BEIS Consultation on Insolvency and Corporate Governance

Sales of Businesses in Distress

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

Possibly; however, before committing to new measures we would want to know how commonplace this situation is. Much of the commentary and the example in the consultation document are reminiscent of the situation at BHS. BHS appears to be a relatively unusual case in which the directors and owners (Sir Philip Green and his family) sold BHS to a buyer who had neither the skills, experience or financial backing to be able to turn the business round and make a success of it.

One of the things that makes BHS unusual is that it was a large private company. Its shares were not publicly traded. Had it been a large listed company, institutional shareholder would probably have intervened to oppose proposals that were overtly unworkable.

In the case of subsidiary companies the situation is often different. It is not unusual for a parent company to sell a subsidiary to the directors (and sometimes the employees) of the business – even in cases in which the business is not bankrupt and is only being sold because it no longer fits with the long term strategy of the parent company. Management buy-outs sometimes fail. However, there is little to suggest that there is a significant problem with bankrupt subsidiaries being sold to an existing management team who are not capable or fit to run them and who lack sufficient funding. Usually, banks and others providing the funding will do their own checks to ensure that the venture stands a reasonable chance of being viable. If they are in any doubt they will not advance the necessary funds.

One might argue that there is nothing to be lost in tightening up the rules in this area. However, the risk is that measures put in place prove to be either:

- Anodyne and toothless so that there is little real deterrent to a repeat of the BHS situation, or
- Unintentionally restrictive so that they discourage the legitimate sale of a business to new owners who have the means to return it to viability and financial health.

There is an old saying that 'there is no problem so bad that government intervention can't make it worse'. Furthermore, it is not clear whether there really is a problem here in the first place. Cases such as BHS appear to be very rare.

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?

It is not uncommon for the directors of a parent company to sell a subsidiary to the managers of the subsidiary company by way of a management buy-out (MBO). For a variety of reasons, MBOs sometimes fail – even in cases in which the vendor's directors give the new owners as much help as they reasonably can. The issue, therefore, is that whatever measures are put in place they should not act as a disincentive to a parent company's directors to sell a business to a new owner, encouraging them instead to shut it down with the result that the employees lose their jobs.

Taking the case of BMW's sale of MG Rover to Phoenix in 2000, it is arguable that BMW compromised the long term viability of MG Rover by retaining the Mini brand and all the assets that went with it. So, on this basis, were BMW directors to blame for the ultimate demise of MG Rover in 2005?

It was in fact government intervention which prompted the sale of MG Rover, rather than its closure, to John Towers and Phoenix rather than its closure. When MG Rover was sold by BMW to the Phoenix Group it was sold with a significant 'dowry' – one that was sufficient to cover generous (at the time) redundancy payments to all MG Rover employees. The government of the day, however, preferred a sale of MG Rover to Mr Towers and Phoenix for £1 because it safeguarded jobs in the short term. This paid no regard to the suitability of the 'Phoenix five' as the new directors of the business and it ignored the long term viability of MG Rover in the face of significant over-capacity in the volume car manufacturing market.

Solutions to actual or potential company bankruptcy which try to address the wider interests of employees, creditors and other stakeholders can easily end up eclipsing basic business realities. In the longer term this usually leads to commercial disaster when the day of reckoning finally comes.

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

Parent company directors should be primarily responsible. Responsibility should also sometimes extend to advisors and auditors who should be held at least partly responsible. However, we would see this applying more to situations in which a healthy company is sold by management following advice from investment bank advisors intent on generating large fees for themselves.

A more intriguing issue is one in which advisors prompt a sound business to overstretch itself by taking over another company or companies and in which this leads to the ultimate demise of the acquirer. Carillion, Conviviality and Marconi are all examples of cases in which this question could be raised. It seems very likely that the advisors have a case to answer here. The same is almost certainly true of the acquirer's auditors in many cases.

Q4. How can we be sure that there is no impact on sales which genuinely seek to rescue distressed businesses, or bring new investment into distressed businesses?

As outlined above, this is not easy. In general the current system does not appear to work too badly in the vast majority of cases. The bigger problem is, even as things stand, trying to get new investment into distressed businesses. Carillion is a case in point. Its demise has been enormously expensive for everyone involved with the company – employees, customers, suppliers, investors and others. Leaving aside the fact that senior management was almost certainly incompetent, this was hardly an insignificant business in a sector in long term decline and with no future. Yet funding to tide it over a difficult period was not forthcoming.

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 tackle this behaviour?

We are not able to comment on this.

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; the government should introduce a value-extraction scheme reversal power as outlined in the consultation document.

The current insolvency test is not appropriate in the circumstances outlined. However, although it does not relate to an insolvency situation, we note with dismay that the government, or its agencies such as Ofwat, has been complicit in allowing egregious value extraction schemes to flourish in the area of the privatised utilities. Jonathan Ford, writing in the Financial Times on 10th September 2017 noted that in the previous week:

'Thames Water, or rather its customers, had obligingly paid off £2 billion of the £2.8 billion debt that the Australian investment bank Macquarie took on when it acquired the company in 2006, despite conditions set by the regulator that the utility's finances would be ring-fenced from the acquirer. The financing cost of this corporate transaction - from which water users received no conceivable benefit - was simply lobbed onto their bills.

Other companies are similarly accommodating when it comes to prioritising shareholder interests. With the removal of all but three utilities from the stock market these are all now mainly owned by international private equity firms and infrastructure funds operating through complex offshore, tax resident structures. Over the past decade, the nine main English water companies have made £18.8billion of post-tax profits in aggregate according to a study by Greenwich University. Of this, £18.1billion has been paid out as dividends. Consequently, almost all capital expenditure has been financed by adding to the companies' debt piles. Collectively these now stand at a towering £42billion.

In the long run, this is clearly unsustainable. But Ofwat, the regulator, permits it because it takes no interest in the companies' capital structures as long as they maintain investment grade ratings.'

The water companies may not be in a turnaround situation but, as the FT points out, the value-extraction approach being used by the owners of the water companies is unsustainable. In other words the value-extraction currently being practiced will ultimately lead to insolvency.

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?

Yes; the proposals could affect the availability of finance for distressed companies. However, There should be a test of 'reasonableness' which the insolvency office-holder can apply. In any distressed company situation there is high degree of risk that the turnaround will fail. It is reasonable therefore for those putting new money into the business to require a 'risk premium'.

An environment should be created in which the new investor understands that the risk premium that they are seeking to apply could be challenged and the value that they have extracted could be reversed. This would encourage them to consider carefully whether they wish to proceed with the rescue. They may decide to walk away and the company may collapse. This, however, is probably better than allowing a refinancing to be put in place which is so onerous that it simply defers the day of reckoning and, in doing so, creates an even bigger mess because any assets the company may have had have now been stripped using a value-extraction scheme.

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?

The consultation document refers to 'distressed companies'. We note the points made in the consultation document that:

- 'in a small minority of cases, complex investment structures allow sophisticated investment parties to unfairly insulate themselves from risk to the detriment of other parties'.
- 'the Government also recognises that 'unfairly' and 'excessive' may be subjective terms'.
- 'the Government does not wish to deter lenders in this sector'.

Given that this appears to be a situation that occurs only rarely and in which critical evaluation involves a high degree of subjectivity, we question whether it is worth introducing new rules and powers which are limited only to distressed companies. As pointed out in the response to Q6, there are examples of value extraction taking place which do not relate to business which are currently distressed but which have worrying implication for the longer term viability of the business to which they relate.

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?

Yes, absolutely.

Q10. Do you agree that director conduct in a dissolved company should be brought within the scope the Secretary of State's investigatory powers? Do you have any other comments on the proposal?

Yes, director conduct in a dissolved company should be brought within the scope of the Secretary of State's investigatory powers.

The suggestions set out in the consultation document look eminently sensible and appropriate. We have nothing else to add.

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?

The FRC has recently reviewed the Corporate Governance Code and, although some elements may be debatable, we believe that most of it is sensible, practical and proportionate.

Management has to be allowed to manage. If shareholders are not happy about the apparent controls and oversight there are already measures they can take to bring about change. There are good reasons to believe that large investors in publicly quoted companies are not as diligent as they could be in monitoring the companies in which they invest (using other people's money). They often acquit themselves as poor stewards of other people's money. However, this is a different issue and one which needs to be addressed by the Stewardship Code which is due for revision – a process which we understand is to be started by the FRC later this year.

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?

Three specific issues need to be addressed:

1. **Disenfranchisement of private shareholders**: Statistics from the ONS show that in 2016 (the last date for which figures are available) UK individuals owned 12% of UK quoted shares by value on the main market and 29% by value of the shares on AIM. It has been a serious concern of both the UK Shareholders' Association (UKSA) and The UK Individual Shareholders Society (ShareSoc) for many years that investors who hold their shares in nominee accounts are disenfranchised. They have no right to receive notification of

company AGMs, no right to attend the AGM and no right to vote at the AGM. This is this unfair and unsatisfactory. The disenfranchisement of private shareholders is one of the key reasons for the emergence of the 'ownerless corporation' which has come in for so much criticism from investors, politicians and many other groups over the last five to ten years.

How can there be any form of effective corporate governance based on shareholder oversight when the legal shareholders, as defined in UK law (nominees and fund managers), make no attempt to consult the beneficial owners and, in a significant number of cases, fail to exercise their own voting power on behalf of the beneficial shareholders or else simply vote in favour of resolutions regardless of the stewardship implications of their voting?

As it stands, the definition of the term 'shareholder' in UK law could hardly be more perverse in the way in which it frustrates meaningful shareholder oversight of UK companies and their governance.

This might be understandable if there was some sound justification for this lamentable state of affairs but there appears to be none. There are no technical reasons why, in this day and age of sophisticated information systems, it should not be possible for private investors who are invested through a nominee account to enjoy normal shareholder rights.

2. **Stewardship role of intermediaries**:
    a. ***Alignment of intermediaries' interests with those of investors:*** It is not correct or appropriate to assume that the interests of fund managers are aligned with those of their clients. An individual investing in a pension or for any other purpose may be investing with a time horizon of forty years or more. Most fund managers (the legal share owner or shareholder) are almost invariably driven by short term fund performance. The failure in the Corporate Governance Code, the Guidance and the Stewardship Code to recognise that the legal shareholders are nothing more than agents handling other peoples' money is a depressing sign that those drafting the Codes have not properly considered the governance issues that this raises.

       The managers of index funds, closet trackers and active funds benchmarked against an index not only have no incentive to exercise proper stewardship (because a rising/falling tide raises/lowers all boats); but it's worse than that:

       - Stewardship costs money, and those who spend it put themselves at a competitive disadvantage to those who don't.
       - For active funds bench-marked against an index, if active stewardship determines that a company is in trouble the most profitable action is to conceal that fact and 'short' the shares rather than publicly engage to correct matters (giving away the competitive advantage). 'Shorting' the shares is an incentive to make matters worse, not better.

       With the increasing dominance of index funds this undermines the whole principle of stewardship by intermediaries, to an extent perhaps not foreseen when the original framework of the Code was put in place.

    b. ***Weaknesses in the current system of reporting on stewardship***: The current 'tiering' system which the FRC introduced to monitor standards of stewardship is based largely on self-certification by asset managers / owners etc. Their web sites simply

provide fine words and reassurances. The Standard Life website shows the number of company engagements during the quarter. This came to 209 in Q4 2016 – the latest data available in January 2018. It looks impressive but 'engagement' includes an email or a phone call. And why is no data available since December 2016? Company visits came to 26 in the quarter - approximately one per day across the whole investment team. There is a tick box list of issues discussed. We wonder if Carillion was visited in Q4 2017 and what was discussed? It all looks plausible but the information given is' tick-box' and process oriented. We need something more than this to demonstrate real stewardship. Asset managers should also be emailing their clients every quarter with a link to an updated stewardship report on their website. It shouldn't just be left to the clients to have to remember to go and look for this or access it via the FRC website.

Furthermore, most reporting is done in PDF format, which makes it very difficult to analyse and compare fund manager voting and engagement practices. The FRC should insist that fund managers' reports include easily analysable versions of the data in, say, Excel.

In addition to this, fund managers should organise at least one and ideally two events each year to which all their investors are invited. The managers should give an account of how they have exercised their stewardship of other people's money.

3. **Shareholder Committees and Forums:** We believe that these have a potentially important role to play in fostering shareholder engagement and in strengthening the links between companies and their investors. We have outlined above the difficulties that currently exist in allowing retail investors to engage with the businesses in which they have invested. This lack of engagement is just as much a drawback for the companies themselves. We have also outlined (2 above) the low standards of stewardship that are required of asset managers. Some do take their stewardship responsibilities seriously but many do not.

   Even in cases in which major shareholder take their stewardship responsibilities seriously they face conflicts which are often difficult to reconcile. The Work and Pensions Committee's report on Carillion makes the point that a number of major investors approached the Carillion board in private in the period preceding its collapse and urged it to 'change its direction of travel'. Having failed to exert much influence, many of the large shareholders decided to sell their shares and walk away. This may have been a logical course of action for them; however, it clearly demonstrates the fundamental flaws in this approach to shareholder oversight of the board – namely, its secrecy and its ineffectiveness in holding the board to account. It also further reinforces the point made in 2a above about the attractions of shorting a company's shares when they know, from insider information, that there is trouble brewing.

   Up to now the idea of implementing shareholder committees has been seen by many as an optional, 'nice-to-have' feature of corporate governance. A shareholder committee with a responsibility to report back to all shareholders cannot simply be told by a cavalier board to 'push-off' if it raises serious questions about business strategy; any dismissive attitude of this sort would have to be mentioned in the annual report.

Shareholder committees also have the scope to reinstate the proper relationship between auditors and those they are supposed to serve. The external auditors are supposed to look after the interests of the shareholders. In reality they are appointed by the board of directors and their sole interaction is with the directors. There is plenty to suggest that this relationship is too close, cosy and riddled with conflicts of interest. An active and effective shareholder committee has the potential to address this problem by playing and active role in both the selection and appointment of the auditors (appointment to be ratified at the AGM). It also provides the opportunity to re-establish a direct link between the auditors and the shareholders.

We have made further comments about shareholder engagement and shareholder committees which are contained in Appendix A.

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?

Reform is undoubtedly required in this area as evidenced by the collapse of Carillion. It should not be possible for a company to go on paying out dividends when, essentially, it does not have the means to do so.

This also means that companies should not be able, in effect, to borrow to pay dividends over a period of more than two years. 'Borrowing' in this context should include borrowing from suppliers by extending their payment terms in order to give the company an artificial (and transitory) cash-flow boost. In the case of Carillion, the company relied heavily on borrowings from the Government's Early Payment Facility – ostensibly to pay suppliers promptly. In reality, it was still taking over 120 days to pay suppliers and worse, still, it was able to 'hide' its borrowings from the Early Payment Facility so that they did not appear as part of the Company's total debt on its balance sheet. This was just one of a number of factors which wrong-footed many experienced investors.

Cancellation or reduction of the dividend is a good early warning for investors that a company is suffering problems. It is wholly unacceptable that directors should be able to find legitimate ways of staving off any indication to the outside world that the business is facing serious problems by finding ways of avoiding a dividend cut.

Considerable reform is required to the legal, governance and technical framework around 'distributability' of capital, i.e. the ability to make dividend payments.

The reform would involve developing a more scientific and quantitative approach to the risk of capital being exhausted. This is already well developed in the risk management profession, but the accounting profession has lagged somewhat behind since the professions diverged in the 1950s. A practical approach would be to add a risk management module to the IFRS accounting standards, which currently have little or no engagement with the issue. This would encourage investment by allowing a company to articulate a clear risk appetite to its prospective shareholders. A market-based and principles based reform would be the most practical solution. Using publicly available accounting standards (e.g. IFRS) would be preferable to excessive and complex (and 'gameable') regulation. Some government involvement might be required, but this should be limited to ensure

the standards have not been upset by vested commercial interests. The concept of 'distributability' of capital is discussed in more detail in Appendix B.

Although not mentioned in the consultation document, some mention needs to be made of action required to plug deficits in defined benefit pension schemes. Most of these are now in run-off. However, there remain many companies with significant deficits in their DB pension funds. It could be argued that these are the result of the unusual investment environment that has prevailed since the financial crash of 2007/8 and the very low interest rates that have prevailed since then. However, this raises the question of why the interest rate risk was not hedged. Furthermore, there needs to be a consistent method of valuing the deficit in the first place. Tesco, the supermarket group, recently announced that it had reduced its deficit by up to £3bn through changes to its accounting method. This suggests there is no consistency of valuation, even though the correct method of pension accounting has been well understood for a long time. Both investors and pensioners need a clear, transparent and correct view of pension deficits on the balance sheet.

Nor is it appropriate that another Carillion-style situation should be allowed to arise in which the pension fund trustees were pleading to the Company to make additional payments into the pension fund, that these pleas were going unheeded by the Company (and apparently by the pensions regulator) and that this should not have been public knowledge. Once again, this information would have been a useful warning sign to investors. The obligation to disclose it might have prompted the Company to rethink its priorities and its policy on dividend payments.

It may be worth considering if dividends should only be payable out of distributable profits less any pension liabilities. This would mean that no dividends would be paid if the pensions liabilities were higher than distributable profits. Were it not for investor preferences, it might be more logical for the company to take on risk and invest in equities (on its own balance sheet) than to encourage its pension scheme to adopt a high risk, high return investment strategy, because the potential returns to the company are asymmetric. If the investment strategy produces low returns then the company is asked to top up the pension fund, but if the investment strategy produces high returns, any surplus is usually used by the trustees to fund improved benefits. The maximum funding allowed of 105% makes this issue quite a challenge such that most companies are no longer offering DB pension schemes.

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 a standard clause in a director's contract or letter of appointment that he/she may obtain appropriate advice at the company's expense. We would be surprised if some directors were not aware of their rights and duties in this respect.

The director's duties are clearly laid out in law. When a director is considering buying part of a company in distress or making a bid for all of the company, he /she clearly will have a conflict and must disclose this to fellow directors.

Directors are usually much less well informed than the insolvency practitioners, who are to negotiate terms and conditions that guarantee them large fees, often open ended. This leads to them having financial incentives to make the case last as long as possible and to incur large expenses. Such

behaviour is not in the best interests of creditors, employees or other stakeholders. Insolvency practitioners also try to insist on and frequently obtain guarantees and indemnities. They seem to be very unwilling to put their own capital at risk, which we would view as an appropriate quid pro quo for the high fees they are charging. It is wrong to charge very high fees and not put your capital at risk.

Insolvency practitioners too often seem to operating for their own benefit. From an investor point of view, there are not many stories of good insolvency practitioners and perhaps this is evidence of them not operating in the best interests of their clients.

In the US, Chapter 11 seems to work well in some cases and companies continue to trade and emerge after a period back into normal operations. The UK environment seems to favour either a pre-pack, a quick trade sale or an insolvency. All of the UK options are very painful to one or more groups, with the exception of the Insolvency Practitioners.

Q15. Should Government consider new options to protect payment 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.

It would be good if something could be done in this area. However it is not easy to see what that might be. Our main observations are:

- The term SME's is a convenient shorthand for small businesses which are not capable of standing up to the big players who may be their customers. The EU definition of an SME is a business with fewer than 250 people and either an annual turnover not exceeding Euros 50m or a balance sheet total not exceeding Euros 43 million. There are also criteria surrounding voting rights. It is questionable whether protection should just be limited to SMEs.

- It should not be permitted for customers to unilaterally extend payment terms once a contract has been put in place. This should include simply failing to pay supplier invoices on time as well as trying to force a renegotiation of payment terms once a contract is in place – a technique which, anecdotal evidence suggests, the major supermarket chains use.

- Although it is possible for any customer to issue a winding-up order against a supplier who fails to pay reasonably promptly, many are reluctant to take this line of action.

- In many cases suppliers are fearful of upsetting a major customer and refrain from taking tough action to get outstanding invoices settled.

- In some cases small businesses (particularly 'micro-businesses') are their own worst enemies in that they are slow to issue invoices and to chase them when they are overdue.

- Any scheme that involves government support to underwrite debts to SMEs would be ill-advised as it is likely to add to 'moral hazard'.

- Factoring and credit insurance schemes already exist for those that want to use them but they can be expensive. For example, if a factoring company suspects that the debt is risky, it is likely

only to pay a relatively small proportion of the face value of the invoice or, as in the case of Santander and Carillion, may refuse to take on further invoices, so precipitating the very problem the original contract was set up to avoid.

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 not able to comment on this.

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?

Regarding other areas for improvement, there needs to be a consistent method of statutory reporting which ensures that the same values or the same risk is reported in the same way across different companies. Comparability of reporting is an important accounting principle, and is fundamental to good governance. This would be aided by an Excel-style reporting system where key balance sheet items are reported in the same way. There is already something similar in the insurance industry for Solvency II balance sheet reporting, but the principle could, and should be extended to statutory reports.

APPENDIX A

Shareholder Engagement (Q.12)

The informal nature of current shareholder engagement (cosy chats with selected shareholders behind closed doors) does not work well for the broad shareholder base. It is not clear whether investors are each being told the same story, how information is being spun, or whether complete or only partial information is being given out. Investors will ask different questions during engagement meetings and so may develop different interpretations of what the company is trying to achieve.

Ad hoc engagements tend to only occur when a problem arises.

Currently, when a large number of investors are "consulted", it is difficult to have the same conversation with each investor and the proposal often changes over the process of engagement. Currently, the different views of different investors create a very "messy" backcloth in which to engage.

For example, in relation to remuneration proposals, there is often no clear trail from the initial proposal though to the final version voted on by shareholders.

Voting happens too late in the process. Discussion and voting at the AGM is ineffective, as institutions do not like to vote against the directors' recommendations. A more professional and systematic process is required.

This impasse can be broken by the introduction of a Shareholder Committee.

The Benefits of establishing a Shareholder Committee are:

1. Systematic briefings between the company and knowledgeable Shareholder Committee Members.
2. Shareholder Committee Members will develop good background knowledge, relationships and trust with the company over time.
3. Shareholder Committee Members will be presented with consistent information and explanations, and members will have a forum for the exchange of questions and views.
4. Increased transparency.
5. A Shareholder Committee will report to all shareholders via the annual report, AGM or other route as appropriate.
6. A Shareholder Committee will focus on governance and strategy issues, and will not interfere with the day-to-day management of the company.
7. A Shareholder Committee can be established on a purely advisory basis and does not require any specific powers.
8. A Shareholder Committee might also include workers, customer representatives and other key stakeholders if desired. There is considerable flexibility on how it might operate in practice.
9. It is unlikely that the cases of Persimmon, Carillion, BP, BHS and Sports Direct would have occurred if such a committee had existed at those companies. And the problems would surely have been resolved quicker if each had had a Shareholder Committee.

Appendix B

'Distributability' of capital

The notion of 'distributability' of capital is an old and potentially valuable one, however it has disappeared from modern accounting standards. It should be re-introduced, but in a way that reflects modern (i.e. post 1950s) understanding of capital markets valuation and risk management.

'Distributable' is effectively the ability to reduce capital by making payments to shareholders, while leaving sufficient capital to absorb losses and protect creditors. 'Sufficient capital' is relative. It may be acceptable to take high risk through a relatively small amount of capital available to absorb losses, but this risk should be clearly communicated to creditors and shareholders, so that investors with a moderate or low appetite for risk are not exposed to unwanted amounts of it, and the risk should not be miscommunicated. For example, a company that has paid large dividends out of capital is signalling to investors that the remaining capital is available to absorb losses without significant risk to creditors. If it subsequently goes into insolvency, this suggests that it has not been quantifying risk in the correct way.

If shareholders and creditors do have a high risk appetite, they may want to invest in companies whose statements and dividend policies reflect that risk, and there is nothing inherently 'wrong' with such companies going insolvent. Investors understand that their capital is at risk, perhaps at high risk, and can lose it all in the event of insolvency. However, many investors do not have a high risk appetite, and it is crucial that the information provided to them is sufficient for a reasonable assessment of the risk. Capital should be there to absorb losses in a way that is not damaging to the stability of the whole financial system, and so is socially important. The system as a whole, including the system that informs investors, should not discourage investors with a moderate to low risk appetite. The problem with recent insolvency events is the way that apparently sound companies, i.e. companies where audit reports suggested moderate to low risk, have gone into insolvency. This reflects badly on the current reporting system, and discourages future investment.

Accounting standards therefore need to be developed to set clear and measurable tests for when capital is 'distributable'. Current legal and reporting requirements set no such clear test. Take, for example, 'accumulated realised' profits. Company A invests in secure assets worth 100, with debt of 90, equity 10. Company B invests in junk, same amount of debt. The assets of B are coupon paying, the assets of A are not. So A's unrealised profit, while secure, are not 'accumulated realised', whereas B has a constant stream of cash coupon. Company B can therefore distribute capital, company A cannot. This situation is absurd.

The concept of 'high' or 'low' debt also needs to be clarified in the light of asset risk. For example, company A might have secure assets, and a relatively large *percentage* of debt. But the debt is not necessarily high in relation to the asset volatility. By contrast, company B might have a relatively low percentage of debt, with highly risky assets. So the debt might be relatively high in such a case. Modern financial theory has a well developed understanding of the mathematical relationship between debt and equity, but this is not currently reflected in current accounting theory.

In summary, it is clear that the definition of distributable profits is no longer fit for purpose. Accounting standards need to be developed to allow sufficient transparency to shareholders and creditors (and other stakeholders such as pensioners and employees) for decisions taken by companies on how to allocate capital. The insights of modern financial theory, while not perfect or complete, could be the basis for such developments.