

Disqualification of company directors

A Guest Article by Xiaohan Guo and Henry Farris
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for TCii Strategic and Management Consultants

Director disqualifications – an upward trend

The number of company directors who have been disqualified has risen sharply in recent years. According to figures published in the *Financial Times* in August 2011, the number of director disqualifications has risen by 23% in the last five years. The total for the year ending 31 March 2011 was 1,437.

Such an increase is consistent with figures from the UK insolvency trade body R3, which states that in 2010 insolvency practitioners submitted 7,030 reports of directors' behaviour that they believed warranted further investigation by the Insolvency Service.

These statistics suggest that difficult economic times lead to one or both of the following:

- Company directors, in an effort to save their company, are more likely to neglect their duties by ignoring latent problems that they would normally address to discharge their directors' duties.
- Company directors are scrutinised more closely by insolvency practitioners.

Grounds for disqualification of directors

The Company Directors Disqualification Act 1986 ("CMD Act") sets out the grounds upon which a director may be disqualified. These grounds generally relate to matters of unfitness to act as a director or breach of directors' statutory duties. It is important to note that disqualification (as with the statutory duties) applies equally to executive, non-executive and "shadow" directors.

The Insolvency Service is an executive agency of the Department for Business, Innovation and Skills and it exercises its powers and duties on behalf of the Secretary of State under:

- the Insolvency Acts 1986 and 2000
- the CMD Act
- the Employment Rights Act 1996
- the Companies Acts 1965 and 2006.

Its aim, as described in the Insolvency Service Annual Report and Accounts 2010–2011, is to "provide the framework and the means for dealing with financial failure and misconduct".

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The same Annual Report stated that, during the year to March 2011:

- An average of six company directors were disqualified every working day, for an average of 6.1 years each.
- An average of more than three criminal convictions per week were being obtained on the basis of initial investigations done by the Insolvency Service and handed on to criminal prosecutors.

If, after investigation by the Insolvency Service, a director's conduct is likely to give sufficient grounds for a disqualification, the Secretary of State will consider bringing proceedings against that director.

Such grounds include:

- fraud
- persistent breaches in companies legislation
- conviction of an indictable offence (whether on indictment or summarily) in connection with the promotion, formation, management or liquidation of a company with the receivership of a company's property or with such a director being an administrative receiver of a company.

Disqualification may occur as a result of a court order following the proceedings. Alternatively, the director may offer an undertaking to disqualify himself or herself for a period of time.

A disqualification order or undertaking will prevent a director from:

- acting as a company director
- being involved with the formation, marketing or running of a new company and/or
- acting as a receiver of a company's property.

It also prohibits the disqualified person from being an insolvency practitioner for the period of the disqualification.

The prohibition is applicable to directors acting in UK companies. It also applies to all building societies, NHS foundation trusts and incorporated friendly societies.

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Disqualification undertakings

Section 1A of the CMD Act provides that the Secretary of State may accept an undertaking, given voluntarily, that the director will be disqualified and will abide by conditions similar to those of a disqualification order. The Secretary of State will offer to accept an undertaking when the matters underlying the action against the director are not disputed by the director. It is essentially a way for both parties to avoid the expense and strain of court proceedings when they may not be necessary.

However, some directors erroneously consider that an undertaking is an easy option or some sort of plea bargain. The effects and implications are identical to a disqualification given by the court. A disqualification, however procured, is likely to be looked upon seriously by current and future employers as well as by regulatory bodies both in the UK and internationally.

Removal of disqualification undertakings

Although disqualification undertakings are given voluntarily, there are some circumstances in which the court will make an order for an undertaking to cease to have effect. (The CMD Act does not give the court the power to totally remove an undertaking – only to make it cease to have effect.)

The courts in England and Wales are generally reluctant to make such an order. On very rare occasions they have agreed to do so, but only when there is a reasonable prospect that the disqualified director may successfully defend the disqualification proceedings and where exceptional circumstances justify the order.

An example of exceptional circumstances that the court might consider persuasive is if, after the undertaking has been given, new information comes to light that demonstrates that the director's conduct was not so improper as to justify disqualification.

The legal position of non-executive directors

The role of a director with non-executive responsibilities is often misconstrued as one with lower responsibility than that of executive directors, i.e. those who take a more active role in the management of the company. Legally, however, all directors – whether executive or non-executive – have the same level of duty and accountability to the company.

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Directors who have delegated the responsibility of a company's daily operations should therefore be performing a supervisory role and overseeing the conduct of fellow board directors and, in particular, executive directors.

The risks of investigation and disqualification by the Insolvency Service for a breach of directors' duties are the same for executive directors and for non-executive directors who may not have had an active role in running a company.

It is vital that directors with non-executive responsibilities should, at the very least, attend annual general meetings and keep themselves up to date with the company's accounts and general state of affairs.

This is especially so where fellow directors make decisions on behalf of their non-executive director colleagues and there may be a conflict of interest, perhaps because an executive director has a vested interest in the outcome of the decision. Common situations may include:

- loan arrangements between a director and a company
- performance reviews of the business that involve assessment of the executive director in their capacity as a member of executive management
- significant capital investment decisions that have the potential to affect the company's overall risk profile and, potentially, its viability.

The board is a collective decision-making body, and only the board as a whole can determine the level of risk that is acceptable. Non-executive directors should be vigilant as to decisions that may alter this risk profile and in which only a minority of directors and not the board as a whole are involved.

It is too late to try to unwind lack of participation once the Insolvency Service begins its investigations.

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This information was correct to the best of our knowledge and belief at the time it was submitted. It is, however, written as a general guide, and is not intended to apply to specific circumstances. The content should not, therefore, be regarded as constituting legal advice and should not be relied on as such. Accordingly, we recommend that specific professional advice be sought before any action is taken.

If you would like more information on any of the points covered in this Guest Article, please contact **TCii** on **020 7099 2621**.