

Internationalisation of the Directors Disqualification Regime: A Perspective from the UK

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Abstract

The law generally puts few obstacles in the way of becoming a director of a company. Thus, inappropriate people might come to hold this position and harm the public in a variety of ways. The origins of the disqualification regime can be traced back as far as the Companies Act 1928. The most significant piece of legislation in this regard, extending the grounds, has been the Company Directors Disqualification Act 1986, which aims to protect the public against breaches of commercial morality and conduct showing an inability to comply with the duties related to conducting business. This article will outline major changes to this regime, especially those recently introduced by the Small Business, Enterprise and Employment Act 2015. In doing so, it will primarily focus on the international context of the new disqualification ground of convictions abroad as well as draw a comparison with similar jurisdictions, such as Ireland and Singapore. The article concludes that the changes are likely to lead to a significant improvement in the accountability of directors.

Keywords

Directors Disqualification, Small Business, Enterprise and Employment Act 2015, Reform, Convictions Abroad

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I. Introduction

In many larger companies today, there is a separation between those who own the company collectively (shareholders) and those who manage it (directors). This idea of separation of ownership and control was expanded and has come to be known as agency theory¹. This theory, considering shareholders and directors as being rational self-interested actors, points out the conflict that may arise between the principals (shareholders) and the agents (directors) because shareholders usually want the company to maximise their return, whereas directors are more interested in their own wealth that can be to the expense of the shareholders.² Agency theory is considered to be the theory that has most influenced the development of corporate governance³, although it has been criticised for being a rather simplistic conception of human behaviour because other motives may also influence directors' decisions⁴. Yet, in order to ensure that companies' directors perform their duties responsibly with due regard to the interests of the company's creditors, customers, shareholders and employees⁵, *the Company Directors Disqualification Act 1986* (hereinafter *CDDA 1986*) was introduced.

Over the last three decades *the CDDA 1986* has been amended several times and the grounds for disqualification have continuously been widened. Reports by the National Audit Office, for instance, estimated that the Insolvency Service spent £22 million on disqualification work between 1997 and 1998, whereas the future losses to creditors likely to be saved by the disqualification of those directors only amounted to £11 million.⁶ One interesting change occurred in 2002 when disqualification for competition infringements was introduced to *the CDDA 1986*⁷ linking company law with competition law. In practice, however, there has not been a single case dealing with a competition disqualification order until December 2016.⁸ This limited practical significance may also be seen by the fact that the Secretary of State has not

¹ This theory of separation and control originates in the famous work by Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Transaction Publishers 1932). See also Muhammad Z. Abbasi, 'Legal Analysis of Agency Theory: An Inquiry into the Nature of Corporation' (2009) 51 *IJLMA* 401

² Stephen Lofthouse, 'When Agents Appoint Principals' (1999) 20 *Co Law* 254

³ Christine A Mallin, *Corporate Governance* (4th edn, OUP 2013) 23

⁴ David Crowther and Renu Jatana, 'Agency Theory: A Cause of Failure in Corporate Governance' in David Crowther and Renu Jatana (eds), *International Dimensions of Corporate Social Responsibility Vol 1* (ICFAI University Press 2005) 135

⁵ The Insolvency Service, 'Company Directors Disqualification Act 1986 and Failed Companies: A Guide to Director Disqualification' (January 2016) 3 <www.gov.uk/government/publications/company-directors-disqualification-act-1986-and-failed-companies> accessed September 2017

⁶ National Audit Office, *Company Director Disqualification - A Follow Up Report* (HC 1998-9, 424)

⁷ *Enterprise Act 2002*, s204 inserted the new ss9A-9E into *CDDA 1986*

⁸ Competition and Markets Authority, 'CMA Secures Director Disqualification for Competition Law Breach' (*Press Release*, 1 December 2016) <www.gov.uk/government/news/cma-secures-director-disqualification-for-competition-law-breach> accessed September 2017

yet used its power under section 9D⁹ to make regulations for the purpose of co-ordinating the performance of relevant functions.¹⁰

Recent figures show that the total of disqualification orders (including disqualification undertakings) for 2015-2016 amounted to 1,327¹¹. At the same time, there were 28,201 liquidations and other insolvency proceedings in the UK. Assuming (to simplify) that each insolvent company was represented by one director, approximately a mere 5% of company failures resulted in a director being barred from holding office.¹² That creates the impression that the disqualification regime is not as successful as it probably was supposed to be. Hence, in order to ensure that the confidence in the business environment in the UK remains robust and the disqualification regime is efficient and effective, a series of legislative measures were taken.¹³

The next section of this article will focus on the impact of the Small Business, *Enterprise and Employment Act 2015* (hereinafter *SBEEA 2015*), which has introduced some of the most significant changes to the disqualification regime to date.

II. The Impact of the Small Business, Enterprise and Employment Act 2015 on the Disqualification Regime

The SBEEA 2015 was introduced to take forward the UK Government's G8 commitments that were intended to promote greater transparency as well as ensure that the UK continues to be a fair place to do business and is globally recognised as such.¹⁴ In addition to setting up new rules requiring companies to obtain and provide more information with regard to their ownership and control, *the SBEEA 2015* aimed at tackling misconduct by directors and unfair employment practices.¹⁵ Therefore, it brought various changes to *the CDDA 1986*. These changes were results of consultations of the Department for Business, Innovation and Skills on measures to strengthen the director disqualification regime in 2013 and the Government's

⁹ Sections cited in this paper without reference to a specific act always refer to *the CDDA 1986*

¹⁰ Abbas Mithani and Victor Joffe, *Mithani: Directors' Disqualification* (2nd edn, Butterworths 1998) para 809

¹¹ Companies House, 'Companies Register Activities 2015/16 Spreadsheet' (25 August 2016) Table C1 <www.gov.uk/government/statistics/companies-register-activities-201516> accessed September 2017

¹² Paul Zalkin, 'Director's Disqualification: The Law in Theory and Practice' (2015) 3 *CR & I* 120

¹³ Department for Business, Innovation & Skills, 'Transparency & Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business', (*Government Response*, April 2014) para 27 <www.gov.uk/government/uploads/system/uploads/attachment_data/file/304297/bis-14-672-transparency-and-trust-consultation-response.pdf> accessed September 2017

¹⁴ Explanatory Notes to *the SBEEA 2015*, para 3

¹⁵ *Ibid*

response and proposals in 2014.¹⁶ The rest of this article will discuss and analyse some of the main changes brought about through *the SBEEA 2015*.

A. Misconduct Overseas

One of the main objectives and intended effects of these changes is the protection of the UK business market from persons who have been convicted overseas of an offence with regard to a company. This is achieved by allowing the Secretary of State to seek their disqualification and bar them from management of a UK company.¹⁷ Therefore, a new ground for disqualification for certain convictions¹⁸ abroad (section 5A) was introduced.¹⁹ Section 5A(5) provides that ‘company’ includes an overseas company²⁰. In addition to this change, various other sections have been widened to include companies based overseas, for example, sections 2, 3, 5, 6, 8, 10, 12C, 16, as well as Schedule 1 (see below). Interestingly enough, section 1184 of *the Companies Act 2006* empowers the Secretary of State to make provisions by regulations to disqualify a person subject to foreign restrictions from inter alia being a director of a company. Although this provision envisages the Secretary of State to play an important role in terms of choosing from various options set out in the Act and introduced a rather broad scope of this regime²¹, these powers have not yet been used.

There are some interesting questions which arise, when taking into account convictions abroad. For example, can a disqualification order made in the UK have effect overseas? Can a director be barred from management positions in more than one country? What if a director is disqualified in the UK but in another country, in which they wish to operate, there are no similar regulations regarding disqualification whatsoever?

Firstly, it should be noted that even before the insertion of this new ground for disqualification, extra-territoriality was recognised in jurisprudence. For example, in *Bilta (UK) Ltd v Nazir (No 2)*²² the Supreme Court unanimously held that section 213 of the

¹⁶ *Ibid* para 55

¹⁷ Department for Business, Innovation & Skills, 'Final Stage Impact Assessments to Part B of the Transparency and Trust Proposals (Director Disqualification Regime)' (25 June 2014) 92 <www.gov.uk/government/uploads/system/uploads/attachment_data/file/324713/bis-14-908b-impact-assessments-part-b-director-disqualification-regime-transparency-and-trust.pdf> accessed September 2017

¹⁸ A definition of a relevant foreign offence is provided in s5A(3)

¹⁹ *SBEEA 2015*, s104

²⁰ Section 5A(5). For a definition of an overseas company see s22(2A)

²¹ Ailbhe O'Neill, 'Part 40 of the UK Companies Act 2006: Disqualification Orders Go Global' (2007) 18 *ICCLR*

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²² [2015] UKSC 23 (SC)

Insolvency Act 1986 concerning fraudulent trading has extra-territorial effect because although this provision affects the winding up of a company registered in the UK, the effect of such winding up is worldwide.²³

Secondly, it is valuable to compare the UK disqualification regime with other jurisdictions with similar rules in this regard. For example, under Irish company law a disqualification order may be made if a person is disqualified under the law of another State and it would have been proper to make a disqualification order also in Ireland if the same circumstances had occurred there.²⁴ Generally, it is possible for a person who was disqualified in another State to still become a director of a company in Ireland. In this case this person is required to make an additional statement²⁵ regarding his disqualification in another jurisdiction which must be delivered to the Registrar.²⁶ In Singapore - by way of another example - a person shall be disqualified if the person is convicted of any offence involving fraud or dishonesty punishable with imprisonment for at least 3 months, whether committed “in Singapore or elsewhere”.²⁷

To summarise, it is possible that a person is barred from becoming a director in more than one country. Yet, there are also situations where a person is disqualified in one country but can still become a director in another. Furthermore, in jurisdictions that do not have similar rules regarding directors’ disqualification (e.g., Austria), a UK disqualification order will not necessarily preclude this person from becoming a director there.

B. Persons Instructing an Unfit Director

The disqualification regime was further broadened by introducing disqualification orders against persons instructing unfit directors (sections 8ZA-8ZE).²⁸ This applies where a director has been disqualified and any of the conduct for which he was disqualified was caused because he followed the direction or instruction of someone else.²⁹ In this case, the person giving that instruction or direction may also be disqualified.

²³ *Ibid*

²⁴ *Companies Act 2014 (Ireland)*, s842(i)

²⁵ *Companies Act 2014 (Ireland)*, s23

²⁶ Explanatory Memorandum to the Companies Act 2014 (Ireland), 13

²⁷ *Companies Act 1967 (Singapore)*, s154(1)

²⁸ *SBEEA 2015*, s105

²⁹ Explanatory Notes to *the SBEEA 2015*, para 625

There has been criticism as to whether a person instructing a director can have so much control or influence that they can be disqualified by simply giving instructions or directions.³⁰ It has also been observed that a director has always been subject to demands of individuals (e.g., shareholders), but that the decision whether or not to follow these demands has to be a result of his own and independent judgement.³¹ The new section 8ZA would therefore undermine this fundamental rule of English company law.³² In addition, it was argued that when thinking about joint ventures and similar structures, the introduction of this regime of *front* directors could mean that a joint venture participant who has a close relationship with a nominated director could be subject to disqualification and other claims. Hence, this approach could make UK companies less attractive for international business, especially joint ventures.³³

C. Compensation Awards

A third distinct change was that of compensation orders and undertakings introduced through sections 15A-15C of *SBEEA 2015*.³⁴ This change was deemed necessary because the persons who have suffered from a misconduct of a director did not directly benefit from a disqualification.³⁵ The objective of this policy is to improve confidence of stakeholders in the enforcement regime. Another intended effect is to change directors' behaviour by increasing the likelihood of culpable directors having to pay for their actions out of their own pocket.³⁶ There has been criticism, however, that the new legislation is not helpful towards those people that lose out in companies where directors are not disqualified; additionally, the courts may only make compensation orders where the company has become insolvent.³⁷ Thus, in solvent companies the burden to take actions in order to recover losses by the company lies upon the shareholders.³⁸

³⁰ Donald Lilly, Neil Davies and Ann-Marie Chinnery, 'Transparency and Trust: A New Era for Directors' disqualification?' (2014) 57 *Disqualification Newsletter* 5

³¹ *Ibid*

³² *Ibid*

³³ *Ibid* 4

³⁴ *SBEEA 2015*, s110

³⁵ Department for Business, Innovation & Skills, 'Final Stage Impact Assessments to Part B of the Transparency and Trust Proposals (Director Disqualification Regime)' (25 June 2014) 74

<www.gov.uk/government/uploads/system/uploads/attachment_data/file/324713/bis-14-908b-impact-assessments-part-b-director-disqualification-regime-transparency-and-trust.pdf> accessed September 2017

³⁶ *Ibid*

³⁷ Andrew Keay, 'Enforcing Breaches of Directors' Duties by a Public Body and Antipodean Experiences' (2015) 15 *JCLS* 255

³⁸ *Ibid*

D. Matters to be Taken into Account for Determining Unfitness Broadened

Another recent amendment was the replacement of section 9 with a new section 12C³⁹ which regulates the matters that must be taken into account when determining unfitness. Accordingly, Schedule 1, which sets out various factors the court is required to take into account when determining unfitness, has also been amended and may serve to remind directors of the wide range of misconduct that could lead to disqualification, to ensure that relevant matters of public interest are being taken into account and to include directors' actions regarding overseas companies.⁴⁰

III. Conclusion

The recent changes will most certainly have an impact on the numbers regarding disqualification orders which has been illustrated through recent figures. For example, in the first quarter of 2016 the sum of disqualification orders amounted to 390. Compared to the same quarter of the previous year this was an increase of 56%.⁴¹ Directors will have to be more careful than ever before (both in the UK and abroad) with regards to their responsibilities and the breadth of misconduct which might lead to disqualification. Additionally, the possibility of compensation orders introduces a threat to the director's personal finances and will be an extra motivation to adhere to legal requirements whilst operating a UK company. However, some aspects, such as the disqualification of persons instructing an unfit director, may need to be revisited in the light of experience.

The updated disqualification regime will improve individual accountability and should therefore make an important contribution to good corporate governance, help to prevent major corporate failures, as well as create potential savings to the market.⁴² An effective

³⁹ *SBEEA 2015*, s106

⁴⁰ Department for Business, Innovation & Skills, 'Final Stage Impact Assessments to Part B of the Transparency and Trust Proposals (Director Disqualification Regime)' (24 April 2014) 2 <www.gov.uk/government/uploads/system/uploads/attachment_data/file/324713/bis-14-908b-impact-assessments-part-b-director-disqualification-regime-transparency-and-trust.pdf> accessed September 2017

⁴¹ The Insolvency Service, 'Insolvency Service Enforcement Outcomes (Experimental Statistics) - January to March (Q1) 2016' (12 May 2016) <www.gov.uk/government/uploads/system/uploads/attachment_data/file/522927/Insolvency_Service_Enforcement_Outcomes_-_2016_Q1_-_web.pdf> accessed September 2017

⁴² Department for Business, Innovation & Skills, 'Transparency & Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business', Government Response (April 2014) paras 203, 237 <www.gov.uk/government/uploads/system/uploads/attachment_data/file/304297/bis-14-672-transparency-and-trust-consultation-response.pdf> accessed September 2017

disqualification system with clearly defined legal boundaries is vital for the directors in charge and will enhance international and domestic confidence in the UK business environment.⁴³

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⁴³ *Ibid* paras 203, 206

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