably lead to BHS's collapse. A potential buyer will almost certainly project an optimistic view of their plans for the subsidiary. How should holding company boards assess these claims in a way that mitigates their ongoing financial liability?

In order for the Government's proposals to be workable, it will be necessary to define a clear and realistic process by which holding company directors can fulfil a duty of care to the stakeholders of subsidiaries at the time of the potential sale, and thereby protect themselves from unacceptable exposure to ongoing financial risk.

We suggest that the following type of process could be defined.

- As part of a disposal process, the board of the subsidiary company could be required to undertake a consultation process with the subsidiary's major stakeholders - particularly its creditors, but also its employees, pension fund trustees, etc.
- In order to inform the consultation process, the subsidiary board would circulate to stakeholders their summary of the various disposal options (e.g. sale to one or more third party buyers, placing the subsidiary into an insolvency procedure, etc), the implications for each stakeholder group, and a statement of the board's preferred disposal option.
- The results of this consultation process would then be shared with the holding company board.

If there were evidence of reasonable (although not necessarily unanimous) support amongst stakeholders for the sale of a subsidiary to a third party, this would discharge the holding company board from any ongoing liability to the creditors of the subsidiary. Such a process would provide clear evidence that the holding company board has taken account of the interests of stakeholders, and thereby discharged a duty of care to a sufficient extent.

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?

We are not sure how such a dilemma might come about. At the moment when insolvency is not realistically avoidable, the directors of the subsidiary company have a legal duty to cease trading and place the company into an insolvency procedure. It is important that subsidiary board directors are educated to understand the nature of their responsibilities in that situation.

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

In our view, both the boards of the subsidiary company and the holding company have responsibilities with respect to a sale. Ideally, the relative responsibilities of the subsidiary and holding company boards should be disclosed in the form of a Group Governance Policy (see answer to question 11). In most cases, the holding company board is likely to be the ultimate decision maker. However, it will also be reasonable for the subsidiary board to fulfil a duty of care in respect of the decision. As discussed above, this could involve consulting with relevant stakeholders and advising the holding company board on the implications of the various disposal options.

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?

As discussed, the key challenge will be to define a clear and realistic process for the boards of holding and subsidiary companies to follow in the event of a sale of a distressed subsidiary. By following such a process, boards must have confidence that they can fulfil a sufficient duty of care to stakeholders. If there is no such process, or if it is unclear or impractical, holding company boards will be more likely to play safe, and immediately place the distressed subsidiary into an insolvency procedure without consideration of alternative options.

Value Extraction Schemes

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

We agree that it would be beneficial to provide insolvency office holders with more power to reverse transactions that unfairly remove value from a company, to the detriment of other creditors, suppliers and other stakeholders.

We share the Government's concern that the present law does not adequately deal with the scenario where an ailing (though not yet in administration or liquidation) company has been 'rescued' by investors who then exploit their control over the company to extract value, thereby minimising their potential loss should the company subsequently fail.

As described in the consultation document, these value extraction arrangements may take the form of management fees; excessive interest on loans; charges over company property being granted; excessive director pay or other payments; or sale and leaseback of assets. These types of transactions may unfairly benefit the so-called corporate 'rescuers' whilst putting other creditors in a worse position if the company subsequently becomes insolvent. The Government's proposals therefore represent a reasonable updating of insolvency powers currently available under the Insolvency Act.

However, given the timeline of a number of recent cases which have allegedly involved these types of value extraction mechanisms (e.g. BHS, MG Rover), we wonder if a look-back period of only two years would be sufficient. Given the nature of these mechanisms, we suggest that a longer period would be more appropriate (e.g. 3-5 years), although we agree that the period of look-back should not be open-ended.

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?

Yes, we agree. In our view, it is important to note that the existing antecedent recovery provisions only apply to transactions that occur when the company is technically insolvent (i.e. having liabilities more than its assets or being unable to pay its debts as and when they fall due) or if the company has become insolvent as a result of entering into the transaction. This is an excessively restricted range of transactions.

We agree that any transaction which may have unfairly put the beneficiary in a better position than other creditors in a subsequent insolvency procedure could be subject to investigation by the insolvency office holder. This should be potentially reversible if found to be unfair or undertaken against the longer-term interests of the company and its stakeholders.

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?

We do not believe that the proposed measures will affect the activities of investors or corporate rescuers who are acting in good faith with the intention of turning round the company. However, it may act to deter those investors whose main purpose is to extract value from ailing companies regardless of the longer-term impact of their actions on the viability of that company.

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?

We believe that the proposals should be formulated in a way that provides insolvency office holders and courts with flexibility and discretion over their implementation. This will involve placing the main focus on cases which affect significant numbers of stakeholders or are otherwise seen as being in the public interest.

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?

In our view, it is anomalous that the current legislative framework does not allow for the investigation of the conduct of directors whose companies have been dissolved, and only applies to live companies or companies that have become insolvent. This loophole obviously needs to be rectified. As a result, we support the Government's proposals.

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 with extending the Secretary of State's powers to investigate the directors of dissolved companies as follows:

- Requiring any person to provide such information as may be reasonably requested to allow the Insolvency Service to investigate the conduct and actions of former directors of a dissolved company;
- Seeking an order disqualifying a former director from being a director of any other company;
- Seeking an order that the former director financially compensates creditor(s), where the director's actions caused identifiable losses; and
- Seeking a prosecution where there is evidence of criminal conduct.

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?

Yes. Many corporate organisations are organised as complex groups of legal entities. The governance of these group structures is a neglected aspect of modern corporate governance, which typically focuses on the boards of holding companies in isolation from the rest of the group components.

An underlying problem is the mismatch between how legal frameworks and holding companies themselves view subsidiaries. Company law typically views subsidiaries as entirely separate legal organisations – boards of subsidiary entities owe their fiduciary and legal duties to their legal entity and not the wider Group. But this does not reflect the way that multinational organisations are managed in practice - parent boards see legal entities as just a part of their overall business. This mismatch can create problems of governance and accountability for the boards of both parent and subsidiary companies.

For example, if the parent board is seen as pulling the strings of the subsidiary board, it risks becoming the de facto board of the subsidiary. Parent board members effectively become shadow directors of the subsidiary, although they are rarely held accountable for fulfilling this role. Conversely, if too much autonomy is given to subsidiaries, their behaviour may not be aligned with the mission, values and policies of the Group, with potentially negative results.

Subsidiary board directors also face a range of conflicts between their duties to the subsidiary and to the Group, which this may place them in a legally ambiguous position. Areas of potential conflict between these two roles include: transfer pricing policies; subsidiary board appointments and compensation; flow of confidential information from subsidiary to parent; remittance of profits to parent; investment prioritisation between subsidiaries; and culture/business norm conflicts between the subsidiary and the parent, to name but a few issues.

In our view, the best way to address these issues is by defining a transparent Group Governance Framework. This should clarify roles and responsibilities between the parent and the subsidiary in both a legal and a governance sense, and thereby help reduce conflicts and increase accountability. Such a framework could cover the following type of issues:

- List of all group legal entities and board members
- Policy on formation and dissolution of legal entities
- Group delegation of authorities to subsidiary boards
- Group representation on subsidiary boards
- Group control over subsidiary board composition and management appointments
- Policies concerning training of subsidiary directors
- Group board site visits to subsidiaries
- Group-wide training sessions on risk/fraud/internal control awareness
- Group-wide policies which should be applied in all subsidiaries
- Group-wide risk management framework, code of conduct, whistleblowing policy, CSR and diversity strategy, etc
- Group internal audit activities in subsidiaries
- Group approval of external auditor of subsidiaries

In our view, regulators should not be overly prescriptive about the contents of a group governance framework – each framework needs to be tailored to the needs of each specific group. The main thing is that one exists and that it is accessible to key stakeholders.

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?

We believe that initiatives like the Stewardship Code, the Investor Forum, and section 172 reporting are worthwhile mechanisms through which the engagement of institutional investors in corporate stewardship can be encouraged.

However, it is important to be realistic. Institutional investors' primary legal responsibility is to their own clients, not to the companies in which they are invested. Despite efforts to nudge them towards more engaged stewardship, institutional investors will ultimately act in ways that are most consistent with the achievement of their own business models. Although there are some asset managers that seek to make good corporate stewardship a distinctive feature of their investment proposition (which we applaud), they are in a minority. Most asset managers will win or retain investment mandates by generating investment outperformance over relatively short periods of time. In reality, neither active nor passive asset managers have much incentive to devote significant resources to their corporate governance engagement activities.

Consequently, although we welcome efforts to encourage investor stewardship, we believe that they should not be overemphasized as a means of enhancing overall standards of UK corporate governance. In our view, there should be a much greater focus on enhancing the professionalism of boards of directors, particularly through relevant training and professional development. After all, the board is the body with the most direct responsibility for good corporate governance. Better boards will drive a much more direct impact on governance standards.

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?

We believe that that there is a need to examine the relevant accounting standards relating to the payment of dividends. Recent cases (e.g. Carillion) have raised questions about how "distributable profits" are defined, and the extent to which both external auditors and non-executive directors have either the willingness or the capacity to challenge management judgements about them.

However, we feel that the debate over dividend payments gives rise to a broader debate about the extent to which board and management believe that they are required to prioritise short-term shareholder interests. This may partly reflect a widespread lack of understanding of the full implications of directors' duties under section 172 of the Companies Act 2006 – which requires directors to take account of a broader range of factors. In our view, the solution to this knowledge gap is a much greater focus on the education and professional development of board members, particularly at so-called public interest entities.

In addition, for major public sector contractors like Carillion, we believe that a structured legal framework - through which to ensure a better balance between the interests of shareholders and other stakeholders - could be made available. We have proposed the establishment of a newly-defined corporate form – the Public Service Corporation – through which the outsourcing of public services and related activities could be delivered.

Like a private company, such a vehicle would have shareholders and operate on a commercial basis. However, its underlying legal framework would require a balance to be maintained between the interests and obligations relating to its various stakeholders, including its shareholders, employees, pensioners, creditors and public sector clients. For example, it would not be possible within such a legal entity to make significant dividend or bonus payments if there was a substantial pension fund deficit or if defined levels of corporate indebtedness were exceeded. This duty to maintain balance between the interests of stakeholders would be defined in the law relating to the general legal duties of the board of directors at such Public Service Corporations.

The composition of the board could also reflect a more pluralistic approach. In particular, the appointment or dismissal of directors could not only be a matter for shareholders – as is currently the case according to UK company law - but for other key stakeholder groups as well.

We are not advocating that such a corporate form be imposed on outsourcing firms or public contractors on a mandatory basis. However, it could be encouraged through government procurement decisions on the basis that such entities would embody a good balance between commercial know-how, prudent governance and social legitimacy.

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?

The consultation paper is right to highlight that the ultimate responsibility for corporate decisions lies with the board of directors, not with professional advisors. However, we urge caution in discouraging directors from seeking, or giving weight to, such advice. In practice, the bigger risk is that directors avoid or delay seeking such advice in circumstances of financial difficulty, with serious consequences for both the company and directors’ own personal liability.

On our training courses for directors, we advise board members to actively consult with professional advisors in cases of financial difficulty. We also state that, by taking account of professional advice, directors can mitigate some of the personal liability which may arise in a subsequent insolvency situation. We believe that this is sound advice, which serves the interests of the company and its stakeholders, and urge the Government to reinforce this message.

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 are acutely aware of the impact of the collapse of a major company on smaller suppliers, many of whom are members of the IoD. We would support measures to encourage the following kind of safeguards for suppliers:

- Greater use of Project Bank Accounts, which ring-fence payments to the supply chain down to second tier suppliers.
- Discouraging the potential misuse of certain payment provisions included in construction contracts, such as the withholding of retention payments or demanding a proportion of the value of the contract used as surety against defects (subject to the findings of the current Government investigation into these contractual mechanisms which are due for publication later this year).

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 are sceptical about the likely benefit of these proposals. The unintended consequence could be reduced availability of credit, or higher cost of credit, for the corporate sector as a whole.

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?

According to the Executive Summary of this Consultation Document, a primary objective of the Government's proposals is: "to strengthen the responsibilities of directors of firms when they are in or approaching insolvency."

In our view, there is another important measure that should be considered in order to achieve this objective. It involves establishing a framework of professional conduct for directors of significant corporate entities aimed at improving director accountability and professional competence.

All persons joining the board of directors of a significant corporate entity could be required to commit themselves to a professional Code of Conduct and in appropriate cases, the conduct of the director or the board could be publicly censured or criticised by their peers.

In order to achieve a significant enhancement in director competencies and awareness of director duties, this framework could also incorporate commitments from individual directors to undertake tailored programmes of continuing professional development. CPD requirements could be defined based on a risk assessment relative to an approved competency framework for directors.

We believe that such an initiative would play a significant role in increasing the accountability of boards of directors, both to their peers and society as a whole.

Furthermore, it would represent significant progress in shifting the role of director (particularly that of non-executive director) away from that of “gifted amateur”, and more in the direction of competent professional with a clear understanding of fiduciary duties and responsibilities.

I hope you have found our comments helpful. If you require further information about our views, please do not hesitate to contact me.

Kind regards,

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