Business Frameworks Directorate
Department for Business Energy and Industrial Strategy
1st Floor, 1 Victoria Street
London, SW1H 0ET

By email: insolvencyandcorporategovernance@beis.gov.uk

11th June 2018

Dear Sirs

Re: Insolvency and Corporate Governance – BVCA response to the consultation

1. We are writing on behalf of the British Private Equity and Venture Capital Association ("BVCA"), which is the industry body and public policy advocate for the private equity and venture capital ("PE/VC") industry in the UK. With a membership of over 700 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. Our members have invested over £27 billion in nearly 3,800 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 448,000 people, and 87% of UK investments in 2016 were directed at small and medium-sized businesses.

2. Every year many businesses are saved from collapse by turnaround investments made by private equity firms who provide a critical injection of capital, ideas and execution skills to underperforming or failing companies. As such, the BVCA has a voluntary code of conduct for members engaged in turnaround activity. This can be found in Appendix 1. In 2016 and 2015, BVCA members rescued 49 companies experiencing trading difficulties, investing close to £0.5 billion and helping safeguard around 23,200 jobs. This does not reflect our members that do not identify as turnaround members (e.g. traditional private equity or venture capital firms), but have invested in turnaround situations or injected further capital into underperforming companies. The 2017 numbers are due to be published shortly and we would be happy to share these in due course.

3. We welcome the opportunity to comment on the questions posed in the consultation.

Our overall view

4. We consider the existing law in relation to the limited liability of companies and the duties of a director of an insolvent or near-insolvent company to be fit for purpose. Any increased personal liability for directors of a holding company in relation to a sale of a subsidiary will result in fewer sales of companies and is likely to result in more companies going into insolvency rather than being sold as going concerns.

5. We do not consider the introduction of specific value extraction scheme reversal powers to be necessary as the existing legislation is broad enough to address deliberate fraud and

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mismanagement. It is important that businesses have the ability to obtain financing in order to continue to trade and meet their obligations to creditors and employees. Turnaround situations may require immediate funding and there may be no other option than to fund the capital requirement by equity. These "equity cure" financings will be deterred if there is a risk of reversal (beyond the current regime which we consider to be fit for purpose in preventing transactions designed to prefer or defraud creditors).

6. We believe the proposed changes to the existing law will be detrimental to the business of private equity and venture capital firms generally, particularly in relation to firms which specialise in turnaround businesses. The UK is currently an attractive forum for business restructurings and we believe the proposed changes would have a materially negative deterrent impact.

Responses to consultation questions

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

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

7. We do not consider that it is necessary (or indeed appropriate) to introduce new measures. Currently, under English law, a director of a near-insolvent or insolvent company must be mindful of a number of additional duties. These duties, together with the personal liability directors may face if they fail to discharge such duties, already provide a very high standard of conduct for directors. These duties include:

    - Where a company is insolvent, or of doubtful solvency, the directors are under a duty to consider the interests of creditors ahead of those of the company. The duty to promote the success of the company under s.172 Companies Act 2006 is subject to this duty;

    - Once a company has gone into insolvent liquidation, a director (which for these purposes also includes a shadow director) may be required to make a personal contribution to the company's assets if the liquidator can prove that, before the start of the winding up, the director knew or ought reasonably to have concluded there was no reasonable prospect of the company avoiding insolvent liquidation;

    - If any business of the company is carried on with the intent to defraud creditors or for any other fraudulent purpose, the liquidator may apply to the court for a contribution from any person who was knowingly a party;

    - The offence of misfeasance permits claims to be brought against directors to repay money or property they have misapplied, retained or been held accountable for; and

    - Directors of an insolvent company may also be disqualified.

In recognition of the fundamental principle of limited liability of companies, these duties are not imposed upon shareholders in relation to the companies they invest in, although a shareholder that is also a director, or that is determined to be a "shadow director" in relation to its investee company may face liability on the basis listed above.

8. A director is also already subject to a statutory duty to his company to avoid conflicts of interest and if a director breaches this duty, the company has the right to bring proceedings in respect of the breach, whereby the available remedies include: (i) the award of damages; (ii) the grant of injunctions; (iii) setting aside of transactions; (iv) restitution and account of profits; and (v) restoration of company property held by the director. Within a group of companies, directors must perform their duties in relation to to the specific company in the group of which s/he is a director and in considering duties, must consider them with respect to such company on an individual basis. Where there are common directorships, such directors must be aware of the potential conflict of interests that can arise if one company in the group is distressed and take action to avoid any such conflicts.

9. The proposal envisages imposing liability on the directors of a holding company following a sale of a group subsidiary if the business fails within two years, if the creditors have been adversely affected between the date of the sale and the insolvency and there was no reason to believe that the sale would lead to a better outcome when compared with a liquidation. Our first objection is that this imposes a somewhat arbitrary distinction between a company selling part or all of its business or assets generally versus a holding company selling a group subsidiary.

10. More fundamentally, this would introduce a new and highly unusual legal liability for sales of UK companies. In the context of share sales, warranties may be negotiated and given by the seller in favour of the buyer as to the state of affairs of the company (which are not forward looking typically) and/or indemnities given in respect of specific risks or liabilities. The proposal seeks to go beyond any contractual agreement to impose liability and is essentially cutting across the established principles of (i) limited liability; and (ii) directors acting as agents of the companies to which they are appointed (rather than in a personal capacity), each of which is enshrined in English law. Whilst the English Court may pierce the corporate veil in very exceptional circumstances and in addition extend liability to shadow directors, those circumstances do not extend into forward looking scenarios. The question of whether a person (whether a shareholder, director of a holding company or otherwise) is a shadow director of a subsidiary company (and subject to the same standards of liquidator recourse as ordinary directors) should be based on the specific facts and not a presumption that holding company directors will invariably meet that standard.

11. We understand that there are specific policy concerns in relation to companies with defined benefit pension schemes. It should also be remembered that in the context of pension scheme liabilities additional liability may be faced by group companies either as a named employer in the relevant pension scheme or as may be imposed pursuant to the moral hazard provisions contained in the Pensions Act 2004 (e.g. by virtue of being

associated or connected with that employer). We note a separate white paper has been published in relation to defined benefit pension schemes and concerns about pension schemes are best addressed through the pensions regulation regime rather than by a more general change to the established principle of limited liability.

12. The proposals are seeking to impose future liabilities on a shareholder's directors for failures which are entirely outside of their control or influence. It is not possible for such former directors to have any influence in how the business is run post sale since third party owners and new executive officers will be in place making strategic and operational decisions. It would be very difficult for directors to accurately assess or diligence whether a particular buyer will be successful or not. Future plans would typically be commercially sensitive and subject to change depending on market conditions and other specific circumstances, many of which are not foreseeable. Our concern is that a subjective assessment that a buyer is "appropriate" may, with the benefit of hindsight, prove to be incorrect thereby exposing directors to personal liability for an assessment about future behaviour made in good faith. We would expect sellers to seek to pass this risk onto the purchaser by seeking comprehensive warranties and/or indemnities in relation to their plans for the business. It is unlikely that a potential purchaser will be prepared to expose itself to this contractual risk (and limitation on how they run the business post-purchase) on top of the business risk of turning the company around. This is not an attractive proposal from the buyer's perspective, who should from a policy perspective be encouraged to salvage a sustainable business for the benefit of stakeholders, rather than to allow it become insolvent. Furthermore it is a wholly unusual proposition that is not customary in other jurisdictions.

13. Additionally, speed is paramount in rescuing a distressed business. Any further diligence required under the new proposals is likely to lengthen the time taken to complete a transaction to rescue a distressed business. Any delay in investment, via a new buyer, into a business that is struggling to survive will increase the possibility of it not surviving.

14. Under the proposal, potential conflicts will arise between the different creditor pools of the insolvent subsidiary (which may have become unprofitable due to economic conditions and/or market dynamics) and the holding company. Selling the underperforming cash draining subsidiary might well improve the creditor position in the holding company and the remaining group and conversely, not selling might worsen the position. We do not consider it right that this should result in a personal liability for a director, when the director needs to properly consider the interests of the group and its stakeholders as a whole.

15. We believe the criteria set out in the consultation to impose liabilities on directors of holding companies will essentially result in either no sales taking place at all or more pre-pack asset sales taking place within a formal insolvency process. Currently in a pre-pack context, where sales are to connected parties, there is a voluntary submission process to the Pre-Pack Pool. At present within that voluntary process, a viability statement is required in relation to the purchaser which only requires a viability statement in respect of the purchaser which extends to 12 months (or possibly longer if consideration is

deferred). The purpose of the viability statement in that process is simply to consider the prospects of the purchase consideration being paid. In contrast, in the current proposal the suggested change;

- will have a statutory footing (which the government has a reserve power to do in relation to all connected party sales under the Small Business, Enterprise and Employment Act 2015);
- will include sales to unconnected third parties;
- involves the onus failing on the vendor rather than the purchaser; and
- the forward looking aspect extends to 2 years from the date of sale.

16. This would make such sales especially unattractive for vendors, who would be exposed to greater risk than in a pre-pack to connected parties. It should be noted that these pre-pack asset sales often result in no or little value passing to the vendor in return for the purchaser assuming the problem. Under the current proposal, if the directors of the holding company are at risk of personal liability if such decision to sell proves to be "wrong", it is likely they will end up not transacting at all and put the business into a formal insolvency process instead. This could severely impact the prospects of rescuing the businesses as a going concern and have more of a detrimental impact on employees and suppliers than an ordinary course of business sale or a pre-pack administration.

17. We think this proposal would significantly impact the private equity industry business model which is to acquire companies, grow them through driving efficiency and best practice to expand through acquisitions, inject further equity to facilitate capex investment and then to sell such portfolio companies, distributing the profits to its investors (many of whom are pension funds and other institutional investors). Introducing changes that allow the piercing of the corporate veil and disallowing a clean break on a sale would act as a strong deterrent to investment in UK businesses.

2. 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?

18. Directors who act as such in relation to more than one company, including within a group of companies, are already obliged to take measures to avoid conflicts both in ordinary and distressed circumstances.

19. As mentioned above, the proposal seeks to suggest that the ability to pierce the corporate veil should be more widely available. We do not consider that this is in the interest of the economy and investment in the UK. Imposing more onerous responsibilities on holding companies, and potentially their directors (if they are determined to be acting in a

personal capacity) is already possible in circumstances where those directors have taken an active role in the management of the subsidiary. English law contains the statutory concept of a shadow director which imposes director's duties on a person who is not formally appointed as a director of the company but who is able to direct and instruct the appointed directors. We consider that reliance on the provisions against holding company directors who act as shadow directors of the subsidiary are sufficient. We believe that any further inroads made into the principle of limited liability will force many businesses to move to non UK corporate structures which respect the principle.

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

20. No, for the reasons stated in response to questions 1 and 2 above.

4. 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?

21. The danger with this aspect of the proposal is that it risks deterring genuine attempts to rescue and restructure distressed businesses (of which there are many positive examples with private equity/turnaround owners where jobs have been preserved) and may result in more formal insolvency cases which in turn may have a more significant and negative impact on employees and creditors. The collapse of The Carillion Group serves as an example of the considerable negative impact formal insolvency can have in these respects.

22. As above it is vital to move quickly in distressed situations where any delay needed through additional diligence on the purchaser as a result of the proposal threatens the survival of the business that is being rescued.

Value Extraction Schemes

5. 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?

23. We note in the consultation that the Government is concerned about the complexity of the financial arrangements put in place. The arrangements are often the same structuring that a third party bank or credit fund would use to advance monies to a company. They advance money to the group to enable it to continue to trade (and meet its obligations to creditors and employees) and take security for that lending. The current legislation acts to disqualify certain floating charge security (often over the valuable assets of the group such as stock and creditors) to the extent adequate consideration is not advanced for the granting of the security and that challenge period is extended for connected creditors. Often it is not possible (or desirable) to introduce third party funding immediately into a turnaround situation and so there is no option but to fund the entire capital requirement (both the consideration for the business and the working capital needed to run it) by

equity funding. In a private equity context, an investor's appetite to do this could be negatively impacted, particularly at the riskier end of turnarounds, if all the capital was at risk and the returns expectations and/or level of downside protection would not justify that risk. Ultimately private equity fund managers have duties to their investors who place trust in them to invest their money. Under this proposal, such investors would be placed in a different position to a third party funder when they are taking the same or greater risk.

24. In many turnaround situations, new investment is replacing existing secured lending from third parties, often in a cross guaranteed context throughout a corporate group. If an investor introduces replacement (and new) funding this would not prejudice most unsecured creditors given they ranked behind the initial third party lender in any event. This legislation should not be used to create an imbalance between secured and unsecured creditors. The current regime is a key reason why the UK is an attractive forum for business restructurings.

25. In any event, we do not consider that new tools are required to tackle value extraction schemes. We consider that existing antecedent recovery powers under the Insolvency Act 1986 (IA 86) are already sufficient. For example section 238 IA 86 (Transactions at an Undervalue) already provides that where a company does not receive adequate consideration, recoveries can be sought by an administrator or liquidator if the business subsequently fails. Likewise section 239 IA 86 (Preferences) also allows a remedy where creditors/guarantors are put in a better position than they otherwise would have been treated in an insolvency. Whilst both these provisions are linked to the insolvency at the time of the transaction being complained about, for connected parties this is presumed to be satisfied (see section 240(2)). There is also very wide provision in section 423 IA (Transactions Defrauding Creditors), where transactions which involve assets being deliberately put out of the reach of creditors (or other victims of the transaction) or otherwise prejudice them, can be challenged. There is no insolvency requirement and any victim can bring such action. In terms of excessive credit terms, there is also a separate provision in section 244 IA 86 which has a 3 year look back period where any person providing credit has done so on an extortionate basis. The court in each of the remedies to the provisions mentioned above can make orders affecting third parties.

6. 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?

26. We do not consider that introducing specific value extraction scheme reversal powers are necessary. The example provided on page 15 of the consultation could in theory be challenged by either sections 238, 239, 244 or 423 of IA 86. In summary, we believe that the existing legislation strikes the right balance; it is already broad enough to address deliberate fraud and mismanagement

7. 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?

27. Yes, please see our response in question 5 above. Pricing and finance terms in distressed situations may vary and will be linked to the potential risks. Having additional broad risks with no causal link required to the failure, which could impact on genuine high risk transactions is far from ideal and may deter investors and turnaround financiers from investing or lending at all. As the consultation states it is seeking to address "only a small minority of cases". As is currently suggested, the proposal risks "pouring out the baby with the bath water".

8. 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?

28. We are of the view that any further legislation in this area would have a detrimental effect. The distressed debt/rescue finance market in the UK is arguably already behind other jurisdictions which actively promote investment by allowing super priority ranking or provisions that shield any such investment from being upset in a subsequent insolvency. The US for example is always much referred to for its successful promotion of "debtor in possession" finance. Other European countries have used this as a blueprint for their regimes and the draft European directive on preventative restructuring frameworks will provide further protection for rescue financing. Singapore also recently introduced reforms in this direction. It seems ill timed (particularly when the UK is already experiencing economic uncertainty due to Brexit, and other jurisdictions are actively promoting rescue financing) that the UK is moving to make it even more difficult for distressed companies to get access to credit and investment. Such access underpins a culture of rescue and business continuation and has been at the heart of UK insolvency policy for many years.

Dissolved Companies

9. 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?

29. Given the powers already available to restore a company to the register and which would allow directors to be scrutinised, we do not consider it necessary to introduce further mechanisms.

10. 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?

30. Please see our response to question 9.

Strengthening Corporate Governance in Pre-Insolvency Situations

11. 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?

31. By way of background, PE/VC firms seek to introduce and strengthen existing corporate governance arrangements in the portfolio companies in which they invest. Strong governance arrangements allow the PE/VC firms to effectively monitor and manage their investments from a strategic perspective. For the PE/VC firm itself, the benefits of good governance at a portfolio company level are intrinsically linked to its own success. It protects and enhances the value of investments which is important from a reputational as well as economic perspective, especially as the PE/VC firm will need to fundraise in the future to secure its own longevity. Many investors also insist on contractual undertakings from PE/VC firms to enhance corporate governance arrangements.

32. In addition, we note the Government is currently working on a comprehensive new Corporate Governance regime for UK companies and the BVCA is pleased to be working with the FRC and other organisations to develop a set of corporate governance principles for large private companies.

33. We do not have any specific comments on the FRC's Stewardship Code, but note that FRC will consult on a revised UK Stewardship Code later this year.

34. In respect of transparency measures generally, we note the Government recently introduced the PSC register regime into the Companies Act 2006 applying to all UK companies (other than those with voting shares listed on an EEA regulated market or certain other specified markets) and UK LLPs. These new requirements provide greater transparency in respect of the ownership and control of UK companies, LLPs and SLPs.

35. In light of the current Government work on the corporate governance regime and the PSC legislation, we do not believe further corporate governance and transparency measures are required in relation to group structures.

12. 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?

36. Please see our response to question 11.

13. 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?

37. No, we believe the existing framework is sufficient and that the definition of "distributable profits" remains fit for purpose. Any changes to the framework would risk and discourage investment.

14. 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?

38. We believe directors are aware of their duties with regard to commissioning and using professional advice. If the Government has any concerns in this regard we believe they would be best addressed through education and making guidance on these topics readily available rather than through penal legislation. Our members are well informed and advised about the duties of directors and they seek to ensure that board members have the requisite skills and experience to serve on the board and can help to implement the strategic priorities of the relevant portfolio company.

15. 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.

39. We are in agreement with the Government's initiatives already taken in this regard, such as the Reporting on Payment Practices and Performance Regulations, which encourage prompt payment in the supply chain generally. We believe these measures rather than any special insolvency treatment are more likely to have a positive impact on SMEs generally and limit the risks caused by the insolvency of a large company, without acting as a deterrent to future turnaround transactions, or investment in the UK generally.

16. 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?

40. No, we believe the existing cap is sufficient and do not believe increasing it will have a positive impact as it may increase the cost of lending. The impact may be disproportionate to any benefit to be gained.

17. 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?

41. In our view, the proposals do not offer the right balance between the debtor and stakeholder interests. They have the potential to undermine and disrupt genuine business rescue and may deter creditors and/or stakeholders from investing and doing business with the entities.

42. We would be happy to discuss the contents of this letter further with you. Please contact Gurpreet Manku (gmanku@bvca.co.uk) at the BVCA in the first instance.

Yours faithfully

Amy Mahon
Chair, BVCA Legal & Accounting Committee

Appendix 1 – BVCA Code of Conduct for Turnaround Investors and BVCA Members Encountering Turnaround Situations

Members of the BVCA who sign up to the Turnaround Code agree to the following commitments:

I. BVCA members aim at business rescue rather than closing a business to realise its assets.

II. The positive and negative impact on lives of employees, customers and creditors will be carefully considered before investment. To the extent that the investment results in a negative impact on these lives, the investor will ensure that communication is clear to ensure that the affected people can make alternative plans where necessary and due process is followed.

III. Interest rates charged on any debt funding will be set commensurate with the risk. Investment will be made with the dual aims of improving business and saving, or better, growing, where possible employment whilst also generating an acceptable return for investors who have funded the turnaround.

IV. Insolvency procedures should not be considered the default option. Alternatives which may achieve a better all round outcome (e.g. agreeing compromises with creditors or a pension scheme outside of formal insolvency) should be considered carefully before insolvency routes are adopted. However in some circumstances, where for example a business is exposed to large and uncertain liabilities, insolvency will be the only route to save a business.

V. In the event of pre pack administrations, investors will request Insolvency Practitioners to ensure compliance with Statement of Insolvency Practice 16 as issued by the Insolvency Regulatory Body, R3.

VI. The investors will annually provide feedback to the BVCA on their turnaround activities to ensure that the BVCA can properly communicate with key stakeholders such as government bodies and the press about the turnaround activities of its members.