CORE Insolvency and Corporate Governance Consultation Response

CORE is the UK civil society coalition on corporate accountability. We aim to advance the protection of human rights with regards to UK companies’ global operations by promoting: higher standards of conduct; compliance with the law as part of a more effective regulatory framework; and improved access to remedy for people harmed by UK-linked business activities. We welcome this inquiry and the opportunity to submit evidence.

Q. 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?

1. Transparency will not lead to accountability without clear oversight mechanisms. It must be clearer who directors are accountable to and what power these groups have when serious management failures occur. In the current UK corporate governance framework, the overriding assumption is that shareholders oversee the behaviour of boards. Both the UK Corporate Governance Code and the Stewardship Code are predicated on this model. But as a string of recent corporate failures indicates, this model of accountability is not working.

2. There are several reasons for this. There is substantial evidence that short-termism is pervasive in UK equity markets. Other trends in equity markets have additionally heighted the disconnect between some shareholder interests and companies’ long-term success. For instance, the Investment Management Association has said that on average its members hold shares in around 450 different companies, reducing the capacity for effective scrutiny and engagement, even amongst those investors holding for the long-term. Over recent decades the proportion of UK-listed shares held by investors outside the UK has also risen considerably, while the proportion of the market held by individuals and pension funds has fallen.\(^1\) In this context, shareholders are not ideally suited to oversee board decisions. Shareholders have little capacity to engage with boards, and often their interests are not aligned with the long-term interests of the company.

3. It is often held that when a company like Carillion goes into insolvency it is the shareholders that hold all the risk. Many have pointed out that Carillion’s shareholders were wiped out when the company folded, but this ignores the massive social costs inflicted on workers, suppliers and recipients of public services. By March 2018, 1,458 individuals had lost their jobs because of the firms collapse and 30,000 sub-contractors risk losing out on a total £1billion.\(^2\)

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4. To strengthen company resilience to risks, directors should be accountable to all those with a real stake in the future of a company. This includes workers, suppliers, and customers as well as shareholders. Stakeholder interests would then be integrated into the decision-making process, allowing for better management of risks that threaten the shareholder value the success of the company is intended to promote.

5. To fix gaps in board level accountability and increase company resilience through greater stakeholder voice we recommend:

- Extending the category of person who can legitimately bring derivative actions to ‘anyone who appears to the court to be interested in the company’. This could be either those who have a direct financial interest in the affairs of the company, or a particular legitimate interest in the way that company is being managed. Whilst in the UK only shareholders can bring derivative actions, other jurisdictions including Canada and Singapore allow ‘any other person who, in the discretion of a court, is a proper person to make an application’.

- Amending directors’ duties under s.172 of the Company’s Act to place a positive obligation on directors to mitigate against serious harms, place stakeholders’ interests on a par with shareholders, and make director’s primary duty to the long-term success of the company.

- Widening the director’s disqualification regime, making it possible to disqualify directors of going concerns as well as directors of insolvent companies.

- Having elected workers on company boards. The current proposal to revise the FRC Corporate Governance Code to require companies to institute a worker engagement mechanism is extremely weak. As a Code provision it is on a comply and explain basis, and therefore not mandatory. Moreover, companies are given the option to develop a workforce advisory panel or appoint a designated non-executive director to represent the workforce instead of putting a worker on their board. This seriously dilutes the provision.

Q. 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?

6. Improving the voice of stakeholders on boards will work best if shareholders and stakeholders can offer directors a unified message. While shareholders alone cannot be relied upon to hold directors to account in the context of serious management failures for the reasons we give above, steps should be taken to improve shareholder engagement and reduce short-termism. The Stewardship Code should therefore focus its interest on the long-term shareholder with the aim of developing the engagement capacity of that category of shareholder.

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7. The first step should be to reframe the Code as an obligation. This would extend the reach of the Code to all relevant actors, not only signatories. Because of the ‘comply or explain’ format, those subject to the Code would still retain a great deal of flexibility.

8. The Code could also develop specific guidance for different categories of investor. This would, for example, allow the Code to establish a clearer link between the activity of asset management and the consultation of shareholders and end beneficiaries on their stated goals and to encourage asset owners to focus more clearly on the mandates they give to asset managers, their alignment with strategic goals, and to explain how those mandates reflect their approach to stewardship.

9. The Code should also include a specific obligation on all institutional investors to draft and disclose their policy in relation to the ESG risks and social impacts associated investments, or to explain why they have not done so.

Q.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?

10. Carillion provided a clear example of how companies prioritise dividends over investment, wages and even their long-term interest. Between 2012 and 2016 Carillion paid out £376 million in dividend payments while generating only £159 million in cash. Moreover, Carillion is part of a longer-term trend – over the past 50 years the percentage of profits returned to shareholders from the FTSE100 has risen from less than 10% to 60%. One important reason for this is that, as discussed above, the shareholder primacy model gives shareholders significant corporate governance rights resulting in boards that prioritise the interests of shareholders. Our recommendations described under question (11.) would rebalance the corporate governance framework to improve the situation.

11. While only fundamental reforms of this kind will fix the problem, improving visibility around the distribution of company revenues could be useful. Companies could be required to include two pie charts in their annual reports that details (1.) how their revenues have been allocated, including dividends, R&D, executive remuneration and workforce pay, and (2.) how their cashflow has been generated, including the use of debt.

ENDS

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* TUC, *What lessons can we learn from Carillion – and what changes do we need to make?*, (2018).