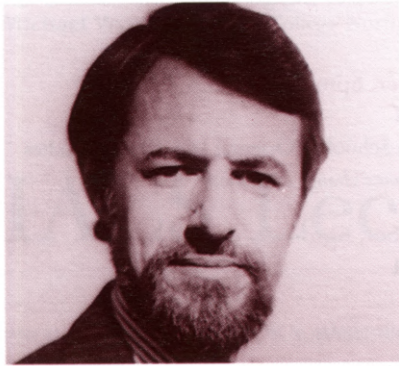


# Insolvency

## Disqualifying the unqualified – a quixotic crusade?

by Andrew Hicks



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It has long been the policy to make cheaply available to firms of all sizes the privilege of trading as limited liability companies in order to stimulate business activity and the economy in general. As the recent Strategic Framework Document of the DTI's review of company law (*Modern Company Law for a Competitive Economy*) puts it, there is a presumption in our company law against 'interventionist legislation and in favour of facilitating markets'. This desire to minimise the burden on companies of start-up and continuing regulatory costs means that the onus then falls on achieving an adequate official response when individual directors abuse the privilege of limited liability. An energetic policy of disqualifying unfit directors of insolvent companies is thus now presented as being at the centre of regulatory policy for the protection of creditors and the commercial public from those who abuse the privilege of limited liability.

The *Company Directors Disqualification Act 1986* requires liquidators, etc., to report on the conduct of directors of companies that have gone into formal insolvency proceedings. It is then for the Insolvency Service, where it is of the view that the conduct of the person makes them unfit to be a director, to prepare an application to the court for an order under s. 6 that they be disqualified for between two and fifteen years from being a director or taking part in the management of limited companies. Thus, while entrepreneurs do not require a qualification to set up limited companies and to become

directors of them, they may subsequently be 'disqualified' from taking part in their management.

In the early years of the legislation the number of s. 6 disqualification orders was modest but following a critical National Audit Office report in 1993 the pace has quickened. Since then the number of disqualifications has multiplied several times and is currently well in excess of 1,000 disqualifications a year. A recent Parliamentary answer revealed that the expenditure of the Insolvency Service in 1997–98 attributable to the disqualification of directors was £22,013,000. The Insolvency Service in effect runs at a surplus, if totals of fees received and interest earned on creditors' funds are regarded as its income. Its expenditure on disqualification can therefore be said to be financed by the creditors of insolvent companies. Government ministers have repeatedly tried to assure the public of their determination to use the law on director disqualification to purge the business world of directors who have shown themselves to be unfit to be involved in the management of companies. However, whether this represents an efficient use of such substantial public resources depends upon whether disqualification is effective as a regulatory device.

This article summarises some of the main conclusions of my research into the effectiveness of director disqualification, which was recently published as a 150-page monograph under the title *Director Disqualification; No Hiding Place for the Unfit?* (ACCA Research Report No. 59). The report examines the legal rules and procedures which are contained in the *Company Directors Disqualification Act 1986* and, by reference to the extensive body of case law which has accumulated over the years, considers the extent to which the legislation is achieving, or is capable of achieving, its apparent objectives. Surveys carried out of insolvency practitioners and disqualified directors contribute a basis of empirical data from

which conclusions are drawn as to how the legislation is perceived by those with direct experience of its operation. Finally, comparison is made between the UK rules and those which apply in other jurisdictions. In the light of all the information collected, the report assesses the overall effectiveness of the law on disqualification and suggests a number of major reforms. The following summary outlines the principal factual, legal and practical conclusions of the report.

### BACKGROUND

The vast majority of limited companies in the UK are owner-managed small businesses. The advantage of setting up in business as a limited company is that, in the absence of personal guarantees, the directors/shareholders will not be personally responsible for the debts of the company. On the one hand, this principle acts as a legitimate stimulus to entrepreneurial activity as it protects business people from their honest commercial mistakes and failures. On the other hand, it holds the potential for abuse by unfit directors. Thus creditors may suffer prejudice through the directors' long-term improper practice and failure to minimise losses in the run-up to closure. They suffer when directors dishonestly or improperly misuse company assets and its interest, and when they fail to comply with legal obligations such as disclosure of accounts and liquidation formalities. The disqualification legislation focuses on such abuse by directors rather than on general incompetence. The broad objectives of the legislation are protecting the public interest by removing unfit individuals from the management of companies, deterring improper conduct and establishing and disseminating standards of good practice in the management of companies.

### MAIN FINDINGS OF THE RESEARCH

- Most s. 6 disqualifications are of directors who are owner-managers of

small businesses and who operate within what is essentially a self-employed culture. Unfortunately, disqualification tends to be least effective against this type of director since, once disqualified, they are generally able to find new work or to set up in business again in their own name. The impact of disqualification is much greater on career executives and professionally-qualified directors, for whom disqualification is a major threat to their reputation and professional or business status. The latter are more likely to respond to the potential threat of disqualification by adopting proper standards of practice.

- Due to the ease with which companies may be incorporated, and the fact that no qualification is required to act as a director, disqualifying a few thousand small company directors constitutes a limited control on the numbers of the potentially unfit who are able to enjoy the privilege of trading with limited liability.
- While disqualification is aimed at those who set up companies and abuse the privilege of limited liability, disqualification of large numbers of small company directors has a limited benefit. In reviewing its achievements the Insolvency Service should be given more credit for disqualifications of directors of larger companies. Their unfit conduct has the potential to cause the greatest damage within the commercial world and their disqualification is likely to have the greater regulatory benefit. Further, the legislation needs to be reformed so as to allow longer, even indefinite, periods of disqualification in appropriate cases. Overall, the emphasis should be on quality and length and not merely on the number of disqualifications achieved. Crude numbers of disqualification orders are not a reliable measure of effectiveness. For example about 10 per cent of those disqualified are already disqualified by reason of bankruptcy. Increasingly the numbers of disqualification orders include inactive directors/spouses and others who have no intention of setting up companies and so do not present a risk to the public.
- The overall effectiveness of disqualification is limited. Given a current population of perhaps 3m directors, with millions more who

could easily buy a shelf company and become directors, the direct protective benefit of one or two thousand short-term disqualifications annually is relatively small. The deterrent effect of disqualification is also weak, although, as has already been said, it is more effective in relation to the more 'professional' executive. The threat of disqualification is also relatively ineffective in encouraging directors to act properly towards their company's creditors, because disqualification is not seen as a significant sanction and because of the absence of any clear and authoritative statement of the principles which have been developed by the courts with regard to directors' duties to creditors.

- When companies fail or are struck off, the level of investigation of their directors' past conduct varies. If the directors have succeeded in dissipating all the assets of the company, creditors will have no reason to initiate a formal winding-up, and so there will be no investigation at all. Whether in a liquidation an in-depth investigation takes place usually depends on the availability to the liquidator of sufficient assets within the company or of pro-active creditors who are willing to provide funding for proper investigative work to be done. Further, as an alternative to liquidation, directors can now apply for their company to be struck off the register, thereby avoiding any investigation of their conduct. This procedure should be reviewed in order to assess whether it is being used to the detriment of creditors.
- A disqualified director who takes part in the management of a company, in breach of the terms of the order, commits a criminal offence and is liable to prosecution. Unfortunately, infringements of this kind are difficult to detect, and this constitutes an intrinsic limitation on the effectiveness of disqualification. In recent years, while huge efforts have gone into achieving disqualifications, there have been only a handful of prosecutions for acting as a director in breach of a disqualification order. Recent publicity for disqualification orders on the Companies House website, and the introduction of a disqualified directors 'hotline', on which members of the public can report those they believe to be acting in breach of a disqualification

order should be of value in detecting breaches. Disqualifications nonetheless remain difficult and expensive to enforce.

- While Companies House routinely checks the names of current directors against its separate register of disqualifications, there is no such check against the names of those who have been made bankrupt. Yet being an undischarged bankrupt is sufficient to disqualify a person from being a director or from taking part in the management of a company. There are currently perhaps 80,000 undischarged bankrupts who may thus avoid apprehension if their names are notified to Companies House as being company directors.
- The results of the questionnaire surveys of disqualified directors and insolvency practitioners tends to confirm suspicions of the existence of a relatively high level of infringement of s. 6 disqualification orders and also of the perceived low risk of offenders being apprehended. This suggests that the achievement of ever-higher numbers of disqualifications may not achieve the sterilisation of rogue directors that is claimed for it by official policy makers.

#### FURTHER READING

The full report of the author's research findings is contained in *Director Disqualification; No Hiding Place for the Unfit?*, Research Report No. 59, Association of Chartered Certified Accountants, available from ACCA Sales, PO Box 66, Glasgow, G41 1BS; [Publications@acca.org.uk](mailto:Publications@acca.org.uk).

#### AREAS FOR FURTHER REFORM

The above findings suggest the need for reforms in the following areas.

##### *Involvement of the insolvency practitioner*

While imposing a statutory duty on insolvency practitioners ('IPs') to report to the Disqualification Unit of the DTI any directors of a failed company who they believe to be 'unfit' has, in general, been a successful innovation, achieving consistency in the standards by which they report is difficult. IPs seem to be unclear that they must identify a prima

facie legal case for unfitness in order to be obliged to report an individual director as unfit. Under the present law IPs should not report as unfit where they identify matters for determining unfit conduct but where in their opinion these are not sufficient to amount to a prima facie case for disqualification. However, expecting consistent decisions by IPs in cases where, despite instances of unfit conduct by a director it would not be prima facie in the public interest to disqualify, is unrealistic and impracticable. The law should therefore be reformed so as to require IPs to report whenever they identify any matter which is significant for determining unfitness, even though this may increase the number of reports submitted to the Disqualification Unit. The unit, with its trained and dedicated staff, is best placed to assess instances of unfit conduct on a consistent basis, using any other information available to them, and consequently, to decide whether in the public interest there exists a prima facie case of unfitness that justifies an application being made to the court.

### ***Partial or conditional disqualification orders***

At present, the act empowers the court to make a standard disqualification order, the effect of which is to exclude an individual from any direct or indirect involvement in the management of any company. Only on an application by a disqualified director for leave to take part in the management of a company does the court have any discretion to allow a limited or supervised role in management. Leave applications are rare and expensive. Consideration should therefore be given to empowering courts to make a wider range of partial or conditional disqualification orders that do not demand a complete withdrawal from management but allow some specified and conditional involvement in corporate management. For example, a director of a public company which fails might be disqualified from management of public companies but be thought fit to run his/her own private company.

### ***Mandatory disqualification***

The mandatory requirement to disqualify for at least two years a director whose past conduct was unfit has the result that the courts have no option but

to disqualify, regardless of the director's current suitability to be involved in the management of a company and regardless of whether his disqualification is still in the public interest. This mandatory minimum disqualification is inflexible and should be reconsidered to enable judges to disqualify solely where the protection of a disqualification order is necessary in the public interest.

### ***A director disqualification tribunal?***

For many reasons, the courts are not best adapted to determining the fitness of individuals to take part in the management of companies. Disqualification trials have become a costly and artificial exercise which determine not whether the person is currently unfit but whether they infringed the required technical standards at some point in the past. Further, public resources and the expertise of the DTI are arrayed against the individual, who often feels that access to justice is being denied him. To remedy these failings, a Director Disqualification Tribunal is needed to hear all applications for disqualification on the ground of unfitness. This tribunal should also hear applications for leave to take part in management by those disqualified on all grounds under the act, including bankruptcy. With proceedings more informal than those of the courts, a tribunal would have many advantages. It would offer a fairer trial and better access to justice. It would be better able consistently to promote the policy behind the legislation. It would relieve the courts of the burden of disqualification cases, should be more able to minimise delay and would reduce costs for all concerned. The human rights implications of achieving a fairer and swifter hearing are obvious.

### ***A code for creditors***

The standards of unfitness laid down in Sch. 1 to the act, and in a mass of case law, are complex, obscure and inaccessible to directors. A directors' Code for Creditors should, therefore, be drawn up as a means of improving the capacity of the legislation to promote best practice in the conduct of directors towards creditors. Pulling together the principles found in the legislation and developed through case law, the courts, when deciding whether an individual

director is unfit, would be required to judge the director's conduct against this code. The code, which would be supplied to all directors by Companies House, would answer the criticism that there is at present no accessible statement of best or required practice to assist the well-intentioned director facing insolvency. The dissemination of the code would also enhance the moral justification of a disqualification where its contents are clearly infringed.

### ***Disqualification by 'agreement'***

Any call for automatic disqualification on corporate insolvency, or for disqualification by administrative means and not by an independent court or tribunal, should be resisted. The current proposal that legislation should be introduced to allow disqualifications to be made without a court hearing where the respondent so 'agrees', is not desirable. The burden on the individual of resisting an application by the DTI is so great that in most cases consent to a disqualification could hardly be refused. Such a process could therefore be oppressive and deny a fair hearing in breach of the director's human rights. It could also appear to be anti-enterprise and to increase the fear of failure. The better, swifter and more accessible alternative is, as suggested, to relieve the courts of the pressure of disqualification cases by introducing a Director Disqualification Tribunal.

## **OTHER WAYS TO PROMOTE GOOD CONDUCT**

There are a number of alternative approaches which could be considered.

### ***Disqualification of the convicted***

When compared to the level of attention which has been given to disqualification on the ground of unfitness, the provision for disqualification under s. 2 of the Act – where a director has been convicted of a criminal offence in connection with the management of a company – has had a relatively low profile. Criminal conduct will often be a substantial justification for disqualification and more attention needs to be given to sentencing policy in this area in order to maximise the section's effectiveness. Other reforms which should be considered include permitting

disqualification where the offence committed was other than in connection with the management of a company, where a conviction occurred outside the UK and where an offence has been committed but has not led to a conviction.

### **Penalising the unfit director**

While provision in the law for unfit directors to be disqualified remains desirable, there may be other and more cost-effective ways of deterring misconduct and establishing best practice. In this connection the criminal law should be reviewed to ensure that it can properly achieve the punitive function that disqualification is sometimes seen as performing. New strict liability offences and civil penalties which penalise the misuse of corporate property to the detriment of creditors could be highly effective. Proof of intent or dishonesty should not be required. Even if requiring a higher burden of proof, it may thus be easier to prove a limited set of facts to show an infringement than the broad and uncertain test of personal unfitness in order to disqualify. Care has to be taken, however, not to discourage valid enterprise and risk-taking and to ensure that business failure is not unfairly stigmatised.

### **Compensating creditors**

Provision already exists in the law, in certain limited circumstances, for errant directors to be required to compensate creditors for the losses they suffer. Compensation can have not only a deterrent but also a formative effect. It can also provide some redress for the loss suffered. Yet, despite trading at risk to creditors being the most common default alleged against unfit directors, none of the disqualified directors who answered the questionnaire issued for the purpose of this study had had a wrongful trading or other claim made against them. The laws and procedures enabling compensation to be recovered from directors need, therefore, to be reviewed. Possible avenues for reform include allowing disqualification orders to be accompanied by a compensation order and enabling the Insolvency Service to provide resources in some way for the pursuit of wrongful trading or other compensation claims.

### **Moderating the use and abuse of limited liability**

Lastly, disqualification for the abuse of limited liability raises questions as to the economic purpose of limited liability and whether the unquestioned policy of making private limited companies freely available as the only off-the-peg vehicle for small businesses is desirable. The ease with which limited companies may be incorporated, and the sustained legislative efforts to deregulate the small company sector, have made the privilege and protection of limited liability accessible to huge numbers of small businesses, many of whose directors are either not able or not prepared to assume the consequential responsibilities to creditors. If there were fewer such businesses trading as limited companies, the incidence of abuse of limited liability should fall proportionately. Given that there should be no substantial impediments to incorporating with limited liability, what policies could be adopted? A compulsory minimum capital for private companies would be a modest 'entry fee' which would give entrepreneurs pause for thought before setting up a limited company. The development of a new unlimited corporate vehicle (such as an incorporated partnership or 'business corporation', as proposed by this author in *Amicus Curiae*, Issue 5, March 1998, p. 8) would also help to reduce the number of new small limited company registrations. The small business sector would then have a clear choice between, on the one hand, a simple, unlimited corporate form for whose debts the proprietors would be liable or, on the other hand, the limited company, along with a higher level of regulation and legal responsibilities to creditors. If the range of business vehicles were increased, the process of disqualifying directors would become more credible and justifiable. While a disqualification would withdraw from the abuser of limited liability the right to be involved in a limited company, it would not deprive that person of the legitimate opportunity to use a corporate business structure which did not confer limited liability.

### **CONCLUSION**

Disqualification is a costly process for all concerned. When a director targeted for disqualification is faced with the resources and expertise of the Insolvency Service, the process and its rhetoric may

be oppressive and may risk appearing anti-enterprise in spirit. At the point at which the increased numbers of disqualifications begins to have some effect, so also it may tend to instil in entrepreneurs a fear of failure. It is very difficult to assess the public benefit secured at such cost and, in many respects, disqualification of unfit directors is relatively ineffectual. It is not, however, useless and, while the regime should be improved by means such as those put forward in this report, it should be retained.

It is unrealistic to suggest that for rogue directors there is 'no place to hide' and that the threat of disqualification can substantially protect creditors from such individuals. Disqualification should be seen as but one device in a regulatory armoury for protecting creditors and the public interest. There are many alternative approaches to the problem. It is important also to realise that, if the abuse of limited liability at the expense of creditors is recognised as a serious problem, its cause may in part be that too many small businesses have been seduced into incorporation by a policy of deregulation and for want of any viable alternative unlimited corporate form. It is at the very least surprising that anyone can form a limited company and become a director of it simply by paying a registration fee of £20, but, if things go wrong, tens of thousands of pounds of public money may then be spent on achieving a brief disqualification. The current crusade to disqualify unfit directors has some value but for the Insolvency Service, expending scarce public resources, there may simply be too many windmills at which to tilt. The strident and high-minded rhetoric of government ministers claiming that they will pursue rogue directors to extinction is properly intended to increase the deterrent effect of disqualification. However, it is a matter of concern if the government comes to believe its own rhetoric as to the effectiveness of disqualification. With the disqualification process currently under review by the minister, one fears that the intrinsic limitations on the effectiveness of disqualification will not be appreciated. ☺

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