Insolvency and corporate governance: far-reaching reforms on the cards

In a move likely to have been triggered by the high-profile failures of BHS Ltd and Carillion plc, the Department for Business, Energy & Industrial Strategy (BEIS) is consulting on insolvency and corporate governance. The consultation is intended to update the law to:

- Reduce the risk of major company failures through shortcomings of governance or stewardship.
- Strengthen the responsibilities of directors of firms when they are in or approaching insolvency.

The consultation was published on 20 March 2018 and the deadline for responses is 11 June 2018.

Sale of business in distress

The consultation looks at how to ensure that directors who are responsible for the sale of an insolvent subsidiary of a corporate group take proper account of the interests of the subsidiary's stakeholders.

Currently, directors of a holding or parent company cannot be held liable for the sale of an insolvent subsidiary, even if that sale is damaging to the subsidiaries' creditors and stakeholders. BEIS proposes to change this by enabling the directors of a holding or parent company to be held to account, and penalised, where the sale of an insolvent subsidiary causes harm to creditors and was foreseeable at the time of the sale. Penalties being considered include disqualification and personal liability.

This proposal may make it more difficult for a corporate group to deal with a failing subsidiary. It is also not clear how far up the corporate group the responsibility will lie. The key issue, which the consultation gives no guidance on, is how intensively the directors of a holding or parent company will have to investigate the viability of a buyer's proposals and assess the impact of the sale on stakeholders; for example, whether the directors will be entitled to rely on statements that the buyer might make.

Reversal of value extraction schemes

The consultation considers the situation where a company in financial difficulty has been "rescued" by investors, who then strip it of its assets to lessen their loss or protect their profits should the company eventually become insolvent. BEIS's proposals would cover arrangements such as management fees, excessive interest on loans, charges over company property, excessive director pay or other payments, and the sale and leaseback of assets.

The proposal may make it more difficult to put in rescue funding, which would jar with the Insolvency Service's proposal to encourage a rescue finance regime in the UK in its consultation on the corporate insolvency framework issued on 25 May 2016 (*www.practicallaw.com/8-630-2262*).

Investigating directors of dissolved companies

Companies may be closed in a number of ways. If a company is insolvent, there are a range of formal insolvency procedures available to close it down. If these procedures are employed, the Insolvency Service has the power to investigate the conduct of the directors. As an alternative to insolvency, dormant companies can be struck off by Companies House and then dissolved. This can happen even if the company has outstanding debts or there are allegations of director misconduct. If a complaint is received about the actions of the directors of a dissolved company, the current statutory requirements mean that it is time-consuming and costly for the Insolvency Service to investigate the complaint.

BEIS proposes to make these investigations simpler. This should close an obvious gap in the regime, which the unscrupulous have been exploiting.

Strengthening pre-insolvency corporate governance

BEIS has a number of aims in relation to strengthening the corporate governance of companies before they might enter into insolvency.

Complex group structures. BEIS intends to improve the governance, accountability and controls within complex group structures. This could include better records of the structure, directors and inter-company positions within a group. The consultation refers to the requirements of the UK Corporate Governance Code, which is overseen by the Financial Reporting Council (FRC), and which looks for the better disclosure of corporate governance arrangements and material controls, including financial, operational and compliance controls.

Role of shareholders. The consultation looks at how to strengthen the role of shareholders in stewarding companies in which they have investments. It refers to a number of developments on this front, such as the UK Stewardship Code and the requirement since 2014 for listed companies to produce risk and viability statements under the UK Corporate Governance Code (*www.practicallaw.com/3-584-9227; see also feature article "Developments in narrative reporting: keeping up and looking ahead", www.practicallaw.com/7-618-1227*). The FRC will be consulting later in 2018 on a revised UK Stewardship Code.

The consultation also refers to the impact of the Shareholder Rights Directive (*2017/828/EU*), which is designed to strengthen engagement and increase transparency (*see News brief "Amending shareholder rights: towards long-term sustainability", www.practicallaw.com/w-008-7750*). The consultation notes that the government will be introducing a new statutory requirement on all large companies to report each year on how directors are fulfilling their duty under section 172 of the Companies Act 2006 (section 172).

This is clearly an area where there is a great deal of focus and development, and BEIS is asking for views on how arrangements could be made better to ensure that lessons are learned from large company failings and controversies.

Dividend framework. BEIS aims to improve the legal and technical framework in which dividend decisions are made. Dividends can only be paid out of realised profits that are available for distribution. The link between profit and a company's financial statements and any reserves available for distribution are elaborated on in guidance issued on 10 April 2017 by the Institute of Chartered Accounts of England and Wales in TECH 02/17 (*www.practicallaw.com/w-008-3577*). However, the consultation raises concerns that large companies have paid out large dividends in the period immediately before

their insolvency and so this raises questions about whether reform of the rules is needed.

Professional advice. The consultation considers directors' use of professional advice and its interplay with the duty of directors to apply an independent mind. Directors are under the duties set out in section 172 as well as duties to exercise independent judgement and to exercise reasonable care, skill and diligence (*see feature article "Directors' duties on insolvency: navigating the twilight zone", www.practicallaw.com/w-013-6147*). Professional advisers, on the other hand, are subject to whatever legislation, standard or supervision applies to their particular profession and contractual obligations to their client.

The consultation specifically queries whether some directors are commissioning and using professional advice without a proper awareness of their duties as directors, and in particular the requirement to apply an independent mind.

Supply chain protection. BEIS intends to create better protection for the supply chain in the event of insolvency. The requirements of the Payment Practices and Performance Reporting Regulations 2017 (*SI 2017/395*), which came into force on 6 April 2017, shed light on the length of payment terms in the supply chain (*see News brief "Payment practices reporting: shining a light", www.practicallaw.com/1-639-2690*).

However, the consultation notes that transparency alone does not fully correct the imbalance in market power between large and small companies. It seeks views on whether more should be done to help protect payments to suppliers, particularly smaller firms, in the event of an insolvency of the customer. This could be through ring-fenced mechanisms preventing the abuse of contractual clauses; for example, withholding money as a surety against defects or revising the quantum of the ring-fenced funds known as the "prescribed part", which is currently capped at £600,000.

Far-reaching implications

The consultation lists an odd assortment of questions whose origins can be traced back to recent scandals (*see News brief "Carillion liquidation: questions to answer", www.practicallaw.com/w-012-8830*). However, the implications for companies and their advisers may be far-reaching, and even now should colour the way in which advisers approach questions affecting companies in difficulty. Given its slightly piecemeal approach, the consultation opens the opportunity for respondents to raise any other ideas, themes or proposals that could be explored to strengthen corporate governance and the regulation of insolvency and rescues.

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The consultation is available at www.gov.uk/government/consultations/insolvency-and-corporate-governance.