

## Rating (Coronavirus) and Directors Disqualification (Dissolved Companies) Bill 2021

### Written evidence submitted by R3, the insolvency and restructuring trade body (July 2021)

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#### About R3

1. R3 is the trade association for the UK's insolvency, restructuring, advisory, and turnaround professionals. We represent licensed insolvency practitioners, lawyers, turnaround and restructuring experts, students, and others in the profession.
2. Our members work across the spectrum of the profession, from global legal and accountancy firms through to smaller, local practices. Our members have direct experience of insolvencies and their impact on individuals and businesses across the UK.
3. The insolvency, restructuring and turnaround profession is a vital part of the UK economy. The profession promotes economic regeneration, resolves financial distress for businesses and individuals, saves jobs, and creates the confidence and public trust which underpin trading, lending and investment.
4. Our members play an important role in the fight against fraud and in supporting the integrity of the UK's corporate governance framework. When appointed over corporate entities, insolvency practitioners are required to investigate the company's affairs and director conduct, in order to discharge their duties.

#### Overview

5. Clauses two and three of the *Rating (Coronavirus) and Directors Disqualification (Dissolved Companies) Bill* will introduce powers to enable the Insolvency Service to investigate directors of companies that have been dissolved. Currently, the Insolvency Service is only able to investigate directors of insolvent companies.
6. R3 welcomes this policy, having supported the proposal when it was initially put forward by the Government in 2018. The change will help to deter from the use of dissolutions by directors to avoid scrutiny and liabilities, helping to solve a current issue highlighted by many of our members.
7. However, there are three key questions that need to be answered by the Government in order for the policy to be effective:

- **How will these additional investigations be funded?**

The Insolvency Service must be sufficiently resourced to deal with the expansion of its investigatory powers, so that investigations into directors of *dissolved* companies do not come at the expense of investigations into directors of *insolvent* companies.

- **How will the Government actually *prosecute* those directors of dissolved companies it identifies as culpable?**

The legislation does not set out the mechanism by which the Government will actually seek to recoup monies from those directors identified as culpable. The director disqualification regime does not by itself facilitate this repayment and is often not much of a deterrent to committed fraudsters.

If the Government intends to use a tool like Compensation Orders, it should say so – unlike an insolvency process, where returns are made to the creditor body, Compensation Orders usually only benefit one creditor. While the Government has indicated that it will expand the number of creditors who can benefit from a Compensation Order, this has not been made clear in the legislation.

Where there are multiple creditors, an insolvency procedure is likely to be better suited to recovering monies owed to these creditors; very few Compensation Orders have been issued since they were introduced and as such it is not clear that they have been a completely successful addition to the redress-seeking toolkit. In contrast, thousands of insolvency procedures take place every year that return hundreds of millions of pounds to creditors.

- **As well as prosecuting directors of dissolved companies, what will the Government's approach be to dealing with the dissolved companies themselves?**

While R3 supports this legislation, it would only be a partial solution to the use of dissolutions to commit fraud: a dissolved company's director may end up being disqualified, but creditors may still be left out of pocket if the dissolved company is not restored and put through an insolvency procedure to identify and distribute the company's assets. Pursuing culpable directors of dissolved companies without also restoring the dissolved company and using the insolvency framework to identify and distribute any assets would undermine the value of this legislation.

As well as introducing this measure, the Government should also make it easier and less costly for creditors and the insolvency profession to restore a company so that it can be placed into an insolvency procedure and the company's assets realised for the benefit of creditors.

8. The insolvency and restructuring profession already plays an important role in the fight against fraud and in supporting the integrity of the UK's corporate governance framework. The observations made here to improve company dissolution/restoration processes and investigation into directors who abuse those processes will not provide more work to R3's members, it will though have the side-benefit of improving the efficiency of our members' efforts to tackle such abuses in addition to improving the efficiency of similar efforts by the Insolvency Service.
9. We would urge the Government to consider how it can work with the insolvency and restructuring profession to this end.

## **Background**

10. The proposal to bring the behaviour of directors of dissolved companies under the Secretary of State's investigatory powers was first proposed in the Government's *Insolvency and Corporate Governance 2018* consultation.
11. Dissolving a company, instead of going through a solvent or insolvent liquidation process, is a legitimate way of shutting down a corporate entity. However, the insolvency and restructuring profession has raised concerns in the past that this route is used by some directors to avoid scrutiny of their behaviour, as dissolution does not involve examination of the dissolved company's finances by an external party such as an insolvency practitioner.
12. At present, the Insolvency Service has powers to investigate and sanction directors of live companies or those that have entered an insolvency process. The changes proposed by the Bill will allow the Insolvency Service to also investigate and sanction directors of dissolved companies. In light of concerns over directors

inappropriately dissolving companies that have benefited from COVID-19 state-backed loans, the Government's interest in cracking down on directors who attempt to evade their debts is welcome and will improve the integrity of the UK's corporate governance framework.

#### How will these investigations be resourced?

13. However, one key question is whether the Insolvency Service will have the resource available to conduct these investigations alongside those they already carry out into directors of insolvent companies. It is important that the former does not come at the expense of the latter.
14. When acting as an office holder in a formal insolvency process (administration or liquidation), an insolvency practitioner must compile a report on the directors' conduct which is then filed with the Insolvency Service.
15. R3 members already currently express frustration that not all of their reports – even where serious breaches of the law are suspected – are acted on when reported to the Insolvency Service, due to resourcing issues.
16. With the Insolvency Service potentially set to receive many more potential cases of dissolved companies to investigate, on top of its existing caseload, it is vital that the Government's decision to expand its powers will be matched by an expansion of the resources available to it to gather evidence and shut down anyone abusing the dissolution process.

Year	Disqualifications by the Insolvency Service of directors of insolvent companies <sup>1</sup>	Dissolved companies <sup>2</sup>	Percentage of companies struck off and dissolved <sup>3</sup>	Percentage of companies wound up voluntarily or subject to the supervision of the Court under the Companies Acts <sup>4</sup>
2019/20	1,280	531,590	95%	5%
2018/19	1,243	504,307	94%	6%
2017/18	1,231	486,671	94%	6%
2016/17	1,214	432,347	94%	6%
2015/16:	1,211	395,606	94%	6%
2014/15	1,210	365,881	93%	7%
2013/14	1,282	329,245	93%	7%
2012/13	1,034	299,700	92%	8%
Average	1,213	418,168	94%	6%

17. The table above shows the number of disqualifications made by the insolvency service of directors of insolvent companies by year in Great Britain, as well as the number of companies dissolved or struck off the Companies Register in Great Britain. On average, c.1,200 disqualifications are made annually by the Insolvency Service in relation to the c.17,000 corporate insolvencies that occur annually. However, some 418,000 company dissolutions take place annually. Of these, c.94% were struck off and dissolved at the behest of Companies House through its automatic strike-off routines for failures to file accounts or confirmation statements, rather than at the request of directors or the courts. Although it is unclear how many of these automatic strike-offs by Companies House are of insolvent companies, it is estimated these may be around 50% of that total, which represents a volume some 12 times greater than the annual number of corporate insolvencies. It is therefore likely that Insolvency Service resource will have to be scaled up significantly to deal with this magnitude of investigation into insolvent dissolutions.

<sup>1</sup> [Table 1A: Director Disqualification Order and Undertakings by Section](#), Insolvency Service

<sup>2</sup> [Table A9: Companies removed from the register, 2012-13 to 2020-21](#), Companies House

<sup>3</sup> *Ibid*

<sup>4</sup> *Ibid*

18. It would yield more effective and earlier investigation of insolvent company dissolutions, if the automatic strike-off power of Companies House was removed and such companies that would have become subject to it were quarantined for Insolvency Service review. This would enable the Insolvency Service to identify and put insolvent quarantined companies into the appropriate procedure of compulsory liquidation, with the Official Receiver as the first-appointed liquidator commencing investigation of the directors conduct and recovery of misappropriated company assets at that (earlier) point in time for the benefit of all creditors of such companies.
19. On the issue of funding, we were disappointed to note the suggestion in the Government's Impact Assessment of the Bill that: *"Although the changes will expand the investigatory power of the Insolvency Service to include directors of dissolved companies it does not necessarily follow that additional funding will be made available to the Insolvency Service, because this will be determined by Spending Review processes which considers the relative priority of all Government expenditure. Our assumption is that the funding envelope for the Insolvency Service's investigation and enforcement activity will remain unchanged, as it was in the most recent Spending Review 2020. It follows therefore that we assume that the extent to which the new powers will be used will be discretionary with cases being prioritised for investigation where it is most strongly in the public interest"*.
20. We simply do not believe that this legislation can work in a way that truly closes the 'dissolved company loophole', while at the same time preventing any reduction in the number, or efficacy, of the Insolvency Service's investigations into directors of insolvent companies, without a suitable increase in resources for the Insolvency Service to carry out this new set of investigations.

#### **The Government's approach to prosecuting culpable directors and dealing with the dissolved companies**

21. As noted above, it is currently unclear which method the Government will use to prosecute a culpable director of a dissolved company once their behaviour has been investigated.
22. During the Second Reading of the Bill, we were pleased to see the Minister recognise the value of the insolvency framework and the fact that *"dissolution should not be used as an alternative to insolvency proceedings but there is evidence that some directors have been using the process both as a way of fraudulently dodging the payment of company debts and of avoiding insolvency proceedings and the scrutiny of their behaviour that comes with that [entry in to an insolvency procedure]"*.
23. The Bill would only bring a partial solution if the company's creditors do not receive compensation when a dissolved company's director is disqualified. To ensure that creditors are not left out of pocket, it is crucial that the Government ensures dissolved companies, where the companies' directors have been found to be culpable, are put through an insolvency procedure, so that the company's assets might be identified and distributed to all of its creditors in the statutory order of priority.
24. There are also other reforms that the Government should introduce alongside those in the Bill, to ensure that the 'dissolved companies loophole' is properly closed. Historically, disqualifications alone have had little to no effect on fraudulent directors. For the policy to be effective, it is key that investigations lead to prosecutions. It is currently unclear as to how the prosecution of a director of a dissolved company (i.e. a company that effectively no longer exists) can legally take place without the company first being restored.
25. However, in many instances, restoration of a dissolved corporate requires an application to court, which can be costly in terms of both time (typically 12-18 months) and money (typically £1,500-£3,000), and thus all too easily allows directors to create a significant barrier to investigating their conduct. The table below shows that only 2% of dissolved companies are put through a process to restore them to the register each year.

Year	Dissolved companies in Great Britain <sup>5</sup>	Percentage of companies restored to the register <sup>6</sup>
2019/20	531,590	2%
2018/19	504,307	2%
2017/18	486,671	2%
2016/17	432,347	2%
2015/16:	395,606	2%
2014/15	365,881	2%
2013/14	329,245	2%
2012/13	299,700	2%
<i>Average</i>	<i>418,168</i>	<i>2%</i>

26. To resolve this issue, and to make this legislation as effective as possible, the Government should also ensure that the restoration of a dissolved company should be an administrative process rather than a court-based process. This could be triggered by a company director or creditor once suitable requirements have been met, such as producing evidence of an unpaid debt or a commitment to petition for the winding-up of the restored company.
27. It is appreciated by R3 members that UK company formation procedures and processes are delivered efficiently and cost-effectively by Companies House. The costs of company formation and maintenance are kept commendably low. However, this low-cost approach should not be extended by Companies House to those directors and other individuals who choose to abuse it. We recommend Companies House increase the penalties it levies on companies for filing failures (that currently trigger automatic strike-off routines) and funds raised from such penalties are used to fund the Insolvency Service investigations of those companies put into the quarantine recommended earlier.

**About R3:** R3 is the trade association for the UK's insolvency, restructuring, advisory, and turnaround professionals. For further information please contact R3's Public Affairs and Policy Officer, Pim Ungphakorn, on [pim.ungphakorn@r3.org.uk](mailto:pim.ungphakorn@r3.org.uk) or 020 7566 4202.

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<sup>5</sup> *Ibid*

<sup>6</sup> *Ibid*