Title: Giving the court and Secretary of State (SoS) a power to make a compensatory award against a director	Impact Assessment (IA)
IA No: BIS INSS003	**Date:** 05/06/2014
Lead department or agency: The Insolvency Service	**Stage:** Final
Other departments or agencies: Department for Business Innovation and Skills	**Source of intervention:** Domestic
	Type of measure: Primary legislation
	Contact for enquiries: **Muhunthan Vaithianathar** **020 7637 6515**

Summary: Intervention and Options

RPC Opinion: Not Applicable

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, Two-Out?**	**Measure qualifies as**
-0.90	-0.90	0.09	No	n/a

What is the problem under consideration? Why is government intervention necessary?

The main purpose of the disqualification regime is to provide protection to the market and consumers from the acts of those directors whose conduct falls below expected standards. However, those who have suffered from that misconduct do not directly benefit from the disqualification action, and many remain sceptical about how effective disqualification is in tackling poor director behaviour. A complaint often raised in Ministerial correspondence from creditors is that although disqualification can prevent a director acting as such in future, it provides no compensation to those who have suffered from their misconduct and the disqualified directors don't appear to have suffered financially. Information asymmetries and transaction costs might prevent some creditors from protecting themselves against misconduct and therefore government intervention is needed to provide the right level of protection for creditors and discourage director's misconduct, increasing in turn confidence and trust in the overall disqualification regime.

What are the policy objectives and the intended effects?

The objective of the policy option is to improve stakeholder confidence in the enforcement regime and effect a change of behaviour in directors by increasing the likelihood of culpable directors being called to account for their actions, whilst providing better recourse to creditors who have suffered.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Do Nothing: This will likely result in the continuation of the current infrequent use of civil recovery mechanisms and no change to the likelihood of directors being financially accountable for their actions.

Option 1 (**preferred option**): Giving the court and Secretary of State (SoS) a power to make a compensatory award against a director. This option would give the courts the power to require an individual who has been disqualified to pay compensation to the creditors where the actions of that director have caused loss to the creditors (a "compensation order") on application by the SoS. We also propose to allow the SoS to request and accept compensation awards (compensation undertakings) from directors to avoid the need for court proceedings (same principle as a disqualification undertaking – see para. 20 below). This option would also include strengthening the information gateways between liquidators and official receivers and the Insolvency Service to better target cases where financial redress is available. Better communication between liquidators and the Insolvency Service may enable liquidators to decide if it is possible and worthwhile to bring actions to get financial redress for creditors.

No other options were considered as the only mechanism for increasing the likelihood of miscreant directors being held more financially accountable for their actions and to provide better redress for creditors who have suffered is to allow the making of a compensation award against a director. No other mechanism allows this. Existing civil recovery mechanisms are used infrequently and there is a perception that directors of failed companies get off lightly, even where disqualified, if they pay no financial penalty. Compensation awards will allow this.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** April 2020					
Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** No	**Large** No
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible SELECT SIGNATORY: Jeremy Hillett Date: 18.06.2014

Summary: Analysis & Evidence

Policy Option 1

Description: Giving the court and Secretary of State (SoS) a power to make a compensatory award against a director

FULL ECONOMIC ASSESSMENT

Price Base Year 2013	PV Base Year 2013	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -1.30	High: -0.50	Best Estimate: -0.90

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.5	1	0	**0**
High	1.3		0	**0**
Best Estimate	0.9		0	**0**

Description and scale of key monetised costs by 'main affected groups'

There are one off familiarisation costs to insolvency practitioners (IPs) and lawyers in becoming familiar with the legislation estimated to be £0.93m.

Other key non-monetised costs by 'main affected groups'

Since we cannot be certain about the number of compensation cases that will be taken forward, an illustrative scenario has been constructed. The costs which are associated with this scenario have not been included in the NPV or EANCB calculations, as they are not sufficiently robust for this purpose.

Based on our illustrative figures, the increased investigation costs incurred by the Insolvency Service in pursuing a compensation award are in the range of £0m to £1.73m per annum. This is a cost to the Insolvency Service.

Based on our illustrative figures, there could be increased court fees/costs to be paid in the range of £0m to £0.07m per annum.

There could also be wider legal fees in the range of £0m to £1.96m per annum. This will cover both the directors own legal costs and that of the Insolvency Service in pursuing the compensation award. These costs will be paid/claimed from the miscreant director.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	N/A	0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No monetised benefits have been identified (see below).

Other key non-monetised benefits by 'main affected groups'

Since we cannot be certain about the number of compensation cases that will be taken forward, an illustrative scenario has been constructed. Therefore those benefits which are associated with this scenario have not been included in the NPV or EABC calculations.

Based on our illustrative figures there would be a benefit occurring from miscreant directors to creditors (insolvent estates). This equates to a range of £0m to £11.6m per annum. This would be paid by miscreant directors.

There may also be some wider non-monetised benefits relating to increased confidence in the enforcement and civil recovery regime, if directors believe there is a greater chance of them being held financially accountable for their actions, this may deter them from committing misconduct in the first place, which may result in smaller losses to creditors and also fewer disqualifications resulting from any reduced misconduct.

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5

It is difficult to predict either how many cases the SoS (Insolvency Service) will seek a compensation award in or the ability of the directors in these cases to meet such an award. Therefore the analysis undertaken has mainly focussed on identifying the groups affected, describing the impacts and where possible quantifying the effect rather than trying to monetise all the costs and benefits. Monetisation of impacts has only been done when data was readily available. Where none has been available, quantification has been presented as an indicative/illustrative breakdown. The assumptions are explained in further detail below.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies as
Costs: 0.1	**Benefits:** 0.0	**Net:** -0.1	No	n/a

Evidence Base (for summary sheets)

Introduction

The CDDA and Disqualification of Company Directors

The Company Directors Disqualification Act 1986 (CDDA) aims to maintain the integrity of the business environment. Those who become directors of limited companies should:

- Carry out their duties with responsibility; and
- Exercise adequate skill and care with proper regard to the interests of the company's creditors and employees.

The majority of directors do this effectively, but the CDDA is a powerful tool against those who abuse the privilege of limited liability. The CDDA applies not just to persons who are formally appointed as directors but to those who carry out the functions of directors.

If there is any unfit conduct in an insolvent company, then the liquidator, administrative receiver, administrator or official receiver has a duty to send the Secretary of State for Business, Innovation & Skills a report on the conduct of all directors who were in office in the last three years of the company's trading.

The Insolvency Service, on behalf of the Secretary of State has to decide whether it is in the public interest to seek a disqualification order against a director.

The proceedings are brought by The Insolvency Service on behalf of the Secretary of State for Business, Innovation & Skills or, usually in compulsory winding-up cases, by the official receiver at the direction of the Secretary of State. The matter is heard, and decided by the court, unless the Secretary of State accepts a disqualification undertaking from a director. An undertaking has the same legal effect as a court order, but negates the need to go to court.

The minimum period of disqualification is two years and the maximum 15 years.

If a company director is disqualified (by court order or by giving an undertaking), unless they have court permission, that person is disqualified for the period stated in the order or undertaking from:

- Being a director of a company;
- Acting as receiver of a company's property;
- Directly or indirectly being concerned or taking part in the promotion, formation or management of a company; or
- Being a member of or being concerned or taking part in the promotion, formation or management of a limited liability partnership.
- Acting as an insolvency practitioner (IP).

Problem under consideration

1. The main purpose of the disqualification regime is to provide protection to the market and consumers from the acts of those directors whose conduct falls below expected standards. However, those who have suffered from that misconduct do not directly benefit from the disqualification action, and many remain sceptical about how effective disqualification is in tackling poor director behaviour.
2. A frequent complaint in Ministerial correspondence from creditors is that although disqualification can prevent a director acting as a director in future, it provides no compensation to those who have suffered from their misconduct. More importantly, for those creditors who have experienced financial loss, there is the perception that directors are able to walk away from the liabilities of the company, while remaining financially unscathed, and are able to start again, leaving creditors out of pocket and with little financial recourse.

3. Responses to the consultation paper also revealed there is a feeling that the threat of disqualification alone is not a sufficient deterrent to stop directors from misbehaving as the likelihood of them having to personally pay for their actions is not great enough.

4. Currently, there are a number of actions that can be taken against a director with the aim of getting financial redress for the company and creditors under the Insolvency Act 1986. These include actions for wrongful[1] and fraudulent trading[2], misfeasance or breach of directors' duties[3], wrongful preference[4] and transactions at an undervalue[5]. These are all civil actions although a criminal action for fraudulent trading under the Companies Act also exists. This proposal only concerns civil actions.

5. Responses to the Transparency and Trust discussion paper[6] suggested that there have only been 29 reported cases under s214 of the Insolvency Act 1986 (IA86), (wrongful trading claims) between 1986 and 2013 with liability being imposed in only 11 of those cases. There have been 80 cases under s238 IA86 (transactions at an undervalue), over 50 under s239 IA86 (wrongful preference) and over 60 claims were noted under s212 IA86 (misfeasance by directors) over the same period.

6. This might be for example due to insufficient assets in the insolvency estate[7] with which to fund an action by the officeholder and creditors being reluctant to fund the cases, coupled with a high evidential bar and a lack of director's assets, against which to enforce a successful claim. Officeholders are under a duty to realise assets and distribute the proceeds to creditors. It may be the case that there is a potential right of action, but it requires additional funds to proceed with the action. There may not be enough monies from asset realisations to fund an action and creditors may be unwilling to fund the action as they have already lost monies due to the insolvency of the company. Since money is limited, officeholders are only likely to proceed with an action where they believe the case has a very good chance of success and they are funded to bring it.

7. These were all reasons suggested in consultation responses by representative legal bodies, R3 (the trade body for insolvency practitioners), insolvency practitioners, Institute of Credit Management and Jordans (company formation agent and corporate services provider). However, the greatest weight was given to the high evidential bar and lack of director assets with which to pay an award as the main reasons why claims are not currently taken forward.

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[1] Wrongful Trading – Cause of action arises if in the course of winding-up a company where the company has gone into insolvent liquidation and at some time before the commencement of the winding up, that director knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

[2] Fraudulent Trading – Cause of action arises if, in the course of winding-up a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or has been carried on for any fraudulent purpose.

[3] Misfeasance – Cause of action arises if, in the course of winding-up a company, it appears that a person has misapplied or retained, or become accountable for, any money or other property of the company, or has been guilty of any wrongdoing or breached their duties of trust (for example, duty to hold something in trust) in relation to the company..

[4] Preference – Cause of action arises where the company enters administration or goes into liquidation and the company has at a relevant time given a preference to any person where that person is a creditor of the company or a surety or guarantor for the company's debts and the company does anything which has the effect of putting that person in a position which, if the company becomes insolvent will be better than the position he would have been in if that thing had not been done.

[5] Transactions at an undervalue – Cause of action arises where the company enters administration or goes into liquidation and the company has at a relevant time entered into a transaction at an undervalue. Transaction at an undervalue includes the giving of a gift or receiving consideration at significantly less than the value of the asset. However, the court must not make an order where the company entered into the transaction in good faith for the purpose of carrying on the business and at the time it did so, there were reasonable grounds for believing that the transaction would benefit the company.

[6] http://www.gov.uk/government/consultations/company-ownership-transparency-and-trust-discussion-paper

[7] Insolvency estate – assets or property which the officeholder can deal with to pay the creditors. Officeholders are under a duty to realise assets and then distribute the proceeds to creditors after deducting their costs and fees.

8. Although the main purpose of the disqualification regime is to provide protection to the market and consumers from the acts of those directors whose conduct falls below expected standards, greater stakeholder confidence can be achieved by increasing the likelihood of miscreant directors being required to compensate creditors in appropriate cases. This would result in greater personal liability as a result of directors' misconduct, and potentially mitigates the unintended consequences of limited liability protection of directors. The latest survey by the Insolvency Service suggested that around 65% of those questioned had confidence in the enforcement regime[8]. We believe this figure could be increased with the introduction of the proposals to improve financial redress for creditors.

9. The behaviours/misconduct that are often identified in disqualification reports are linked in many ways with the civil recovery actions that officeholders can currently bring under the Insolvency Act, such as those identified above, e.g. wrongful trading, transactions at an undervalue, unfair preferences, misfeasance by directors. Although not specifically mentioned in those same terms, the general behaviour/misconduct identified is similar. By being able to use a lot of this information in seeking a compensation award, the SoS should have less of the evidential issues officeholders may have in pursuing civil recovery actions.

10. The option of the SoS seeking a compensation order or agreeing a compensation undertaking from a miscreant director will enable greater financial redress for creditors, where the officeholder (IP) has not taken any of the available actions him/herself or it is considered that further action in addition to that taken by the IP is merited.

11. This could be due to the IP not having any funds to pursue a civil recovery action, or deciding that it would consume too much of their time to investigate and evidence a potential claim and not worth the risk, or feeling they don't have the specialist expertise to bring a claim. If this occurs, then the SoS (through the Insolvency Service) can consider bringing a compensation claim if they think it is in the public interest and the award can be recovered from the miscreant director. This could result in monies being paid to creditors in circumstances where previously they would have received nothing unless the officeholder (IP) brought a civil recovery action against the miscreant director.

Rationale for intervention

12. Laws to address general director misconduct, primarily the Company Directors Disqualification Act 1986 (CDDA), are currently in place. However, it is the strength of these laws and the level of punishment and compensation built into them that determine the effectiveness of aligning director and creditor incentives and ensuring the right level of protection for creditors.

13. The proposals presented in this impact assessment are aimed at addressing a **regulatory failure** in the public provision of law enforcement goods and services and therefore increase economic efficiency. In particular they are aimed at improving the efficiency of the law in protecting and preventing misconduct by explicitly allowing for a compensation award to be imposed against directors after misconduct has been established.

14. Director misconduct is a **moral hazard**[9] problem. This problem is caused by the perverse incentives, which, in turn, are created by limited liability[10]. Under moral hazard, directors are more likely to engage in misconduct or take more risks if they are not personally responsible for the consequences of their actions. [11]

[8] 'Stakeholder Confidence Survey', Insolvency Service, 2012: http://www.bis.gsi.gov.uk/insolvency/About-us/our-performance-statistics/StakeholderConfidence

[9] In economic theory, a moral hazard is a situation where a party will have a greater risk appetite because the costs associated with risk taking will not be incurred by the risk-taking party.

[10] Halpern et al. (1980) Limited Liability in Corporate Law.

[11] One of the consultation responses argued, that, although there is firm grounding in the literature that limited liability generates a moral hazard problem, there is little empirical evidence of the e*xtent* of this problem. The extent of the problem would determine the degree of regulatory action, rather than the need for regulatory action, which is the subject of discussion in this section.

15. Government action is therefore needed to minimise the unintended consequences of limited liability by achieving a better alignment of creditor and director incentives. This will be done by discouraging directors from engaging in misconduct, by allowing for a greater possibility of miscreant directors being financially accountable for their actions, by allowing the SoS to seek or agree a compensation award from the miscreant director, an individual identified as worthy of being stopped from acting in the management or formation of a company.

Policy objective

16. The objective of the policy option is to improve stakeholder confidence in the enforcement regime and effect a change of behaviour in directors by increasing the likelihood of culpable directors being held financially accountable for their actions, and better compensating creditors who have suffered.

17. In turn, it is hoped that this will enable risk-taking and investment in the market which are nearer to the socially-optimal scale. Under the preferred option, there will now be scope for a compensation award to be paid from directors to creditors. Therefore, there is a greater chance that these monies can be used by the creditors of miscreant directors to grow or create a business. This measure should help support enterprise.

Description of options considered (including do nothing)

Do Nothing

18. There are a number of actions that can be taken against a director with the aim of getting financial redress for creditors under the Insolvency Act 1986. These include actions for wrongful and fraudulent trading, misfeasance or breach of directors' duties, wrongful preference and transactions at an undervalue. However existing civil recovery mechanisms are used infrequently and there is a perception that directors of failed companies get off lightly, even where they are disqualified, if they pay no financial penalty. Liquidators rarely bring actions against directors due to the cost and the complications (including a high evidential burden) involved. By doing nothing, this will remain the case.

Option 1 – Allowing Courts and the Secretary of State (SoS) to make compensation orders (recommended option)

19. This option is to give the courts and the SoS a power to make or agree, respectively, a compensatory award against a director at the time it makes a disqualification order or agrees a disqualification undertaking.[12] This measure is intended to improve stakeholder confidence in the enforcement regime by increasing the likelihood of miscreant directors being required to compensate creditors in appropriate cases.

20. In order to ensure that more directors make financial contributions to creditors of failed companies where they are responsible for that failure, we would like to give the courts the power to require an individual who has been disqualified to pay compensation to the creditors (a "compensation order") on application by the SoS. We also propose to allow the SoS to request and accept compensation awards from directors to avoid the need for court proceedings (a "compensation undertaking"), in the same way as the SoS can currently accept from an individual an undertaking not to act in the management of a company instead of applying to the court for a disqualification order. The size of these awards would be related to the misconduct found in the disqualification and the identifiable loss to creditors.

21. The criteria that must be fulfilled for either a compensation order to be made or a compensation undertaking to be accepted are:

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[12] A disqualification order is made by the court under the Company Directors Disqualification Act 1986 (CDDA). Disqualification proceedings are taken under civil law, not criminal law. An order for disqualification can be made under a number of different sections of the CDDA. The order will specify the period of disqualification. A disqualification order usually carries with it an order to pay the costs and expenses of the SoS or the Official Receiver or both. Alternatively, directors may offer to give an undertaking. An undertaking is the administrative equivalent of a disqualification order and can be entered into, voluntarily, without the need for Court proceedings. Undertakings may be offered to the SoS, and once agreed, have the same effect as a Court order.

i. the individual must be disqualified under the CDDA;

ii. the court (or SoS) must be satisfied that the conduct for which the individual was disqualified has caused loss to creditors of a company of which the individual was a director; and

iii. that company must be or have been insolvent.

22. The compensation may be awarded to a particular creditor or creditors, a class or classes of creditors, or may form a contribution by the director to the assets of the company. The court may order to whom the compensation is paid or the SoS may determine this in the case of a compensation undertaking, taking into account what is equitable in all the circumstances.

23. The amount of the compensation should be at the discretion of the court where a compensation order is made, or agreed between the director and the SoS if a compensation undertaking is given. It should never be greater than the loss caused. There are a number of factors that should be taken into account by the court or SoS in determining the amount of the compensation. These are:

i. The quantum of the loss suffered by the creditors;

ii. The severity of the director's misconduct;

iii. The degree to which the director's behaviour caused loss to the creditors;

iv. Whether the director has already made any financial contribution to the company or creditors in recompense for the conduct that lead to his disqualification (e.g. under a criminal compensation order or following a fraudulent or wrongful trading action);

v. Whether the misconduct was committed by more than one director or is attributable to one in particular.

24. To strengthen the regulation, this option also proposes that the SoS and officeholder strengthen their information gateways to better enable successful recovery actions to be taken forward by the officeholder. Information sharing between the SoS and officeholders already takes place through a formal information disclosure process (D return) and through general 'intelligence requests'. Further mechanisms could be introduced to strengthen and streamline the information sharing process and ensure information is shared as early as possible. Indeed there are further measures proposed to ensure this.[13] This would enable better financial redress for creditors.

25. Recovery actions require a detailed investigation of the books and records and other evidence that is available. The SoS or official receiver may have already carried out a comprehensive investigation of the case and this evidence could be made more readily available to the officeholder. This would make it easier for them to then instigate a recovery action against the directors which would potentially result in financial redress for the creditors.

26. Where the officeholder is a liquidator, the same situation would apply for taking forward wrongful and fraudulent trading cases. These types of cases can be difficult to evidence and take forward so any investigative material that is held by the SoS or official receiver would be of benefit to the officeholder if he/she is considering taking forward such a case. This will help in obtaining some form of financial redress for creditors.

[13] The process to streamline the reporting process i.e. the D return being sent to SoS earlier and submission of the D-return electronically.

http://www.bis.gov.uk/insolvency/Consultations/RedTapeChallenge?cat=open

A regulatory measure which will enable the SoS to go directly to any 3rd party where they believe that 3rd party has information relevant to the investigation of the case.

http://services.parliament.uk/bills/2013-14/deregulation/documents.html

Other options considered

27. Information sharing between the SoS and officeholders is already possible and does take place to some extent. However, this can be made more formal through updating internal guidance used by Insolvency Service staff. This is the reason why it was not considered as an alternative option as it is difficult to know how many more recovery actions would take place if this was further promulgated.

28. The only option of increasing the likelihood of miscreant directors being held more financially accountable for their actions and to provide better redress for creditors who have suffered is to therefore allow for the making of a compensation award against a director. No other option allows this.

29. It was suggested that the evidence bar could be changed for existing civil recovery actions but this policy is not about changing existing causes of action or increasing the potential liability of directors in relation to existing actions. It is about using current misconduct by miscreant directors to obtain financial redress for creditors. We therefore did not consider or consult on reducing the evidence bar for civil recovery actions.

Costs of Option 1

30. Monetised costs

a) Transition costs

Costs to the public sector

It is expected that initial familiarisation will be incurred by the Insolvency Service and the Courts in order to understand and start applying the new legislation. These costs are estimated to be negligible as:

i. Costs to Courts:

One would expect some familiarisation costs to the courts and judges. These are unknown but they are expected to be negligible given the fact that judges are used to considering new legislation and published guidance on a regular basis and as part of their business as usual duties.

ii. Costs to the Insolvency Service:

Additional resource costs to the Insolvency Service to produce the guidance for staff and others on compensation awards are expected to be negligible as they will be incurred as part of the business as usual operation of the Insolvency Service. Information sharing systems between the SoS and the officeholder are already in place so the costs of learning how to share information in an effective way will be negligible.

The Insolvency Service's internal guidance material (the Enforcement Investigation Guide) will need to be updated. However, updating guidance is a continuous, business as usual process. The new guidance will be publicised using the Insolvency Service's existing channels, that is IP guidance material and changes to disqualification guidance on their website.

Costs to the private sector

31. Insolvency practitioners and lawyers will also need to familiarise themselves with the new legislation and the way it works.

32. **Costs to IPs** are estimated to be £760k. We would anticipate familiarisation taking up to one to two hours of an IP's time based on the assumption that this change is not complex to understand and would only need to be understood once. There are currently 1,352 IPs who take case appointments and we have assumed an average hourly rate for an IP of £375 per hour. This is based on the average hourly charge out of an IP firm, at director/partner level. Based on these figures, we would expect familiarisation costs to IPs to be in a range of £0.51m to £1.01m with a mid point of **£0.76m**.

33. Familiarisation **costs to lawyers** are similarly expected to result from one to two hours spent in reading the new guidance. Whilst no hard data is available, officials from the Insolvency Service who deal with disqualification cases, and lawyers instructed by directors, estimate that a third of defendants to proceedings under section 6 CDDA and all defendants to proceedings under section 8 CDDA seek legal advice, with a range of one lawyer per one to two disqualified directors. Including all lawyers instructed with respect to such proceedings by the Insolvency Service gives a range of 210 to 375 lawyers who might want to familiarise themselves with the new guidance. Guidelines for the judiciary indicate that legal professionals can charge between £146 and £409 per hour depending on their grade and location. The cost therefore ranges from (210 lawyers x £146 x 1hrs to 375 lawyers x £409 x 2hrs), £30.7k to £306.8k with a mid point scenario of **£0.12m** (292.5 x £277.5 x 1.5hrs) (see table in para. 35 below).

34. In general costs to IPs and lawyers will fall within their continuous professional development, as they will have to be aware of developments in regulations as part of their job. However, these are still considered additional costs in this impact assessment as the time spent on understanding new guidance could otherwise be spent on other professional activities (including other types of continuous professional development). Any familiarisation costs to business are indirect and out of scope of OITO.

35. Overall one off cost to the private sector from this option is therefore expected to be **£538k to £1.32m with a mid point of £882k**. Table showing familiarisation costs to lawyers and insolvency practitioners:

	Lower estimate (£m)	**Middle estimate (£m)**	**Upper estimate (£m)**
Costs to IPs (paragraph 32)	0.51	0.76	1.01
Costs to lawyers (paragraph 33)	0.03	0.12	0.31
Overall one-off cost to private sector	0.54	0.88	1.32

*b) Ongoing costs (**based on an illustrative approach)***

Costs to the public sector

36. **It is very difficult to estimate the exact number of cases the SoS will decide to pursue compensation on, as the decision will be made on a case by case basis and will depend on the merits of the case and the extent to which it is in the public interest to seek compensation. Therefore an illustrative example of the number of cases has been estimated.**

37. As this will be a new process, it is difficult to estimate the costs and benefits precisely. There is no existing evidence to show the type of cases or what extra investigation activity and how much extra resource (i.e. grade of staff, number of letters/paperwork generated) there would need to be to take forward an investigation claim to pursue a compensation award. This impact assessment can only estimate what may occur and has come up with indicative costs and benefits. Taking an illustrative approach, there are two types of costs which could be incurred by the Insolvency Service from dealing with the compensation proceedings in addition to the existing disqualification process:

38. *Investigatory costs*: Insolvency Service officials will have to determine whether the claim is worth pursuing based on the merits of the case and the capacity of the director to pay the compensation. Data on investigations, including in-house and those passed out to solicitors to progress, shows the average cost to be £35,295 per case. This is the cost required to obtain a disqualification.

39. It is difficult to estimate how much extra investigation would be required to pursue a compensation award, but we envisage the majority of the evidence and work will have been completed in the disqualification investigation. We have therefore estimated that an additional 20-50% investigation cost may be required to pursue a compensation award. This would entail presenting the case for a compensation award in a suitable way to the court so it is clear to all parties the basis and evidence for the claim. This gives a range between £7,059 and £17,648 for the extra investigation costs required for a compensation case with a middle point of £12,353.

40. Internal Insolvency Service data on disqualifications shows that in 2012/13 there were **376** cases where the disqualification was six years or more (formally called middle and upper bracket cases). These cases, in general, tend to involve the most serious misconduct and resulting in most harm to creditors and also most likely to be the cases where the SoS will seek a compensation award.

41. The allegations in the 376 cases were varied; crown debts[14] (41%), accounting records[15] (29%), criminal matters[16] (11%), transactions to the detriment[17] (10%), technical matters[18] (7%), and misapplication of assets (2%)[19].

42. Given that the main purpose of the compensation award is to provide financial redress for creditors, it is reasonable to believe that compensation could be sought from, **at least** those cases where there has been an identifiable loss to creditors, for example: misapplication of assets, transactions to the detriment, criminal matters and accounting records. On the other hand, it is also reasonable to assume that whatever the allegation, the SoS will also seek compensation for those cases where there are a lot of unsecured creditors or 'vulnerable' members of the public who have lost out. A quantification of these types of cases is not available from Insolvency Service internal data.

[14] Crown debts – Where debts are incurred to HMRC by a company and are knowingly treated differently to other debts, for example, slow or non payment or not filing returns, preventing HMRC establishing what they are owed. Crown Debt cases are basically Transactions to the Detriment of the Crown. Further examples of how we have described Crown Debt cases are:
Misconduct ranged from those who treated the Crown unfairly by paying other creditors ahead of the taxman, or who charged customers VAT and then failed to hand it over to HMRC, to those engaged in blatant tax fraud.
And
Directors who push the Crown to the back of the queue when conducting their business affairs are seeking an unfair advantage over their competitors by not paying their taxes and operating with lower overheads, thus undercutting those who play by the rules.

[15] Accounting records - When a company fails, its outstanding affairs need to be dealt with, and its trading history and the decisions of those controlling it come under scrutiny. Without records this process is hampered. This allegation considers the effects of not having records or where those records are not in a position to explain transactions which the company has or has not made.

[16] Criminal matters – For example where there has been intent to defraud creditors or carry on a business for a fraudulent purpose, i.e. knowingly carrying out criminal activity or where an individual has acted as a director of a company whilst bankrupt or in breach of a disqualification order or undertaking – the Insolvency Service may take disqualification action in such cases as well as referring the matter to a prosecuting authority.

[17] Transactions to the detriment - any transaction or series of transactions which adversely affects the interests of creditors. Detriment can be to creditors generally or just to a particular creditor or group of creditors. This allegation particularly considers the directors conduct and motivation in carrying out these transactions.

[18] Technical matters – There are various statutory obligations that a director is responsible for, such as filing accounts, annual returns, etc. Of itself, failing to undertake these duties may not be serious misconduct but persistent breaches of these duties may be considered as misconduct as they undermine the structures for viable and sustainable businesses.

[19] Misapplication of assets - A director has a duty to the liquidator or administrator to detail the assets that a company has. If he/she intentionally omits to detail these assets or provide details of their disposal/sale and they are considered to have a material value, then this can be considered as misconduct - creditors may lose out if assets cannot be traced.

43. Finally, all relevant factors will be taken on board before compensation awards are sought including investigative priorities, whether the pursuance of a case is in the public interest, the likelihood of the director being able to pay the compensation award. The assumption is that 2012/13 is a representative year and therefore these cases are extrapolated for a 10 year period.

44. Based on the assumptions above, the following scenarios have been built to assess the extent of the impact of the policy.

i. High case scenario: From the 376 middle and upper bracket cases, only **50%** of the 196 cases with allegations of misapplication of assets, transactions to the detriment, criminal matters and accounting records are considered for compensation awards. That is a total of **98 cases**.

ii. Middle case scenario: From the 376 middle and upper bracket cases, only **25%** of the 196 cases with allegations of misapplication of assets, transactions to the detriment, criminal matters and accounting records are considered for compensation awards. That is a total of **49 cases**.

iii. Low case scenario: None of the cases above have enough public interest to merit a compensation award to be sought.

45. **Based on these case scenarios, the per annum investigation costs to present a compensation award are estimated to be between £0 and £1,729k. Over a 10-year period, these costs are estimated to be between £0 and £17.29m.** These figures are undiscounted. The discounted NPV figures are shown in the summary table below in paragraph 60.

46. *Court costs*: It is expected that as a result of this proposal, a higher amount of disqualification cases might be taken to court instead of being settled as an undertaking. This could be due to directors having more incentive to litigate the cases in order to determine the 'right' level of compensation if the offer provided by the Insolvency Service is not perceived as fair; or if a director believes that he/she should not pay any compensation requested by the Insolvency Service, the director might decide to defend the case in court or he/she might not have any funds to settle, so might decide to have their day in court.

47. The cost to the Insolvency Service will be incurred in two ways; for cases already going to court for a disqualification, there will be extra court costs involved – these are estimated to be an extra court day and; for cases currently being settled as an undertaking where the director is incentivised to fight, there will be extra costs from taking both the disqualification and the compensation case to court. From looking at a sample of cases, the average length of a disqualification case is three days. Therefore for both a disqualification and compensation hearing together, this would take on average four days. The estimate of one day to hear the compensation award is based on evidence from stakeholders relating to the assignment of other civil recovery actions where a day is set-aside to hear any applications that result in a court hearing and not settled beforehand. Court costs are estimated to be £885 per day based on figures from HMCTS.

48. It is very difficult to estimate how many and which cases directors will decide to take to court and no approximation is available to the Insolvency Service. On average, 80% of disqualification cases are settled by undertaking while in the other 20%, proceedings are issued to go to court.

49. Based on these figures, the following scenario has been considered.

As per paragraph 44, it is assumed that, under Option 1, zero to 98 cases per annum are investigated in preparation for compensation litigation. It is assumed that 80% of these do not currently go to court (zero to 78), and are settled out of court via undertaking. This assumes that the current split for disqualifications (between court orders and undertakings) will equally apply to compensation awards.

Further, 10-20% of the cases currently settled out of court are assumed to be litigated for both disqualification and compensation (0 to 16) under Option 1. This takes into account stakeholder feedback in relation to assignment cases, where only about 10% of cases result in a court hearing. Since this will be a new process, we have used an indicative range of 10-20% based on the fact that compensation awards will be similar to other forms of financial redress, so we have assumed that a similar number of cases will be settled out of court as currently occurs in cases which IPs take forward.

Of the 20% of cases currently litigated (zero to 20 cases per annum), under Option 1, there will be the requirement of further litigation for the compensation award.

The Insolvency Service gathers data on the legal costs borne in cases brought. For 2012/13, the median average legal cost of a disqualification case settled by court order, from a sample of 10 cases, was £35,132. Since the average disqualification court case lasts three days, the average per day legal cost is estimated to be £11,711. Compensation proceedings are assumed to last a further day. So, under Option 1, a disqualification and compensation order hearing is expected to last an average of four days.

Based on these figures, the total legal costs from compensation awards to the Insolvency Service on a per annum basis are estimated to be as follows:

	Multiplied	Plus
Compensation hearing plus disqualification hearing (£35,132 + £11,711) Court costs: (£885/day*4)	By the number of cases that were previously undertakings that are now going to court Zero to 16 cases	Number of cases already currently going to court Zero to 20 cases

50. It has been assumed that the Insolvency Service (acting on behalf of the SoS) will only pursue a case where they are very confident of success (similar to the pursuit of assignment cases by civil litigation firms and IPs), and therefore all additional court and legal fees will be met by the miscreant director. We have also assumed that the legal costs incurred by the Insolvency Service will be matched in size by the defendant director's own legal costs.

51. **Therefore, based on these scenarios, the per annum legal costs will be between £0m and £2.00m. Over a 10-year period these costs are estimated to be between £0m and £20.00m. This covers both parties' costs, with the Insolvency Service legal costs being recovered from the miscreant director.** These figures are undiscounted. The discounted figures are shown in the summary table in paragraph 60 below. Table showing per annum legal and court costs to the Insolvency Service and director's own legal costs:

	Lower estimate (£m) – zero cases	**Middle estimate (£m) – 6 new cases and 10 current undertakings**	**Upper estimate (£m) – 16 new cases and 20 current undertakings**
Legal costs to IS (see paragraph 49)	0	6*(35,132+11,711) + 10*11,711 = £398,168 (£0.40m)	16*(35,132+11,711) + 20*11,711 = £983,708 (£0.98m)
Court costs (see paragraph 47)	0	6*885*4 days + 10*885*1 day = £32,125 (£0.03m)	16*885*4 days + 20*885*1 day = £74,340 (£0.07m)
Director's costs (same as IS – see paragraph 50)	0	0.40	0.98
Overall legal and court costs (subject to rounding on number of cases)	**0**	**0.80**	**2.00**

52. Consultation responses highlighted the potential for a higher investigatory burden falling on the State (Insolvency Service) from instances of free-riding amongst liquidators. That is, liquidators might decide not to pursue investigations for civil recoveries and wait for the Insolvency Service to decide whether to pursue a compensatory award first, hoping to then realise this award. However, since the compensation award will be awarded direct to creditors, this would result in a minimal or no fee for the insolvency practitioner, as he or she would not have spent time determining whether there is scope for a recovery, so the risk of this occurring is much less. They will only be able to charge a fee if they carry out the civil recovery themselves using their existing powers. We therefore do not think the risk of 'free-riding' is high and that the proposal will reduce the current level of civil claims brought by liquidators or administrators. No evidence exists on the likely number of cases of free-riding by liquidators.

Cost to the private sector

53. It is not expected that insolvency practitioners, lawyers, etc., will incur any ongoing costs (apart from the one off familiarisation costs identified above) from the proposal compared to the do nothing option, as all compensation award/undertaking will be taken through the Insolvency Service.

54. Compliant directors will not incur any costs either, as directors will have to be proven guilty of having engaged in misconduct and therefore disqualified, before a compensation award/undertaking can be made.

55. However those directors that choose to defend the compensation award proceedings would incur legal costs. As mentioned above, we have assumed that the defendant director's own legal costs will match those of the Insolvency Service.

Benefits of Option 1

Monetised impacts

56. It is difficult to estimate the compensation award that a court may make against a director or the compensation undertaking agreed between the SoS (Insolvency Service) and a director. It will be based on the damage caused to creditors and the evidence in the disqualification report. From a sample of 26 cases considered by debt recovery agents used by the Insolvency Service, they calculated a quantum of award averaging £132,000 a case. This would be paid by the miscreant director to creditors.

57. For the upper range of cases that might be taken forward for compensation awards, this would result in a benefit of £12,936k (98*£132,000), while the medium range figure would result in a benefit of £6,468k (49*£132,000). However, consultees and internal data from the Insolvency Service costs recovery suggest that a range of 10-20% of this amount may not be recoverable from directors despite the checks that are carried out on a director's ability to pay prior to commencing a case for a compensation award/undertaking. This might occur due to a change in the circumstances of the director during the process of seeking the award or maybe even expenditure incurred by the director in defending the proceedings. **This results in an upper range of award £11.64m per annum and a medium range of award of £5.50m and a lower range of £0m per annum depending on the number of compensation award cases taken forward.** These figures are undiscounted. The discounted figures are shown in the summary table in paragraph 60 below.

58. It is important to note that, while these compensation awards against miscreant directors are a cost to the directors, they are a benefit to creditors (insolvent estates). In effect, Option 1 allows for a benefit/transfer from miscreant directors to creditors (insolvent estates).

59. The main benefit of taking disqualification action is to prevent a director from being in a position to commit further unfit conduct. It therefore prevents a forced transfer of resources from creditors and others to the director, resulting from a breach of their obligations under the Companies Act. Because the benefit of this transfer to the director would occur as a result of a regulatory breach, we do not consider it in this analysis and the result of preventing the transfer is therefore a net benefit.

60. **Summary table of monetised costs and benefits for the illustrative case (in present value terms over a 10 year appraisal period)**

	£m Low (0 cases)	£m Middle (49 cases)	£m Upper (98 cases)
Compensation award to insolvent estates (creditors) – (see paras. 57 to 59) - Benefit	0	47.32	100.21
Cost to miscreant directors – see para. 51 (Payment of court costs and legal fees)	0	6.97	17.22
Investigatory costs to the Insolvency Service – see paras. 39 and 45	0	5.21	14.89
Total one-off familiarisation costs to the private sector (Insolvency Practitioners and Lawyers – see para. 35)	0.54	0.88	1.32
Net Present Value	**-0.54**	**34.26**	**66.78**

Non - Monetised benefits

These entail:

61. Deterrent effect – deterring other directors who otherwise might have been tempted to engage in misconduct. If directors believe there is a greater chance of them being held financially accountable for their actions, this may deter them from committing the misconduct in the first place, which may result in less losses to creditors and also fewer disqualifications resulting from any reduced misconduct.

62. Standards effect – helping to improve standards of company stewardship to the overall benefit to society. Again this relates to directors being aware of their responsibilities and the consequences of any wrongdoing they may undertake. If there is a greater chance of them being financially accountable for their actions, it may improve their overall behaviour in running a company, resulting in less loss to creditors.

63. Increase in trust of creditors and therefore incentivises risk taking. If both directors and creditors believe that directors will be held more financially accountable for their actions, and this results in better company stewardship, this may lead to increased trust and lending to the company, as creditors and directors both know that any wrongdoing could result in a compensation award being made as well as disqualification of the director.

64. In addition, as there will now be scope for a compensation award to be paid from directors to creditors, there is a greater chance that these monies can be used by the creditors to grow their own business or even help start a new business if the loss suffered due to the failed company also caused their company to fail too. This should help foster enterprise in the UK economy.

65. Consideration had been given to improving communication and sharing information between the SoS and the officeholder as a standalone option, but this was will not have the same impact without the compensation awards. Improving the information gateway is very much fundamental in making sure the compensation awards mechanism works. The SoS or official receiver may have carried out a comprehensive investigation of the case and this evidence could be made more readily available to the officeholder. Wrongful and fraudulent trading cases, for example, can be difficult to evidence and take forward so any investigative material that is held by the SoS or official receiver could be of benefit to the officeholder if he/she is considering taking forward such a case. This will help in obtaining some form of financial redress for creditors.

Rationale and evidence that justify the level of analysis used in the IA (proportionality approach)

66. As previously stated, it is difficult to predict how many cases the SoS (Insolvency Service) will seek a compensation award in and the ability of the director to meet such an award. Therefore the analysis undertaken has mainly focussed on identifying the groups affected, describing the impacts and where possible quantifying the effect rather than trying to monetise all the costs and benefits. Monetisation of impacts has only been done when data was readily available. Where none has been available, quantification has been presented as an indicative breakdown.

Risks and assumptions

67. There are a number of potential risks involved with the preferred policy option of allowing the court or SoS to make or agree compensation awards. It may be that the individual concerned does not have the funds to pay any compensation award made. We would envisage before any compensation award is sought, that a check is carried out on the financial means of the individual concerned. There is also the option of pursuing the debt to bankruptcy in enforcing it, so we believe this risk will be adequately mitigated.

68. There is a risk that this will result in compensation orders being made for the benefit of the Crown (HMRC) as they are the major unsecured creditor in the majority of insolvencies. However there will be a provision to allow the court or SoS to determine who should be awarded the compensation award – this may be a particular creditor or class or group of creditors, taking into account what is equitable in all circumstances. This risk should also therefore be mitigated.

69. We envisage that compensatory awards will only be sought in the most serious of cases, where the misconduct by the director's has caused serious harm to creditors (so most likely to be cases in the middle and upper disqualification percentile). We are confident that this proposal will only be used in appropriate cases.

Direct costs and benefits to business calculations (following OITO methodology);

70. The recommended option will not impose any new regulatory burdens on businesses. The only businesses that might be affected by the proposals are IPs and lawyers. Neither of these groups will be imposed with any new regulatory burden that they will have to comply with. They would have to familiarise themselves with the proposals, and we have considered these costs in the IA, but this would be on a voluntary basis and will NOT be associated with any new regulatory burden on their profession. In addition, any familiarisation costs to business are indirect and therefore out of scope of OITO as stated in the Better Regulation Framework Manual[20].

71. It is a regulation on individuals who have already proven to be non-compliant with current laws and therefore is also considered to be out of scope of RRC as well as OITO.

Wider impacts

Specific Impact Tests:

a. **Competition Assessment** – the proposed policy should have no impact on competition as the legislative change represents another opportunity to obtain financial redress for creditors. This should not result in competition with insolvency practitioners to be the first to obtain financial redress for creditors as they should be able to proceed with any action they deem appropriate before the SoS. In addition, greater communication between IPs and the Insolvency Service should reduce any duplicate actions.

b. **Small Firms Impact Test** – there may be familiarisation costs for legal and other professional advisors dealing, together with insolvency practitioners. All appointment takers and advisors will need to be aware of these changes to be able to advise clients and some of these will be represented by small and medium sized firms. However, it is anticipated that any such familiarisation costs will be negligible. Also, some of the creditors who could also benefit from this proposal could also be small businesses. In addition, any compensation awards made will be against directors as individuals, not businesses.

c. **Justice** - The proposed policy will have no impact on Legal Aid, as it is not available to fund defended disqualification proceedings. However due to the likelihood of compensation awards being sought, cases are likely to be heard in Court. We have attempted to calculate the costs to the courts above.

[20] See page 40: www.gov.uk/government/uploads/system/uploads/attachment_data/file/211981/bis-13-1038-better-regulation-framework-manual-guidance-for-officials.pdf

d. **Sustainable Development** - The proposed policy will have no direct impact on sustainable development.

e. **Greenhouse Gas Assessment** - The proposed policy will have no direct impact on greenhouse gas assessments.

f. **Other Environment** - The proposed policy will have no direct impact on other environmental factors.

g. **Health** – The proposed policy will have no direct impact on health.

h. **Equality Impact Assessments** - The proposed policy will not have an adverse or disproportionate effect on any person as a consequence of race, ethnic origin, religion, gender or sexual orientation.

i. **Human Rights** – The proposed policy will have no impact on any human rights issues as the proposed change has no impact on compliant directors. Directors will have to be proven guilty of having engaged in misconduct and therefore disqualified, before a compensation award/undertaking can be made.

j. **Rural Proofing** - The proposed policy will have no direct impact on Rural Proofing.

Summary and preferred option with description of implementation plan

72. Our preferred option is to allow the courts and the SoS to make compensation awards against directors who have already been disqualified. We will also work to improve existing communication channels between insolvency practitioners and the Insolvency Service, so information already held by the Insolvency Service can be used more readily by insolvency practitioners when they are considering pursuing civil recovery action against a director using their existing powers. This will entail some changes to the internal workings of the Insolvency Service, so that we can pursue compensation awards where appropriate and liaison with MoJ and other court officials to implement the new procedure. We envisage this will occur as soon as parliamentary time allows for legislation to be considered and passed.