DELINQUENT DIRECTORS:

An Analysis of the Objectives and Success of Section 6 of the Company Directors Disqualification Act 1986.

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This thesis is presented in fulfilment of the requirements for the degree of Doctor of Philosophy.

For My Mother and Father.

With Much thanks to Professors Dave Campbell and Jill Poole.

Thesis Abstract.

This thesis discusses the objectives and success of the disqualification of directors under section 6 of the Company Directors Disqualification Act 1986. Disqualification under that provision is central to the state's strategy for dealing with undesirable conduct by directors.

However, the objectives of disqualification under section 6 are unclear and is effectiveness can be contested. It is frequently stated that disqualification exists to 'protect the public and commercial' world from abuse of limited liability yet the precise nature of the harm that such abuse causes has not been conclusively determined. As such, some have argued that disqualification seeks to sanction conduct that is 'socially undesirable'.

This thesis set out to establish the nature of the harm that makes certain uses of limited liability undesirable. It argues that the harm the state seeks to eschew through its use of section 6 is conduct likely to result in financial loss to creditors. Consequently it is argued that section 6 exists to control a moral hazard created by the state's policy of allowing entrepreneurs free access to limited liability.

Having established that a reduction in financial loss is the objective of section 6, the thesis processes to evaluate whether the section is likely to bring about a benefit (in terms of reduced loss) that is greater than the costs it generates. It is argued that disqualification under section 6 fails to bring about a meaningful reduction in losses generated by 'unfit' directs. However, it is also contended that there are significant costs associated with the application of the sanction. Consequently, the thesis contends that section 6 is an inefficient method of seeking to control undesirable conduct by directors.

The thesis concludes that the failure of disqualification to provide effective protection from the moral hazard created by limited liability ought to necessitate a review state's policy of allowing free access to it. For, in so far as regulation exists to protect the public from abuse of limited liability, the state must feel that its policy creates losses that are unacceptable. Therefore the failure of that regulation ought to necessitate a review of the policy as the most desirable way of protecting the public from the harm inflicted by undesirable use of limited liability.

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Chapter 1: Introduction.

"The Government recognises that due to the nature of entrepreneurial risk not every business succeeds. Honest directors- our future wealth creators- have nothing to fear from our crackdown. I want to give them every opportunity to start up again in business if they have acted within the bounds of the law. However those who are not fit to be in the privileged position of being a director should be under no illusions – those who abuse the system, often for their own benefit and at the expense of others, will be brought to book".

Dr Kim Howells, Minister for Competition and Consumer Affairs, 4th January 1999[1]

As the state has sought to balance the perceived benefit of increased entrepreneurial activity with the costs of failed business ventures, the disqualification of directors of insolvent companies under section 6 of the Company Directors Disqualification Act 1986 ('the Disqualification Act') has assumed an increasingly prominent role in the sphere of corporate regulation. There would seem to be little doubt that section 6 is now the state's weapon of choice in its quest to ensure that its 'system' of allowing entrepreneurs free access to limited liability is not abused. To this end numerous 'crackdowns'[2], 'clampdowns'[3] and 'offensives'[4] have been launched against individuals who the state perceives to have crossed the line

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[1] DTI press release, *Rogue Director "Hotline" Hits 1,200 calls*, 4th January 1999.
[2] See for example, DTI press release, *Crackdown on Unfit Directors Nets 13% rise and 1,275 Bans*, 23rd July 1998 and *ibid.*
[3] DTI press release, *Clamp Down On Dodgy Directors Continues,* 18th April 2000.
[4] DTI press release, *Rogue Directors Face New Offensive,* 20th July 2000.

between 'unlucky wealth creating entrepreneur' and 'cowboy director'[5]. As such, public regulation now lies at the heart of the regulatory regime for directors with an average of over 1,000 disqualifications under section 6 being obtained by the Secretary of State each year. Indeed, over the period 1999-2004, the Secretary of State has secured disqualification orders against almost 8,000 individuals[6] and in so doing has developed a sophisticated system for the reporting of suspected unfit conduct by directors of failed companies.

1.1 The Purpose of Disqualification.

The state's purpose in disqualifying individuals from being directors is to prevent undesirable use of the corporate form. The court, have stated that "The whole purpose of the 1986 Act is to protect the public from the future activities of those who have...shown themselves unfit to act as directors of a company"[7], and a former Minister for Competition and Consumer Affairs stated before a standing committee of the House of Commons that "The main purpose of the Company Directors Disqualification Act 1986 is to provide the public with protection against those who abuse the privilege of limited liability"[8]. According to the National Audit Office disqualification fulfils its objective of "protect[ing] the public and commercial world" by first preventing unfit individuals from

[5] See for example, DTI press release, *Griffiths Goes Gunning Against Cowboy Directors*, 5th June 1997.
[6] See, *Companies in 2003-2004* (London, HMSO, 2004), table D1.
[7] *Secretary of State for Trade and Industry v Bannister* [1996] 1 All ER 993 at page 988.
[8] Hansard [HC], (Session 1999-2000), Standing Committee B, 7th November 2000, col 119.

being concerned in the management of companies for a specified period of time and, second, by deterring unfit conduct by directors generally[9].

However, it has sometimes been acknowledged that that whilst the power to disqualify is not intended to be penal it does "involve a substantial interference with the freedom of the individual".[10] Thus, disqualification under section 6 has been described as "quasi-penal"[11] and disqualification proceedings have even been described by Hoffman J (as he then was) as 'penal proceedings'[12]. However, the notion that disqualification equates to a punishment was rejected by Morritt LJ, who in the case of *R v Secretary of State for Trade and Industry, ex parte McCormick*[13], considered that disqualification did not amount to a 'depravation of liberty or property' because disqualified individuals were not prevented from setting up a business as a sole trader or partner. It seems then that disqualification is seen as a protective measure, even if it sometimes strays towards punishment. However, whilst the judiciary has waxed lyrical about the nature of disqualification, the State is far clearer that protection is the *objective* of disqualification. Successive ministers at the DTI have emphasised this and statements such as that of Melanie Johnson MP that "It

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9 National Audit Office, Report by the Auditor and Comptroller General: *Insolvency Service Executive Agency, Company Director Disqualification,* (House of Commons Papers, Session 1992-1993, 907), (London, HMSO, 1993), para 1.4. See also Lord Woolfe MR in *Re Blackspur Group Plc* [1998] 1 WLR 422, who declared that at page 426; "The purpose of the 1986 Act is the protection of the public by anticipated deterrent effect on further misconduct and by encouragement of higher standards of honesty and diligence in corporate management, from those who are unfit to be concerned in the management of a company"

10 *Re Lo-Line Electric Motors Ltd* [1988] 1 Ch 477 at page 486.

11 *Re Cedar Developments Ltd* [1994] 2 BCLC 714 at page 719.

12 *Re Swift 736 Ltd* [1993] BCLC 1 at page 3.

13 [1998] BCC 379.

is vital that the business community and consumers are protected from irresponsible, incompetent or rogue directors at the earliest opportunity",[14] are commonplace.

Such ministerial rhetoric ensures that disqualification under section 6 enjoys a high profile in today's corporate arena. However, priority currently accorded to disqualification is very much the result of pressure exerted on the Department of Trade and Industry (DTI) in the early 1990's. For, whilst section 6 has been on the statute book since the mid-1980s, it was only after the Public Accounts Committee[15] and the National Audit Office (NO)[16] published reports severely criticising the DTI for failing to ensure that section 6 'fulfilled its purpose of protecting the public'[17] that disqualification under that section became a policy priority.

1.2 Criticism and Reform.

The reports of the NAO and Public Accounts Committee identified systematic failures in the management of section 6 by the division of the DTI responsible for bring disqualification cases on behalf of the Secretary of State (the Insolvency Service). The report of the Public Accounts Committee was particularly damming, expressing concern about multiple

[14]Insolvency Service, *Annual Report and Accounts*, (House of Commons Papers, session 2002-2003, 963), (London, DTI, 2002), page 31.
[15]Committee of Public Accounts 18th Report, (House of Commons Papers, session 1993-1994, 167), page 3. See also the minutes of the evidence presented to the committee, (House of Commons Papers, session 1993-1994, 167-i).
[16] National Audit Office, *The Insolvency Service Executive Agency: Company Director Disqualification*, (House of Commons Papers, session 1992-1993, 907), (London, HMSO, 1993).

failures at all stages of the disqualification process. The committee noted that at the first stage of the disqualification process there were wide variations in the recording and reporting of unfit conduct by Official Receivers[18] and that only an average of 1 in 22 cases where unfit conduct was identified were submitted to Insolvency Service for further investigation[19]. It also noted that many of the reports that were submitted were of a poor quality. The committee also expressed concern about the fact that the even a majority of unfit conduct reports received by the Secretary of State were submitted late and were often incomplete. As far as the Insolvency Service itself was concerned the Committee alleged that it was taking too long to obtain disqualification orders against unfit individuals, that it had not properly assessed the resources needed to carry out its responsibilities under sections 6 and 7 of the Disqualification Act and that it was not pursuing enough disqualification cases as it should do if section 6 was to deliver effective protection. The criticisms of the Public Accounts committee reflected those made by the NAO.

The two reports prompted significant efforts by the Insolvency Service to enhance its management of the section 6 disqualification system in order to deliver more effective protection to the public. Guidance was issued to Official Receivers and Insolvency Practitioners with the intention of improving the quality, timeliness and consistency of reports of unfit

[17] NAO report, *ibid* at *Summary and Conclusions,* paragraph 9.

[18] The Committee's report expressed particular concern about wide variations in the recording and reporting of unfit conduct between Official Receiver. See *Report of the Public Accounts Committee, supra* note **Error! Bookmark not defined.** paras 16-25.

[19] *Ibid.*

conduct[20] and procedures to deal with 'office holders' who failed to comply with their obligations satisfactorily were put in place. Steps were also taken to improve the Service's own performance, such as the doubling of the budget allocated to disqualification work between 1994 and 1998[21] and reform of the procedures for dealing with reports of unfit conduct.

These efforts to improve the disqualification system appeared to have born fruit by the time the NAO reviewed the progress of the Insolvency Service in meeting the concerns expressed by itself and the Public Accounts Committee. The NAO's follow-up[22] report into section 6 disqualification noted that the number of disqualification orders obtained by the Secretary of State had risen from just 326 in 1992-1993 to 1,267 in 1997-1998[23] and that Official Receivers and Insolvency Practitioners were submitting better quality reports more consistently than had been the case in 1992-1993.

The rise in the number of disqualifications, coupled with improvements in the management of disqualification cases by the Insolvency Practitioners and Official Receivers, lead the NAO to conclude its follow-up report by stating that the Insolvency Service had 'significantly' improved its management of disqualification cases and, further, led it to claim that there were 'direct benefits' from disqualification. The NAO based

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[20] See, Insolvency Service, *Guidance Notes for the Completion of Statutory Reports and Returns*, (London, Insolvency Service, 2001).
[21] Insolvency Service, *Annual Report and Accounts for the Year 1998*, (House of Commons Papers, session 1997-1998, 644) (London, DTI, 1998).
[22] See, National Audit Office, *Insolvency Service Executive Agency, Company Director Disqualification – A Follow Up Report,* (House of Commons Papers, Session 1998-1999, 424) (London, The Stationary Office, 1998).

this conclusion on research which appeared to show that disqualification in 1997-1998 had saved creditors £11 million, in terms of loss that disqualified individuals would have gone to cause had they not been disqualified[24] . The NAO did, however, encourage the Insolvency Service to continue it efforts to enhance its management of disqualification, most notably by taking steps to reduce the period of time taken to secure a disqualification, which had not fallen between 1992 and 1997[25].

With the generally optimistic conclusions of the follow-up report, official inquiry into section 6 disqualification came to an end. However, the follow-up report's favourable verdict on the reform agenda that had been pursued since 1993 has had an enduring influence upon the development of section 6 disqualification. Its legacy was to cement it in place[26] the view that the more *efficiently managed* the disqualification system was, the more protection from the activities of unfit directors it would deliver. Thus, better quality reports by office holders, a higher number of disqualifications and speedier disqualification have continued to be the focus of efforts to reform section 6 disqualification.

Some notable successes have been achieved by this approach. For example, the annual number of disqualifications continued to increase after 1998, up to a peak of 1,761 in 2001-2002, although there has been a

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[23] *Ibid,* fig 9.
[24] *Ibid,* page 37. The veracity of the NAO's figures are discussed below, see 6.2.
[25] *Ibid,* page 6 and paras 2.28-2.34.
[26]The policy has also influenced academic discussion of section 6. See for example, S. Griffin, *The Disqualification of Unfit Directors and the Protection of the Public Interest* (2003) 53 NILQ 207, who, at page 230, cites 'procedural constraints' as a significant factor limiting the effectiveness of section 6.

reduction in the annual number of disqualifications according to the two most recent raft of statistics. Nonetheless, the number of disqualifications obtained in 2003-2004 remained above the number achieved in 1997-1998[27]. In addition to increases in the number of disqualifications since 1998, the average time between insolvency and disqualification has fallen from 5 years to 2 years in 2003[28].

Reducing the delay between insolvency and disqualification has been very much the focus of reform since the late 1990s. The culmination of such reform was the introduction of a system of 'disqualification undertakings' in 2001. the new system of undertakings was intended to remove many disqualification cases from court by allowing directors to give an undertaking to the Secretary of State that they will not act as a director, which if accepted by the Secretary of State, have the same effect as a traditional court ordered disqualification. The intention behind the new system was to reduce the delay associated with court proceedings and as such improve the effectiveness of disqualification. This was made clear by

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[27]In 1997-1998 the Secretary of State obtained 1,266 disqualifications under section 6, see *Companies in 1997-1998* (London, The Stationary Office, 1998), table D1. In 2001-2002, 1,751 disqualification orders were obtained under section 6, in 2002-03 the number stood at 1,594 and in 2003-04 1,367 disqualifications were achieved, see *Companies in 2003-2004, supra* note 6 table D1. The spike in 2001-02 is explained by the insolvency service as a result of the introduction of disqualification undertakings (see Insolvency Service, *Annual Report and Accounts*, (House of Commons Papers, Session 2002-2003, 963), (London, DTI, 2002), page 31). Therefore despite the headline fall in the number of orders obtained in 2002-2003, the overall trend in the number of disqualifications was up, although the annual rises are now a fraction of what they were in the late 1990's when annual rises of 20% or more were seen (see *Companies in 2000-2001* (London, HMSO, 2002), table D1). The exception to the upward trend is the fall seen in 2003-04. However, the Insolvency Service explains the fall as a consequence of the relocation of the disqualification unit from London to Birmingham (see Insolvency Service, *Annual Report and Accounts 2003-2004*, (House of Commons Papers, Session 2003-2004, 812), (London, The Insolvency Service, 2004), page 15.

the minister responsible for steering the reforms through Parliament when he stated that undertakings were desirable in order to "achieve earlier disqualifications to protect the public and to save costs"[29]; "I am sure that the [select] Committee will agree" said the minister, "that unfit directors should be disqualified as soon as possible".[30]

The response to the criticisms of section 6 expressed by the Public Accounts Committee and the NAO, both before and after 1998, can therefore be summarised as having the intention of; (i) improving the performance of Official Receivers and Insolvency Practitioners, (ii) increasing the number of disqualification and (iii) increasing the speed at which disqualifications are obtained, with the allied goal of reducing the cost of disqualification.

The focus upon these three matters as the way to ensure that section 6 effectively protects the public from undesirable use of limited liability is obviously built on the belief that a disqualification for unfitness under section 6 is a *potentially* effective method of achieving protection from unfit conduct. Thus, the 'reform agenda' has focused on improving the management of section 6 in order that this potential be fulfilled. For unless one believes that a section 6 disqualification is capable of effectively protecting the public from unfit conduct, a reduction in the time taken to secure a disqualification could hardly be cited improving public protection.

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[28] Insolvency Service, *Annual Report and Accounts 2002-2003*, (House of Commons Papers, session 2002-2003, 846).
[29] Dr Kim Howells MP, Hansard [HC], Standing Committee B, 7th November 2000, col 118. See also Griffin, *supra* note 31.
[30] *Ibid.*

Similarly, a belief in the potential of section 6 is necessary to sustain the view (popular in some quarters) that an increase in the number of disqualifications necessarily means an increase in the protective benefit of section 6[31].

However, the belief that section 6 is fundamentally effective way to deliver 'protection' must be challenged in the absence of any evidence suggesting that improvements in the management of disqualification have actually reduced instances of unfit conduct. Indeed, the 'significant' improvement in the reporting of unfit conduct by Official Receivers and Insolvency Practitioners and the huge rise in the number disqualification orders achieved in the mid 1990s, seem to have had little impact on instances of unfit conduct recorded in insolvent companies, as the number of recorded instances of unfit conduct has remained stable for the better part of the last 10 years. In 2002, for example, the Insolvency Service received 5,555 reports of unfit conduct from Official Receivers and Insolvency Practitioners under section 7 of the Disqualification Act[32]. This compares to 5,435 reports received in 2001[33] and 5,476 in 2000[34] and 5,253 in 1997[35].

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[31] See for example, DTI Press release, *Crackdown On Unfit Directors Nets 13% Rise and 1,275 Ban*, 23rd July 1998, and "*FastTrack" Disqualification Results in record Bans,* 2nd January 2002. See also S. Griffin, *The Disqualification of Unfit Directors and the Protection of the Public Interest* (2003) 53 NILQ 207 who, at page 217, 'tentatively' asserts that the success of section 6 can be measured by the number of disqualifications obtained. See also A. Hicks, *Director Disqualification: Can it Deliver* [2001] JBL 433. Hicks suggests at page 446, that the "obvious" response to weakness of disqualification is to increase the number of disqualifications. He does however, go on to suggest that more fundamental reform of disqualification may be needed to significantly increase its effectiveness, see pages 451 – 460.
[32] See, Insolvency Service, *Insolvency: General Annual Report for the Year 2002*, (London, The Stationary Office, 2003).
[33] *Ibid.*
[34] Insolvency Service, *Insolvency: General Annual Report for the Year 2000*, (London, The Stationary Office, 2001).

Thus, the increase in the number of disqualifications does not seem to have reduced instances of unfit conduct either by taking unfit individuals 'off the road' or by deterring unfit conduct amongst directors generally. As such the current focus on improvements the management of section 6 as the way to 'protect the public' from unfit directors can be questioned.

Furthermore, doubt over the success, or the likely success, of the 'reform agenda' is cast by careful reading of the NAO's follow-up report, which suggests that even after the improvements made to the system of disqualification in the mid-1990's, section 6 was far from an effective measure. Empirical research carried out for the report indicated that disqualification actually brought very little benefit in terms of protection and deterrence and that its costs were high. Thus, despite its bold conclusions the report did not resolve questions surrounding the utility of section 6 disqualification.

Doubt over the effectiveness of disqualification has been expressed by academic commentators such as Andrew Hicks who concluded in an ACCA report[36] published around the same time as the follow-up report, that section 6 was an *ineffective* sanction. Hicks argued that the impact of a thousand disqualifications each year was limited given that there are over 2 million directors in the UK and suggests that most disqualifications were too short to be effective. He further claimed that section 6 was limited by the fact that only a relatively small number of directors fell with its purview.

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[35] Insolvency Service, *Insolvency: General Annual Report for the Year 1997*, (London, The Stationary Office, 1997).

Some of the criticisms levelled by Hicks seem to follow in the footsteps of the Public Accounts Committee and the NAO, in that that problems with the number and quality of disqualifications being obtained are cited as harmful the effectiveness of the section. Others, however, (such as narrow range of directors falling within the disqualification system) suggest that more fundamental weaknesses with section 6 may be responsible for its failure to deliver effective protection (however, it should be noted that Hicks' suggestions as to how the provision could be made effective also focused on reform of the administration of the sanction).

Therefore, in light of the failure of current policy to bring about any apparent reduction in instances of unfit conduct and doubts raised by the NAO and Hicks reports it can be questioned whether the reform agenda that has been pursued since the mid-1990s addresses the real problems with section 6 disqualification. Essentially this question can be asked because the success of section 6 can still be contested even though most of the failures identified by the Public Accounts Committee have been addressed. That is not to say that, however, that the policy pursued since the 1990s has not brought any benefits. The improvement in the reporting of unfit conduct, for example, has certainly brought a 'benefit' in the sense that unfit conduct is more likely to be identified, reported and sanctioned. What can be questioned however is whether these improvements have been sufficient to make disqualification an effective sanction, which is really a challenge to

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[36] A. Hicks, *Disqualification of Directors: No Hiding Place for the Unit?* (London, Certified Accountants Educational Trust, 1998).

the assumption that section 6 is capable of delivering effective protection from the activities of unfit directors.

However, in addition to the question of whether section 6 disqualification is capable of effectively protecting the public from unfit conduct, dissatisfaction with the current approach to the section can also be expressed in light of the fact that the relationship between disqualification and the State's desire to foster an 'enterprise culture'[37] is unclear. Indeed, it has never been conclusively stated what it is that makes it desirable for some directors of failed companies to allowed to use limited liability again whilst for others it is undesirable. Phrases such as a ' conduct demonstrating alack of commercial probity'[38] have been used to describe disqualification-worthy conduct, but perception of 'harm' that must underlie such phrases has not been explored.

It is widely accepted that disqualification aims to protect the public and commercial world from 'abuse of limited liability', and well established precedents exist from which it is possible to identify many acts which will be held to be such abuse and therefore evidence of unfitness. However, what is not clear from the Act and the cases is the interest or interests that section 6 disqualification seeks to protect Therefore the essence of what separates *desirable*, but ultimately unsuccessful, entrepreneurial activity from *undesirable* unsuccessful entrepreneurial activity is unclear. This lack of clarity about the ideological foundation of disqualification has caused real,

[37] See for example, Department of Trade and Industry, *White Paper, Our Competitive Future: Building the Knowledge Driven Economy*, Cm 4176, (London, DTI, 1998).
[38] *Re Lo-Line Electric Motors Ltd* [1988] Ch 477 at page 486.

practical problems with the application of the sanction. Vanessa Finch, for example, has discussed two conflicting approaches to disqualification by the judges that are essentially borne of differing interpretations of the purpose of disqualification[39]. Similarly, the lack of clarity as to the nature of unfit conduct has lead to some judicial u-turns as the relevance of certain forms of conduct to a finding of unfitness[40].

Therefore, section 6 is in a state of some confusion. The nature of unfit conduct is unclear and its effectiveness at protecting the public from such unfit conduct is, at the very least, open to question. Indeed, the success of the section must necessarily be open to doubt if the very nature of undesirable use of limited liability is not clear. For, if it is unclear what makes certain conduct 'unfit', then it is impossible to identify the harm that such conduct inflicts on the public, and consequently impossible to assess how successful section 6 is at protecting the public from that harm. Therefore, before the success of disqualification can be assessed it is first necessary to establish the harm that makes certain conduct so undesirable that directors are declared 'unfit'.

This Thesis' Discussion of Disqualification.

Therefore, this study of section 6 disqualification seeks to assess the success of the sanction by discussing the nature of the harm is seeks to address and then evaluating whether section 6 disqualification is likely to

[39] See, V. Finch, *Disqualifying Directors: Issues of Rights, Privileges and Employment,* (1993) 22 Industrial Law Journal 35.
[40] There has, for example, been a significant shift over the years in the way that non-payment of tax is treated in disqualification cases. See *Re Sevenoakes Stationers (Retail) Ltd* [1990] BCLC 668 and 4.8.6 below.

provide the 'public and commercial world' with effective protection from that harm.

The thesis begins its analysis by discussing the reason why public regulation of directors is felt desirable by the State. The existence of public regulation (i.e. disqualification) implies a belief that private regulation fails to prevent undesirable conduct, which it is necessary to explore if the 'harm' in unfit conduct is to be identified. Thus, identification of the manner of private regulatory failure that gives rise to the apparent need for disqualification takes us some way to establishing the nature of undesirable use of limited liability in the context of disqualification. As such, the thesis begins with an analysis of the problems surrounding private law regulation of directors, particularly the problems in relation to the sort of director against which disqualification is directed. The thesis builds upon the analysis of the need for disqualification by discussing the significance of the link between disqualification and limited liability in terms of the harm that section 6 is intended to prevent. It will be recalled that it has been stated that "[t]he main purpose of the Company Directors Disqualification Act 1986 is to provide the public with protection against those who abuse the privilege of limited liability"[41], and as such limited liability would seem to be central to the need for disqualification and the ideological function of disqualification.

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[41] Hansard [HC], (Session 1999-2000), Standing Committee B, 7th November 2000, col 119.

At the conclusion of its analysis of the role of limited liability the thesis presents its argument as to the nature of the harm that makes certain uses of limited liability undesirable and worthy of sanction. In the following chapter the common examples of 'unfit' conduct are discussed in order to support the thesis' contention as to the nature of the harm condemned by the State. After advancing its argument as to the nature of undesirable use of limited liability, the thesis moves on to consider whether section 6 is likely to be an effective method of protecting the public and commercial world from such conduct.

It is argued that given the nature of the harm it is intended to prevent, the success of section 6 can be most satisfactorily assessed by means of a cost-benefit analysis that considers both the qualitative and quantitative costs and benefits of the section. The qualitative aspects of section 6 are discussed before a quantitative analysis of the costs and benefits of the section is made. The discussion of the quantitative costs and benefits of the section draws on work carried out by the NAO for its follow-up report. As part of this cost-benefit analysis of section 6 the thesis considers the relative advantages and disadvantages of an alternative system of disqualification. It then goes on the consider the impact of the recent introduction of disqualification undertakings. The discussion of the likely impact of the undertakings system on the effectiveness of section 6 disqualification is made within the broad context of the cost-benefit analysis, focusing particularly on the fairness of the system and its impact upon the effectiveness of the section. The final chapter of the thesis discusses the implications of the thesis conclusion as to the likely effectiveness of section 6 in protecting the public and commercial world from the harm identified in earlier chapters.

It must be emphasised at the outset of the analysis that this thesis assesses the success of section 6 *by reference to its stated goal of protecting the public from abuse of limited liability*. For whilst some have argued that the effect of disqualification is to punish directors, punishment is not the declared objective of the State in its operation of section 6. Therefore, as the purpose of this thesis is to assess the extent to which section 6 effectively achieves it goals, the goal against which it is judged is that which the State professes to secure. That is not to say however, that the punitive effects of disqualification are overlooked in the following chapters, for where punitive aspects of disqualification are not linked to protection, it will be argued that this represents a failure of disqualification to fulfil its stated objective.

It is therefore to the substantive analysis of the effectiveness of section 6 by reference to its goal of protecting the public from abuse of limited liability that this thesis now turns. However, that analysis shall begin with a brief introduction to the main features of the Disqualification Act

Chapter 2: Disqualification and the Failure of Shareholder Monitoring.

2.1 A Brief Overview of the Disqualification Act.

The concept of disqualifying individuals from being company directors has a long pedigree in English law. The first disqualification provision was introduced in 1929[42] and over the next 60 years various Companies Acts introduced several other grounds for disqualification[43]. The current Company Directors Disqualification Act 1986 ('the Disqualification Act') was introduced to consolidate existing disqualification provisions alongside a new power allowing for mandatory disqualification of directors for unfitness that had been introduced by the Insolvency Act 1985[44]. Consequently, the Disqualification Act contains 9 provisions that allow for directors to be disqualified by a court or, in the cases of sections 6, 8 or 9B,

[42] Section 300 of the Companies Act 1929 Act provided for the automatic disqualification of undischarged bankrupts and gave courts a power to disqualify an individual from being a director if that individual had been found to be in breach of the Acts' fraudulent trading provisions. Section 300 was introduced following recommendations of the Greene Committee, see, *Report of the Company Law Amendment Committee* (Chairman, Adrian Greene), (Cmnd.2657), (London, HMSO, 1929).
[43] For example, section 188 of the Companies Act 1947 introduced a new power allowing a court to order the disqualification of a director where he had been found guilty of any offence in relation to the fraudulent promotion, formation or management of a company. Section 9 of the Companies Act 1976 introduced a further power of disqualification which provided that a person could be disqualified for up to 5 years if he had been the director of company that had gone into insolvent liquidation and a court felt that the director's conduct made him unfit to be concerned in the management of a company.
[44] A provision introduced following recommendations of the Cork Committee Report of 1982. *Insolvency Law and Practice: Report of the Review Committee*, (Chairman, Sir

by offering an undertaking to the Secretary of State. Section 11 of the Act provides for the automatic disqualification of undischarged bankrupts.

Disqualification under any of the Act's provisions substantially restricts an individual's right to be involved with the administration of a company incorporated under the Companies Act 1985[45]. Section 1 (1)(a) of the Act states that a person subject to a disqualification order shall not "be a director of a company, act as a receiver of a company's property or in any way, whether directly of indirectly, be concerned or take part in the promotion formation or management of a company unless (in each case) he has leave of the court". Disqualified persons are also prohibited from acting as insolvency practitioners[46]. As is obvious from its wording, the prohibition imposed by section 1(1)(a) is not absolute and, as such, it is possible for a disqualified individual to act in any of the prohibited capacities if he obtains leave of a court to do so[47]. It is not however possible for a disqualified individual to obtain leave to act as an insolvency practitioner as the prohibition imposed by section 1(1)(b) is absolute. Section 17 of the Act therefore gives 'a court having jurisdiction'[48] unfettered discretion to grant leave of a disqualification order.

Kenneth Cork), (Cmnd 8558), (London, HMSO, 1982). The report devoted an entire chapter to the reform of disqualification; see chap. 45 paras 1807-1826.

[45] Rule 4(2) of the Limited Liability Partnership Regulations 2001 (SI 2001/1090) also extend the provisions of the Act to members and shadow members of Limited Liability Partnerships.

[46] Section 1(1)(b).

[47] The same is true of the prohibition imposed by section 1A(1)(a).

[48] Defined in section 17 (1)-(7) as (i.e. that applications for leave of an order must be made to a court with jurisdiction to wind up companies, where the original order was made by such a court, or where the person is subject to a disqualification undertaking, a court which would have had jurisdiction to make a disqualification order had the Secretary of State not accepted an undertaking.

Leave of a disqualification order under section 17 is an important aspect of the disqualification regime because leave clearly modifies the effect of disqualification and fact that leave is provided for under the Act at all indicates that the public interest is not seen to be best served by absolute disqualification.

The desire to ensure a degree of flexibility in the disqualification legislation is also evidenced by the fact that the majority of the Act's disqualification provisions give a discretionary power to disqualify, which in most cases, is linked to specific breaches of the companies legislation. Section 2 and 5, for example, allow a court to order the disqualification of a person who has been convicted of an offence connected with the promotion, formation or management of a company. Section 3 allows disqualification for persistent breaches of the companies' legislation and section 4 for fraud in winding up. Section 10 of the Act allows a court to make a disqualification order against an individual if that court has made a declaration under sections 213 or 214 of the Insolvency Act 1986[49], and section 12 provides that any person who fails to make a payment that is required under Part VI of the County Courts Act 1984[50], may be made subject to a disqualification order.

[49] Section 213 of the Insolvency Act 1986 allows a court to make a declaration that a person is liable to contribute to the assets of an insolvent company if that person is shown to have carried out the business with the intent to defraud creditors. Section 214 allows a court to make such a declaration if a person is found to have engaged in 'wrongful trading', on which see further chapter 4, below.

[50] Part VI of the County Courts Act 1984 provides that where a debtor is unable to pay the amount of a judgment made against him a court may make an order providing for the administration of his estate. Such an order may provide for the payment of his debts by instalments and it is such payments to which section 12 refers.

However, in contrast to the discretionary nature of disqualifications under sections 2-5, 10 and 12, sections 6 and 8 provide for the *mandatory* disqualification of directors where they are found to be 'unfit to be concerned in the management of companies'. Section 9A also provides for mandatory disqualification for unfitness, but only where unfitness is accompanied by certain infringements of the Competition Act 1998[51].

Of all the disqualification provisions in the Act, section 6 is by far the most important, as befits its status as the civil regulatory mechanism used by the State to 'crackdown' on unfit directors who abuse a regime apparently designed to assist 'wealth-creating' entrepreneurs. In 2001-2002, for example, disqualifications under section 6 accounted for 91.2% of all disqualifications made under the Act (excluding section 11), which is consistent with figures from previous years[52]. According to a survey carried out by Andrew Hicks for his ACCA report[53], most of those disqualifications under section 6 concern directors of owner-manager companies. Hicks' survey found that almost 75% of disqualified people were owner-managers and that 82% of the disqualified held shares in the companies they directed. Thus, disqualification is a sanction that appears to be targeted at 'unfit' conduct in owner-managed companies.

Section 6 itself provides that a person shall be disqualified from being a director in any case where a court is satisfied:

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[51] Sections 9A and 9B (competition undertakings), were inserted in the Act by the Enterprise Act 2002.
[52] See *Companies in 2001-2002*, (London, The Stationary Office, 2002), table D1.
[53] A. Hicks, *Disqualification of Directors: No Hiding Place for the Unit?* (London, Certified Accountants Educational Trust, 1998), chapter 3.

"(a) that he is or has been a director of a company which has at any time become insolvent (whether while he was a director or subsequently) and;

(b) that his conduct as a director of that company (either taken alone or together with his conduct as a director of any other company or companies) makes him unfit to be concerned in the management of companies"

The section is given a wide scope by sub-section 6(3) of the Act, which states that the word 'director' in section 6(1) shall include a shadow director[54]. Indeed section 22(1) of the Act states that all references to 'directors' in the Act shall include shadow directors. Under section 7 (1) of the Act an application for disqualification under section 6 (1) can be made by Secretary of State, or the Official Receiver, where it appears to the Secretary of State that it is "expedient in the public interest" that a person be disqualified. Following amendments to the Act introduced by the Insolvency Act 2000, it is now possible for a person to be disqualified by offering an undertaking to the Secretary of State that he will not act as a director. The Secretary of State may accept an offer of an undertaking, if he feels that it is "expedient in the public interest"[55] to do so and if the conditions mentioned in section 6 (1) are satisfied[56].

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[54] A shadow director is a person who acts as a director but who has not been formally appointed to the board. See section 741 (1) Companies Act 1985, see also section 251 Insolvency Act 1986, and section 417(1) Financial Services and Markets Act 2000. Shadow directors are subject to the same duties as an appointed director.

[55] Section 7(2A).

[56] *Ibid.*

Sections 6 and 7 therefore provide the State with a wide-ranging power to seek a disqualification order against (or accept an undertaking from) individuals who, in its opinion, have made undesirable use of limited liability as a vehicle for their entrepreneurial activities. The overwhelming majority of disqualifications under section 6 are now made in the form of undertakings. In 2003-2004, for example, undertakings accounted for 1,154 of the 1,367 disqualifications obtained under section 6.[57] The undertaking procedure is not however, limited to section 6. It is also possible for a person to be disqualified under section 8 by offering an undertaking to the Secretary of State[58] and under section 9B by offering such an undertaking to the Director General of Fair Trading.

2.1.3 The Process of Disqualification.

It is a measure of the importance that disqualification under section 6 has assumed that a sophisticated system for reporting suspected unfit conduct has been developed. Insolvency Practitioners and Official Receivers are at the centre of this system (thanks to the fact that section 6 provides for disqualification only after insolvency) and are responsible for investigating the conduct of directors and reporting evidence of unfitness to the Secretary of State, which in practice means the Disqualification Unit of the Insolvency Service. 'Office holders'[59] are therefore required by section 7(3) of the Act to report unfit conduct when it appears to them that the conditions

[57] *Companies in 2003-2004* (London, The Stationary Office, 2004), table D1.
[58] Section 8(2A).
[59] The class of persons qualifying as office holders for the purpose of the Act is set out in section 7 (3) (a) –(c).

mentioned in section 6(1) are satisfied in relation to the conduct of a particular director. The Insolvent Companies (Reports on Conduct of Directors) Rules 1996[60], as amended, proscribe the manner in which the reporting obligation must be fulfilled. The rules provide that an office holder must make an 'interim report' to the Secretary of State under section 7(3) within six months of "the relevant date"[61] if he feels that the conditions in section 6(1) are satisfied. This initial report is to be made on a form set out in schedule 1 of the 1996 rules and is called a D2 'Interim Return'. When an office holder submits an interim return he falls under an obligation to submit a final and full report on unfit conduct. It has now become the practice of the Insolvency Practitioner Control Unit (I.P.C.U)[62] to notify the office holder of the date by which he is expected to submit a final report. In general, an office holder is expected to submit a final return within nine months of having filed an interim report. The final report is termed a D1 report by rule 3 of the 1996 rules and the form that the D1 report is to take is again set out in schedule 1 of the rules. The duty on office-holders to report is reinforced

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[60] Statutory Instrument 1996/1909.

[61] The relevant date is defined in rule 4 (4) as being :

> "(a) in the case of a company in creditors' voluntary winding up (there having been no declaration of solvency by the directors under section 89 of the Insolvency Act 1986), the date of the passing of the resolution for voluntary winding up,
> (b) in the case of a company in members' voluntary winding up, the date on which the liquidator forms the opinion that, at the time when the company went into liquidation, its assets were insufficient for the payment of its debts and other liabilities and the expenses of winding up,
> (c) in the case of the administrative receiver, the date of his appointment,
> (d) in the case of the administrator, the date of the administration order made in relation to the company."

[62] The I.P.C.U., based in Birmingham, has responsibility for monitoring the activities of Insolvency Practitioners. All D2 reports are submitted to the I.P.C.U., which then forwards them to the Insolvency Service. Upon receiving a D2 report the unit will inform the Insolvency Practitioner of the date by which he must submit a full D1 report.

by rule 4(7) of the 1996 Reporting Rules[63], which makes it an offence for an office-holder to fail to comply with his duty without reasonable excuse. Similarly, office-holders who fail to submit reports promptly may be reported to his licensing authority or be himself disqualified from acting as an Insolvency Practitioner.[64] Once a report has been received by the Secretary of State or the Official Receiver, section 7(4) of the Act permits the Secretary of State to require from the relevant office holder such further information and documentation as he may require.

After the Disqualification Unit has received a D1 report, it is vetted in order to determine whether there is sufficient *prima facie* evidence of unfitness to proceed with an investigation. If there is *prima facie* evidence, the D1 report is subject to a more detailed investigation. At the end of that investigation the Secretary of State again assesses whether it is in the 'public interest' to apply for a disqualification order[65]. However, section 7(2) of the Disqualification Act provides that, except with leave of court, an application under section 6, or the acceptance of a disqualification undertaking, must be made within 2 years of the date on which the company of which the person subject to a section 6 application was a director went into insolvency[66].

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[63] Insolvent Companies (Reports on Unfit Conduct of Directors) Rules 1996 (SI 1996/1909).

[64] See Insolvency Service, Dear Insolvency Practitioner Letter: *Millennium Edition* (London, Insolvency Service, 1999), chapter 10. Available at *http://www.insolvency.gov.uk/information/dearip/dearipmill/chapter10.htm*

[65] See, *Guidance Notes for the Completion of Statutory Reports and Returns*, (London, Insolvency Service, 2001), appendix 3 'how a practitioner's report is processed'.

[66] Section 7(2) of the Disqualification Act states that an application for disqualification under section 6 must be made within 2 years of the date of insolvency, except where the court grants leave to bring proceedings out of time. The procedure for applications to bring and action under section 6 out of time is governed by *Practice Direction: Disqualification Proceedings* [1999] 1 BCLC 717.

Thus, disqualification under section 6 is far from a token attempt to regulate directors. It is a serious form of 'public interest' regulation that plays a significant role in the government's enterprise policy. However, as has been previously noted, the fact that public regulation of directors is felt necessary by the State suggests that private regulatory mechanisms fail to prevent undesirable conduct by directors. Thus, it is expedient to begin this evaluation of disqualification with a discussion of why public regulation of directors is needed. For, a proper understanding of the apparent 'failure' that creates the need for disqualification is essential if a meaningful analysis of the objectives and success of section 6 disqualification is to be made.

2.2 Agency Problems in the Company.

An essential function of company law is to control conflicts of interest that arise among the various actors within companies. The conflict that has pre-occupied most regulation of directors to date arises between shareholders and directors because of what economists call agency problems. An agency problem arises where the welfare of one party (the principal) depends upon the actions of another (the agent) and where the agent has an incentive to maximise his own welfare at the expense of his principal. Smith recognised that the structure of corporations created agency problems when he stated that[67]:

[67] A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*. R. H. Campbell. and A.S, Skinner (eds). (Oxford, Clarendon Press, 1976). See also Fama, who states that the agency theory assumes that both directors and shareholders will be welfare maximises and will tend to act in a self interested way, as such controls need to be placed

"The directors of... [joint-stock] companies...being the managers of other peoples' money rather than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartney frequently watch over their own...Negligence and profusion must always prevail, more or less in the management of such a company[68]".

However, in addition to the agency problem between shareholders and directors an agency problem can also arise between companies and third parties, such as trade creditors, employees and customers[69], in so far as companies have an incentive to maximise their own welfare at the expense of their creditors.

2.2.1 Agency Problems and Shareholder Monitoring.

The existence of agency problems calls for principals to engage in monitoring (regulation) of their agents, which in the case of directors and shareholders, requires shareholders to monitor directors. Monitoring is therefore a form of private regulation that allows shareholders to safeguard their own welfare by preventing directors acting negligently or engaging in self dealing, which indeed, is the general rationale offered for shareholder monitoring of directors.

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on agents' activities. See E. Fama E *Agency Problems and the Theory of the Firm* (1980) 88 J. Pol. Econ. 288.

[68] *Ibid.* page 741.

[69] R. Kraaakman, P. Davies, H Hansmann. G. Hertig, K. Hopt. H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, (Oxford, O.U.P. 2004), chapter 2.

In *The Wealth of Nations'*, Smith was clear that shareholders had such a controlling influence over directors when he stated that:

> "The trade of the joint stock company is always managed by a court of directors. The court, indeed, is frequently subject, in many respects, to the control of the general court of proprietors [shareholders][70]".

Similarly, in the models of the company presented by Alchain[71], Alchian and Demsetz[72] and Jensen and Meckling[73] the primary responsibility for the disciplining of directors is placed on the shareholders. Markets provide some assistance in this task[74], but fundamentally the burden is placed on shareholders and is justified by the proprietary nature of the shareholders' interest in the company[75]. Shareholder monitoring is also a central aspect of the model of the company put forward by adherents to the nexus-of-contracts theory who describe agency problems as problems which can be solved by shareholders negotiating sufficiently binding contracts with directors to ensure that directors act in a way which maximises shareholder welfare and prevents opportunism[76]. Some assistance in preventing agency problems is also given by the effect of market forces[77]. The emphasis on

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[70] *Supra* note 67 at page. 741.
[71] A. Alchain. *Corporate Management and Property Rights*, in *Economic Policy and the Regulation of Corporate Securities*, (Ed) G. Manne. (Washington, American Enterprise Inst. Public Policy Res. 1969).
[72]A. Alchain, H. Demsetz, *Production, Information Costs and Economic Organization.* (1972) A.E.R 62.
[73] M. Jensen, & W. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, (1976) J. Financial Econ. 305.
[74] See, Alchian *supra* note 71.
[75] The notion that shareholders have a proprietary interest in corporations has, however, been challenged by Paddy Ireland, see Ireland, *Company Law and the Myth of Shareholder Ownership* (1999) 62 M.L.R. 32.
[76]Jensen and Meckling, *supra* note 73 and F. Easterborook, & D. Fischel, *The Economic Structure Of Corporate Law*, (Cambridge, Mass, Harvard University Press, 1991).
[77] See for example Easterbrook and Fischel, *ibid.*

private bargaining as a sufficient regulatory control fits well into the contractualists' general view of the company as a complex web of contracts and allows monitoring problems to be explained away as problems of contractual negotiation, which can be solved by contractual *re*-negotiation. It is no surprise that a logical consequence of viewing director-monitoring problems as problems of contracting is the rejection of the need for mandatory regulation of directors[78].

The main assertion of contractual analysis is therefore that agency problems can be resolved thorough *ex ante* measures, rather than *ex post* through expensive monitoring of directors' actions when in office. However, many scholars who analyse the firm in contractual terms recognise that shareholder monitoring through contract is supplemented by fiduciary duties, which are explained as necessary due to the prohibitive cost of reducing the elaborate terms necessary to solve all agency problems into a contract[79]

That private shareholder monitoring, based on proprietary notions, is a central aspect of the State's approach towards the regulation of directors is evident from the government's response to the recent resurgence of the 'fat cat' pay debate. In her forward to the consultation document *"Rewards for Failure" Directors Remuneration – Contracts, Performance and*

[78] See, P. Ireland, *Implicit Contract as Ideology,* in D. Campbell, H. Collins and J. Wightman, (eds) *Implicit Dimensions of Contract*, (Oxford, Hart Publishing, 2003).
[79] F. Easterborook, & D. Fischel, *The Economic Structure of Corporate Law*, *supra* note 76, pages 90-93.

Severance[80], the Secretary of State for Trade and Industry, Patricia Hewitt, declared that the Government has:

> "made clear that setting directors' pay…is a matter for those companies and their shareholders. *It is for shareholders as the owners of the company* to ensure that remuneration levels and structures *provide the right incentives and that directors are held to account for company performance* [my emphasis] [81]"

She further states that:

> "The Government is committed to a framework of company law and corporate governance which enables the owners of companies to exercise their responsibilities in an effective way and promotes high standards of shareholder activism[82]"

The existence of a regulatory relationship between shareholders and directors is therefore clearly felt.

2.2.2 Agency Problems and Third Parties.

Other groups within the corporate sphere who suffer potential agency problems also have to utilise methods of private 'monitoring' to avoid agency costs. In this instance 'monitoring' will most likely have its basis in a contract concluded between the third party and the company and, as such, forms no part of the prevalent models of the company. However, third parties face two distinct monitoring tasks. First they must monitor the 'company' as whole to ensure that it does not seek to maximise its own

80 (London, Department of Trade and Industry, 2003).
81 *Ibid*, *'Forward by the Secretary of State Patricia Hewitt'*, page 5.
82 *Ibid*, page 6.

welfare at their expense. Second, however, third parties will need to monitor the conduct of directors to ensure that they do not seek to maximise their personal welfare (as distinct from the company's welfare) in a manner that is detrimental to third parties. Self-dealing by a director (whereby he appropriates company assets for himself) is a good example conduct detrimental to third the welfare of shareholders and trade creditors, customers and employees[83] because self dealing is likely to reduce the company's assets and hence the ability of the company to settle its debts. However, in respect of this agency problem, shareholder monitoring of directors is of assistance to creditors because, if successful, it ought to reduce 'negligence and profusion' and consequently reduce the need for creditors to monitor directors. . Therefore shareholder monitoring of directors, benefits not only shareholders themselves, but also third parties who deal with the company. As such, shareholder monitoring is an important tool in establishing effective private regulatory controls on directors, which reduces the likelihood of undesirable conduct, to the benefit of several parties. Consequently, when shareholders monitoring fails several groups stand to lose out. If creditors wish to protect themselves from the agency problem arising between them and corporate controllers, they therefore have to incur the expense of attempting to control 'negligence and profusion' themselves. In so far as creditors are more remote from the

[83] Unless otherwise indicated I shall use the general term 'creditors' to refer to all of these groups.

company than shareholders those expenses could be considerably higher than then those incurred by shareholders.

It should, however, be stressed that shareholder monitoring does not erase all risk which third parties face from companies and their directors, as for example, in the situation where shareholder (i.e. company) and creditor interests directly conflict. In this situation the directors are, provided the company is solvent, bound to prefer the interests of shareholders because of their duty to act *bona fide* in the best interests of the company[84], in which case creditors' only protection from agency problems lies in bargaining with the company. Nevertheless, the monitoring of directors by shareholders lies at the heart of the corporate governance model in the Anglo-American legal tradition as the principal means to prevent opportunism by directors. This is clearly evident from the fact that the fiduciary duties of directors, developed by the common law, are owed the company[85], which essentially means the majority of the shareholders

[84]Generally directors are required to act "*bona fide* in what they consider...is the interests of the company and not for ant collateral purpose" per Lord Greene MR in *Re Smith and Fawcett* [1942] Ch. 304 at 306. Any act that is not bona fide in the interests of the company would be *ultra vires*, as was the case in *Hutton v West Cork Railway Company* (1883) 23 Ch.D 654. However, in the final stages before a company becomes insolvent the duty to the company becomes subsumed by a duty to creditors. The precise instances where directors owe a duty to creditors have not been comprehensively defined, but it appears from the authorities that such a duty is owed; (i) when the company is insolvent (*West Mercia Safetywear v Dodd* [1998] 4 BCC 30; where the company is near to insolvency (*Brady v Brady* [1988] 3 BCC 535; where there is a 'risk' of insolvency (*West Mercia Saftywear v Dodd*) or even where the company is going through a period of financial instability (*Facia Footwear Ltd v Hinchcliff* [1998] 1 BCLC 218). For academic discussion of the duty to creditors see D. Prentice, Creditors Interests and Directors Duties (1990) 10 OJLS 265 and A. Keay, *The Directors Duty to Take into Account the Interests of Company Creditors: When is it Triggered?* (2001) 25 Melbourne University Law Review 315.
[85] *Re Smith and Fawcett, ibid.*

However, whilst the prevalent model[86] of the company clearly advocates private shareholder regulation as the means to control undesirable conduct by directors, it has long been recognised that such monitoring is far from guaranteed to be successful and in this, the roots of public regulation of directors can be found.

2.3 Passivity, Ignorance and Managerialism.

That shareholders are often unwilling or unable to monitor directors is an old story. Smith, for example, noted that:

> " the greater part of those proprietors seldom pretend to understand anything of the business of the company; and...give themselves no trouble about it, but receive contentedly such...dividend...as the directors think proper to make them"[87].

In many ways Smith's observation reflects the nature of shareholding in the eighteenth century, when Joint Stock Companies were viewed as a vehicle for the excess capital of the public to be put to good use by entrepreneurs and expert managers. The public at large who invested in railway companies, for example, could hardly be expected to understand the best way to manage a railway company. Therefore, the likelihood of them

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[86] See for example, M. Stokes, *Company Law and Legal Theory* in W. Twinning, (ed.) *Legal Theory and Common Law*, (Oxford, Blackwell, 1986) in which the author describes shareholder regulation as part of 'the model' of company law. Stokes also draws an analogy between the regulatory nature of the shareholder – director relationship and the relationship between a government (executive) and Parliament. The analogy has also been drawn in previous editions of a leading company law text. See, *Gower's Principles of Modern Company Law,* P. Davies, *Gower's Principles of Modern Company Law,* 6th Ed, (London, Sweet & Maxwell, 1997), page 15.

being effective monitors of management must always have been debatable. The advent of general limited liability in 1855 is likely to have reduced still further the prospect of active shareholder monitoring. For by allowing shareholders to put a cap on the financial risk that they face from investment, limited liability reduces the incentive for shareholders to monitor directors[88].

The recognition that shareholders are often 'passive and ignorant' of the company's affairs significantly undermines the notion that private shareholder monitoring is an effective control on undesirable conduct by directors in itself[89]. However the problems with shareholder monitoring do not stop with general passivity and ignorance, for the weakness of many shareholders in the face of powerful management represents a further set back for the notion of shareholder monitoring.

2.3.1 The Division of Ownership and Control.

Throughout the nineteenth and early twentieth centuries there was a rapid expansion of share ownership such that the average number of shares held by investors, relative to the total shareholding in large companies declined to a very small percentage of the total. Berle and Means in *The Modern Corporation and Private Property* discussed the effects of this

[87] A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, *supra* note 67, page 741.
[88] Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra*, note 76.
[89] On the changed role of the shareholder see, J. Hill, *Changes in the Role of the Shareholder*, and R. Austin. *Commentary on Hill*, both in, R Grantham & C Rickett, (eds) *Corporate Personality in the 20th Century*, (Oxford, Hart Publishing, 1998). For a comparative discussion of shareholder oversight as a regulatory control on corporate

phenomenon[90] and argued that the consequence of this fragmentation of shareholding was to attenuate communication and the flow of information between the board and shareholders and between the shareholders themselves to such a degree that effective discretionary power over large corporations lay in the hands of the active management, i.e. the directors[91]. This phenomenon was termed 'managerialism'[92]. Of course, in a strict sense the ownership and control of large corporations always had been separate, at least in the eyes of the traditional corporate governance model. However, what Berle and Means claimed was that the smallness of the stake most shareholders held in such companies exacerbated the pre-existing problems of passivity and ignorance to such a degree that not only had it became *unlikely* that shareholders would exercise their monitoring powers (as Smith noted), it became almost *impossible*. In effect Berle and Means' thesis demonstrated that shareholder monitoring, either *ex ante* or *ex post* could not solve 'agency' problems in large corporations[93].

management, see, L. Lowenstein, *Financial Transparency and Corporate Governance: the United States as a Model?* also in Granthem and Rickett.

[90] A. Berle, & G. Means, The *Modern Corporation and Private Property*, 1967 edn, (New York, Macmillan, 1932).

[91] For another view of the consequences of the division of ownership and control in companies see, M C. Jensen. & E. F. Fama, '*Separation of Ownership and Control*', (1983) 26 Journal of Law and Economics 301.

[92] According to Berle and Means 'managerialsim' could also arise where a company was completely owned by managers; through control of the company by managers who hold a majority of shares; through managers controlling the company by means of some legal device and through minority control. The majority of their thesis, however, concerned the management control caused by the division of ownership and control.

[93] It has also been argued that 'managerialism' illustrated that shareholders could no longer be looked upon as the 'owners' of the corporation. See for example Ireland, *Company Law and the Myth of Shareholder Ownership, supra* note 75.

In Britain the findings of Berle and Means were reflected in the report of the 1945 Cohen Committee[94], which observed that the:

> "illusory nature of the control theoretically exercised by shareholders over directors has been accentuated by the dispersion of capital among an increasing number of small shareholders."[95]

The committee's research showed that, as was the case in the U.S, the share capital of many large British companies had become dispersed during the 1930's and 40's[96] and recommended that the weakness of shareholder control this brought about necessitated reform of English company law. 'Managerialism', did not however, cause the committee to lose faith in shareholder monitoring as an effective way to prevent opportunism. Rather, the committee felt that the most desirable response to managerialism was to increase the flow of information to shareholders by forcing directors to disclose certain information and to increase the matters that the law required the general meeting to ratify.

2.2.2 The Response to Managerialism.

The response to failings in shareholder monitoring adopted by the Cohen committee continues to influence policy makers to the present day. The Company Law Review Group, for example, recently stated that it

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94 The Board of Trade, *Report of the Committee on Company Law Amendment*, (Chairman Mr Justice Cohen) Cmnd. 6659 (London, HMSO, 1945). See also *Report of the Company Law Committee*, (Chairman Lord Jenkins) Cmnd. 1749 (London, HMSO, 1962) para.105, which documented the same phenomenon.
95 'Cohen Committee', *ibid.* para 7
96 *Ibid.*, paras., 40 and 125.

believed that it was the "ultimate powers of control of shareholders" which should ensure corporate powers were not abused, and that:

"[f]or this approach to work effectively, shareholders need timely and high quality information to enable them to assess the performance of the company and the directors' stewardship of their assets"[97]

Prevailing policy is therefore based on the belief that effective shareholder monitoring of directors *is* possible where shareholders are properly informed about the activities of directors. Thus, the State's response to problems with private shareholder regulation has not been to completely replace it with public regulation, rather, it has sought to facilitate private regulation through the imposition of mandatory rules[98], such as forcing directors to disclose certain information to shareholders[99] and empowering the general meeting[100], which is intended to create the ideal conditions in which shareholder monitoring will take place.

As such, one of the major themes of company law regulation for the past 60 years has been the proliferation of company law rules that force directors to disclose financial information to shareholders and increase the powers of the general meeting[101]. However, the effectiveness of this strategy must be questioned in light of the general tendency for shareholders to be

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[97] Company Law Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, (London, Department of Trade and Industry, 2000).
[98] The use of mandatory rules to minimise undesirable conduct by directors is the response to the failing of shareholder monitoring favoured by one eminent author. See M. A. Eisenberg, *The Structure of the Corporation* (Boston, Little Brown, 1976).
[99] See part VII Accounts and Audits, Companies Act 1985.
[100] See for example the provisions of Part XI of the Companies act 1985.
[101] See for example the Directors Remuneration Report Regulations 2002 (SI 2002/1986). These regulations sought to address concerns over excessive boardroom remuneration by requiring a remuneration report to be laid before the general meeting and to allow

passive and ignorant noted by, amongst others, Smith. For, even if the particular problems of managerialism are overcome it is by no means certain that shareholders will be effective monitors. Indeed, the current emphasis on encouraging institutional investors[102] to become active monitors suggests that increasing the flow of information to ordinary shareholders has not stimulated sufficient monitoring. However, even the likely effectiveness of institutional investors can be doubted as numerous studies and a recent report commissioned by the Treasury[103], has cast doubt upon the likelihood of institutions being effective monitors of management.[104] It must also be noted that institutional investment is only a possible source of increased

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shareholders an 'advisory vote' on the report. The regulations also force enhanced disclosure of directors' employment contracts.

[102] The proportion of shares vested in institutional investors rather than private individuals, which was already substantial in 1970's, rapidly expanded in the 1980's and 90's, such that by the late 1990's well over 50% the UK equity market was owned by institutions. The importance of institutional investment for shareholder monitoring is that it concentrates share ownership in the hands of a few professional investment organisations This concentration ought to reduce 'passivity and ignorance' as well as alleviating the problems of managerialism in modern firms. For, as institutional shareholders hold shares on a professional basis it could be expected that they would be able to draw on a pool of expertise in assessing the successes of directors and thus could be effective monitors both *ex ante* through contractual bargaining and *ex post* in on-the-job monitoring.

[103] P. Mynres, *Institutional Investment in the UK; A Review*, (London, HMSO, 2001). The report found evidence of a general reluctance amongst institutional investors to tackle under-performance in investee companies, particularly a reluctance to take pre-emptive action to prevent troubled companies developing serious problems, see paragraphs 5.73-5.94. The report noted (*ibid.* para. 5.84) that in 1999 the voting levels of Institutional Investors were low at around 50%.

[104]See, Stapledon G. *Institutional Shareholders and Corporate Governance* (Oxford, Clarendon Press, 1996), who, notes that institutional monitoring of directors is only one element of a complex system of corporate control which presents certain difficulties to effective monitoring by institutional investors. Stapeldon further states that if an institutional investor is dissatisfied with company management he is much more likely to sell his shares in the company rather than attempting the difficult, expensive and time-consuming task of motivating his fellow shareholders into regulatory action. See also, B. Black, and J. Coffee, *'Hail Britannia'? Institutional Investor Behaviour Under Limited Regulation'*, (1994) 92 *Michigan Law Review* 1997. Black points out that the willingness of institutional investors to question the actions of the board could be limited by other relationships, both corporate and personal, which the institution has with the company.

monitoring in listed companies and has no relevance to monitoring in other companies, where problems of passivity will remain.

Indeed, even as far as public companies with potentially active shareholders are concerned, the increasing prominence given to other monitoring strategies, such as increasing the role and effectiveness of non-executive or independent directors[105] would appear to be a response to the limitations of shareholder monitoring *per se* rather than the effects of managerialism. For, as the corporate scandals of the late 1980s and early 1990s demonstrated[106], the panoply of mandatory rules in company law did not prevent serous instances of undesirable conduct.

It is therefore surprising that shareholder monitoring continues lie at the heart of the Companies Act provisions and government policy[107]. However, despite the faith that is placed on shareholder monitoring the existence of disqualification suggests at least some acknowledgement that undesirable conduct *cannot* be controlled through private regulation. How then, does disqualification fit with the focus on private shareholder monitoring?

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[105] On non-executive directors see generally B. Cheffins *Company Law: Theory Structure and Operation* (Oxford, Claredon Press, 1997), chapter 13. The *Combined Code on Corporate Governance* (London, Financial Reporting Council, 2003) assigns a special regulatory role to non-executive directors, particularly in terms of nominating persons to the board and supervising remuneration packages. The provision A.3.1. of the code states 7 factors against which the 'independence' of directors should be judged. Principle A.3 of the code states that boards should include a balance of executive and non-executive directors, such that no individual or group of individuals is able to dominate the board. There has recently been a flurry of official activity concerning the regulatory potential of non-executive and independent directors aimed at maximising their impact. See, D. Higgs, *A Review of the Role and Effectiveness of Non-Executive Directors* (London, The Stationary Office, 2003)

[106] For example, the collapse of the Maxwell Group Plc and PolyPeck International.

[107] See, for example, the statement of the Secretary of State for Trade and Industry, at 2.2.1, *supra*.

The answer to this question would seem to be that disqualification is primarily aimed at companies where private monitoring is impossible and thus the policy that relies upon it ineffective. That is not to say that the focus on (private) shareholder regulation outlined above necessarily excludes public regulation in cases where shareholder monitoring can take place. For where private regulation fails due to passivity and ignorance there may be scope for public regulation of directors. However, it is suggested that disqualification largely responds to structural breakdowns in the theory of shareholder monitoring in many companies that prevents the regulatory devices discussed above from effectively tackling undesirable conduct.

2.4 The need to Regulate Directors of Owner-managed Companies.

2.4.1 Shareholder Monitoring.

The corporate governance model at the heart of the Anglo-American tradition is based upon the joint stock company of the 19th century, a central feature of which (as I have discussed) was that directors' conduct would be monitored by a body of shareholders who were materially different persons from the managers (directors) of the company. Most corporate theorists accept this as the basis for their models of monitoring[108] and debate tends to focus on how to ensure adequate monitoring by shareholders takes place

[108] See, Alchain, *supra* note 71, Jensen and Meckling, *supra* note 73 and Easterbrook and Fischel, *supra* note 79

within this model. So, whilst some favour mandatory legal rules (such as disclosure obligations) to achieve this[109], and some analyse it in terms of the nexus-of-contracts[110] all appear to be agreed on the basic point that shareholders should monitor directors. In large companies with divided ownership and control the necessary conditions for such strategies to be successful exist and there is no reason why shareholders should not regulate *should they be willing and able to do so.* In many smaller companies however, the conditions for shareholder monitoring do not exist and any regulatory strategy that relies upon shareholder activism is simply not viable. For, where shareholders are also directors, the general meeting of 'shareholders' cannot have an effective monitoring function.

2.4.2 The Dominance of Small Companies.

The DTI's annual statistical publication '*Companies in'* shows that over 99% of all registered companies in England and Wales are private companies[111], and that most (1,235,000 out of the total 1,706,700) have an issued share capital of £100 or less[112]. Research carried out for the Company Law Review showed that 70% of registered companies had only one or two shareholders, and 90% had less than 5 shareholders[113] and recent statistics from the Department of Work and Pensions estimate that there are one third

[109] See, for example, M. Eisenberg, *The Structure of Corporation Law*, 89 Col. Law. Rev, 1461.
[110] For example, Jensen & Meckling, *supra* note 73, Fama, *supra* note 122 and Easterbrook and Fishel, *supra* note 76.
[111] *Companies in 2003-2004* (London, HMSO, 2004), table A2.
[112] *Ibid,* table A7. The particular problems posed for shareholder oversight of directors in owner-managed companies are note by Lowenstein, *supra*, note 89.
[113] See Company Law Review, *Modern Company Law For a Competitive Economy, Developing the Framework* (London, DTI, 2000), para 6.9.

of a million companies which employ only their owners[114]. Thus, the 'average' company is private with a very small share capital and only one or two shareholders, who in all probability, also sit on the board[115]. Such companies have often been called 'quasi-partnership companies', but this description would be misleading in companies with only one active director who owns a majority of the company's shares,; such entities are little more than 'incorporated sole traderships'. Of course in terms of capital, quoted public companies dominate the far greater number of private companies[116]. However, that does not mean that company law should ignore the regulatory problems that exist in non-quoted companies, for deficiencies in the control of directors in these companies has a significant impact on their creditors.

2.4.3 The Breakdown of the Model.

In their consideration of the monitoring of directors in small companies, emphasis is often placed on *ex ante* bargaining between shareholders as a safeguard against 'negligence and profusion' . Thus, is has been variously stated, in academic literature that "[i]n closely held corporations, shareholders often will bargain out at least some structural and distributional rules"[117], or "[a]s well as having the legal status of contract the articles [of private Companies] can also be meaningfully described as

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[114] Department of Work and Pensions press release, "*Good News for Small Companies – Kennedy*" 14th October 2004.

[115] A situation common too many private companies since their inception. Indeed, this was so in the case which is seen by many as one of the foundations of limited liability in English law: *Salomon v Salomon* [1897] A.C. 22, where Mr Salomon was both the majority shareholder and director of his (private) company.

having been determined by a contractual process",[118] or even "[i]n their deliberations courts have in different ways acknowledged the personality-rich, contractual nature of shareholding in such [private] companies".[119]

However, the claim that bargaining will take place (and hence act as a restraint on undesirable conduct) in small companies, must be doubted in companies that are owner-managed, of which there are many. In such companies shareholder monitoring, either *ex ante* through contractual bargaining or indeed *ex post* through on-the-job monitoring, is largely impossible. For, where there is unity of ownership and control between the board and the general meeting no *ex ante* bargaining over the structural rules of the company will take place and neither will *ex post* monitoring of directors by shareholders occur. As such, monitoring mechanisms that rely upon an independent body of shareholders for their effectiveness (such as *ex ante* bargaining), are useless in companies where both owners and managers are the same people. As such directors of owner-managed companies will not be subject to the discipline of private shareholder regulation.

Of course, one should take care to avoid too broad a generalisation about the probability of shareholder monitoring taking place in the 'average company'. At one end of the spectrum, it is clear that no monitoring or *ex post* or *ex ante* will take place in the one man company, however, in the two

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[116] In 2004, for example, the issued capital of the largest 2% of registered companies accounted for over 98% of the total capital issued by English and Welsh companies, see *Companies in 2003-2004* (London, DTI, 2004), table A7.

[117] Eisenberg, *The Structure of Corporation Law*, 89 Col. Law. Rev. 1461 at 1463.

[118] J. Parkinson, *Corporate Power and Responsibility* (Oxford: Claredon Press, 1993), at page 183.

shareholder, quasi-partnership, company we can be less certain. If both shareholders are on the board it is likely at least some 'bargaining', will take place. However, any such bargaining over structural rules is unlikely to constitute an effective monitoring mechanism. In such companies bargaining is likely to be self-interested and be unconcerned with preventing undesirable conduct so long as it benefits both owner-managers. In other 'quasi partnership' companies shareholders may entirely passive and take no interest in the company's affairs, a scenario similar to that in *Salomon v Salomon Ltd*[120]. Again, in such a company, no meaningful bargaining over structural rules, or *ex post* monitoring is likely to take place. Of course, the precise scope of monitoring by fellow owner-managers will vary from company to company. Nevertheless, what is obvious is that owner-managed companies do not conform to many of the assumptions that underlie the idea of shareholder monitoring as a mechanism to control undesirable conduct uses.

2.4.4 Agency Problems in Owner-Managed Companies.

However, before discussing the potential problems that the breakdown of shareholder monitoring in owner-managed companies causes, it is important to state that the complete unity, or a substantial overlap, of ownership and control in the 'average' company solves at a stroke the 'agency' problems associated with a division in ownership and control. For,

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[119] P. Ireland, *Property and Contract in Contemporary Corporate Theory*, [2003] Legal Studies 453, at page 479.
[120] [1897] A.C. 22.

in owner-managed companies directors have control over their own money and in Smith's words 'negligence and profusion' need *not* prevail in their management of the corporation[121]. Thus, the perfect alignment of welfare goals that owner-management brings[122] removes the need for directors to be monitored either *ex ante* or *ex post* in so far as monitoring is intended to prevent directors acting opportunistically to the determent of shareholders.

This therefore brings us to the crucial question of whether there is 'need' to regulate director/shareholders of owner-managed companies if the agency problem that has preoccupied the regulation of directors is resolved naturally. The answer to this question must be that in so far as regulation is intended to prevent directors from maximising their own welfare at the expense of shareholders, it is not needed in owner-managed companies. However, resolution of this agency problem is not the only factor supporting the idea that directors' conduct should be regulated in some way.

2.4.5 Protecting Creditors.

Analysis of shareholder monitoring should not confine itself to viewing shareholder regulation solely in relation to the agency problem that arises between shareholders and directors, because whilst the shareholder-director agency question is the main motivating force behind shareholder monitoring it must also be viewed, in a broader context, as an important general control on undesirable conduct. The twin doctrines of separate

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[121] Smith, *supra* note 67.
[122] See Fama, *Agency Problems and the Theory of the Firm* (1980) 88 J. Pol. Econ. 288, pages 295-296.

corporate personality and limited liability make such control extremely important. For, the notion that those who exercise corporate power are constrained in their use of it is inherent in a model that divides power between shareholders and directors. In the 'classical' company, directors' day-to-day management is subject to review by shareholders and also shareholders exercise of corporate power is to some extent curtailed by the need to 'bargain' with directors. Thus, each group within the company is to some extent accountable to the other for its activities. Of course, the extent to which the division of power between shareholders prevented the abuse of corporate power in relation to the workforce, for example, can be exaggerated. Welfare maximising shareholders and directors are free to conspire to satisfy their own welfare goals at the expense of such groups. However, where successful monitoring takes place it should at least protect creditors from dishonesty or negligence on the part of directors.

Therefore, in many private companies the absolute *unity* of ownership and control poses as many problems as does the *separation* of ownership and control in public companies. For, whereas the separation of ownership and control in larger companies creates the danger that a lack of monitoring will lead corporate managers (directors) to pursue their own welfare goals at the expense of shareholders, an absolute *unity* of ownership and control creates the danger that a lack of monitoring will cause owner-managers to pursue their own welfare goals in a fraudulent, negligent or reckless manner, to the detriment of creditors. In short, when shareholder monitoring fails, undesirable conduct by directors is more likely and this conduct primarily impacts on creditors.

This increased agency problem between owner-managed companies and their creditors is not resolved by the majority of company law rules which can be classed as regulatory in nature. For, much legal regulation of directors (as has been discussed) relies on action by independent shareholders to be effective[123]. Thus, in an owner-managed company the director need not be concerned even with his fiduciary duties, such as the duty to act honestly and for proper purpose, because such duties cannot effectively be enforced against him. For as the only shareholder, he owes such duties only to himself. Thus, he is free to engage in acts such as self-dealing with little risk of sanction[124]. However, whilst in this scenario the breach of fiduciary duties would clearly not harm 'the shareholder' of the company, it would have a detrimental impact upon the company's creditors. Therefore, the lack of any monitoring in owner-managed companies leaves directors free of internal regulatory controls on their conduct and, as such, exposes creditors to a degree of negligence and profusion that is not the case where shareholder monitoring is effective.

[123] An exception to this would be the criminal sanctions contained in Part X of the Companies Act 1985, which obviously do not rely on shareholder activism to be applied. However, the instances where the State imposes criminal sanctions are, on the whole, limited to breaches of specific provisions of the Act and not concerned with the task of ensuring that directors act honestly, for proper purpose and with due care.

[124] The only instance in which owner-managers would be subject to 'regulatory action' for harm done to the company is in insolvency where the liquidator can apply to court for the recovery of certain proceeds of self dealing (e.g. transactions at an undervalue contrary to section 238 of the Insolvency Act 1986) as well as seeking a remedy for harm done to the company as a result of a breach of fiduciary duties.

Thus, the failure of shareholder monitoring in owner-managed companies creates conditions in which undesirable conduct can occur and go unchallenged. As such it would appear to create a real need for regulation. However, before moving to a firm conclusion as to the impact this regulatory failure on the need for public regulation, it is worth pausing to consider whether other mechanisms can act as a break on undesirable conduct not only in owner-managed companies, but also in larger companies. For, several authors such as Manne[125] and Alchian[126], have asserted that shareholder monitoring is supplemented by discipline of markets, which can themselves resolve agency problems. If it were the case that markets could control undesirable conduct, then the need for regulation created by the structural failure of shareholder monitoring in owner-managed companies and failure due to passivity and ignorance in larger companies, could not so easily be seen as necessitating public regulation in the form of disqualification. The regulatory impact of three markets, the product market, the market for directors and the market of corporate control, have been particularly vigorously advocated as a mechanism to control directors conduct and will be considered here.

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[125] H. Manne, *Our Two Corporation Systems: Law and Economics*, (1967) 53 Va. L. R. 259.

[126] A. Alchain, *Corporate Management and Property Rights*, in H. Manne, (ed), *Economic Policy and the Regulation of Corporate Securities*. (Washington, American Enterprise Institute for Public Policy Research, 1969).

2.5 The Effect of 'Markets' on Directors' Conduct.

2.5.1 The Product Market.

The central claim of other than financial economics is that the market for a company's product will effectively prevent its directors from acting in an improper manner. For, when directors act improperly, the firm will become inefficient, its products uncompetitive and falling sales in the product market will plunge the firm into insolvency[127]. However, Eisenberg doubts the effectiveness of product markets due to the fact that imperfect markets may not convert misconduct by directors into insolvency[128]. In addition to such concerns, it is also unclear, for example, whether certain types of conduct that are regarded as undesirable in the current legal environment, would have the effect of making a firm uncompetitive and therefore be effectively sanctioned by the product market. Research undertaken in this thesis reveals that a large proportion of directors are disqualified because it is found that they have 'retained crown money', i.e. not paid taxes due by the company[129]. It is unlikely, that the product market would ever have the effect of preventing this type of action because successfully withholding taxes would effectively cut a company's cost-base and make it *more* competitive. However immoral or illegal such an action may be, it certainly could have the effect of making a company's products

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[127] H. Butler, *The Contractual Theory of the Corporation*, (1989) 11 Geo. Mason U.L. 99.
[128] Eisenberg, *supra*, note 117.
[129] See chapter 4, below.

less expensive. Thus, the product market would not *per se* convert a common form of director misconduct into insolvency.

Nonetheless, even if the product market did convert misconduct into insolvency, the remedy provided is drastic and does not help satisfy the welfare goals of either creditors or shareholders. Indeed, insolvency represents a loss for all parties concerned. Thus, the operation of the product market is not an ideal or necessarily satisfactory response to directors' misconduct and can only serve as a mechanism to prevent misconduct continuing indefinitely. The goal for regulation of directors, be it private or public, must surely be to prevent misconduct occurring or deal with it before it leads to insolvency, for insolvency really represents a failure of regulation.

Another problem with the product market, is that by simply converting self-dealing into insolvency (thereby putting an end to abuse of limited liability), it does not prevent the director from re-incorporating another company and continuing his self-dealing. This, however, is not necessarily the fault of the product market, or any other market. In truth, it may be argued that the fault lies with the law in allowing directors of failed companies to become directors without any automatic check on their conduct or even, with owner-managed companies, allowing limited liability status to be as freely available as it is. However, these are arguments that go much deeper than their relevance to product markets and will be analysed in greater depth below[130]. Nevertheless, the conclusion that the product market

[130] See chapters 3 and 9 below.

is not a convincing force to prevent misconduct by directors, either in public or private companies, is clear.

2.5.2 The Market for Directors as Disciplinary Mechanism.

Another 'market' that has the potential to discipline directors is the directors' employment market. Several authors have commented upon the potential of the 'market for managers' as a device to control undesirable conduct, Eugene Fama being a particularly strong advocate of this type of monitoring. Fama[131] argues that the market for managers exerts pressure on companies to reward directors according to their conduct. In this model good conduct by directors is rewarded with larger salaries etc, and bad conduct is penalised by lower wages, and in the worst-case scenario, unemployability. Fama's model seeks to demonstrate at length how the 'contractual settling up' of directors' past conduct would occur and thus seeks to establish that this mechanism aligns the interests of shareholders and directors. Detailed review of the economic calculations and assumptions that underpin Fama's model are not properly the subject of this thesis, however, the likely success of the 'market for managers' as a disciplinary mechanism for directors in England is. Therefore, I assume that Fama's model is empirically viable and that directors' past conduct can be taken into account by the market in setting 'price' for a particular directors services, i.e. that settling up can occur. The focus of this analysis will be whether

[131] Fama, *supra*, note 122.

such settling up is likely to occur in English companies. It will consider the market for managers in terms of private and public companies separately.

2. 5.2.1 The Market for Managers in Public Companies.

Empirical research carried out in the United States found a statistical relationship between company performance and directors/executive salaries[132], however, as Eiesenberg notes[133], the statistical relationship was not strong, showing only a 1.4 cent rise for every $1000 of change in shareholder wealth. However, the theory cannot stand or fall on the results of just one survey. More important are several factors that may conspire to prevent settling up occurring in practice.

In order for any 'market' to work in an efficient manner, it is desirable for sellers (in this case directors 'selling' their services), to be different persons from buyers. In the context of the market for managers, the buyers of directors' services are most often the shareholders acting through the AGM. However, it has been argued in many companies these conditions are not in place because shareholder passivity and ignorance inhibits the control shareholders can actually have over the appointment of directors, because where boards have the power to nominate directors for office (as most do) and control the proxy voting machinery, *de jure* power to appoint directors will lie with existing directors. Therefore, those who may act as buyers of directors' service have strong personal interests in ensuring that the price paid for directors' labour is high. Such links between buyers and

[132] M. Jensen, and K. Murphy, Performance *Pay and Top-Management Incentives*, (University of Rochester Managerial Economics Research Centre Working Paper No. 89-03, 1989).

sellers could prevent contractual settling up taking place as the buyers may take self-interested factors into account (such as personal wages expectations) when purchasing labour from the market.

In the UK this problem has been addressed by the Cadbury Committee[134] in its recommendation that nominations for appointment to the board should be made by a committee comprising of a majority of non-executive directors. This recommendation has found expression in principal A.5.1. of the Combined Code[135]. These efforts to resolve the conflict of interest, combined with some willingness by institutional shareholders to play an active part in corporate governance are welcome attempts to improve the functioning of the market for managers. However, significant problems remain, not least regarding the degree of independence that non-executive directors really have. Such directors remain *directors* who are responsible for recommending the appointment and remuneration of other *directors* (including non-executives). Therefore, the appearance of a conflict of interest remains and the effectiveness of non-executive directors is still the subject of debate[136]. For example, the appointment of Rupert Murdoch's son to the post of chief executive of BskyB in November of 2003 was

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[133] Eiesenberg, *supra* note 117, page 1490.
[134] *Report of the Committee on the Financial Aspects of Corporate Governance*, (London, Gee Publishing, 1992). See also the *Hampel Report, Committee on Corporate Governance: Final Report*, (London, Gee Publishing, 1998).
[135] *The Combined Code on Corporate Governance*, (London, Financial Reporting Council, 2003).
[136] The events surrounding the collapse of PollyPeck International Plc demonstrated that it can often be unrealistic to expect non-executive directors to control powerful managers. See generally *Re PollyPeck International* (No 2) [1994] 1 BCLC 574. The effectiveness of non-executives was most recently the subject of a report requested by the DTI and Treasury. See, Higgs, *Review of the Role and Effectiveness of Non-executive Directors*, *supra* note 105.

tainted by accusations that the non-executive directors responsible for recommending the appointment were too close to the company chairman...who happened to be Rupert Murdoch. Further, the requirement that nomination to the board be dealt with by special committees is only binding on companies listed on the L.S.E., to which the Combined Code applies. Public companies not listed are not required to make this arrangement and the traditional problem of conflicting interests remain.

Therefore, the potential conflict of interest in a system that has directors' appointments and pay recommended by other directors (whether executive or non-executive) is a barrier to the effective functioning of the market for managers in many public companies. Perhaps the best hope for this form of monitoring would be to require genuinely independent *shareholders* to vet nominations to the board. However, even with increasing signs of institutional shareholder activism, it is likely that the high transaction costs involved in inquiring into a director's past conduct and undertaking the 'settling up' process in determining his remuneration would be a disincentive even for institutional shareholders to undertake the 'settling-up' process. Some reliance upon the recommendations of the board is therefore inevitable. Thus, the market for managers in public companies is an imperfect disciplinary mechanism.

2.5.2.2 The Market for Managers and Owner-Managed Companies.

In his analysis of the operation of the 'market for managers' in owner-managed companies, Fama recognises that traditional market principles do not apply. However, he argues that the owner-manager was still subject to market discipline because he "consumed on the job" and therefore "could not avoid full *ex post* settling up with himself as a security holder"[137]. His reasoning appears to be that any misconduct committed as a director will be paid for as a shareholder, presumably through decreased business or in the case of sustained misconduct, insolvency. However, insolvency or decreased *company* profits do not necessarily mean that the owner-manager suffers a pecuniary loss from misconduct. If, for example, the misconduct included self-dealing on the part of the owner-manager, insolvency would not *per se* deprive him of the benefits obtained through the self-dealing. Similarly a reduction in profits to the *company* would not automatically mean that the owner-manager pays for misconduct if he directly appropriates corporate assets that causes decreased profits. Further, mismanagement of the company would not, due to the privilege of limited liability, mean that an owner-manager would normally have to contribute to company debts[138] if insolvency did occur. Also, insolvency would not prevent the owner-manager incorporating a new company and becoming a director again. Therefore, it is far from certain that any 'settling up' which may take place would be detrimental to the owner-manager in a meaningful and remedial sense. Indeed, the privilege of limited liability ensures that

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[137] E. Fama, *Agency Problems in the Theory of the Firm,* (1980) 88 J. Pol Econ. 288.
[138] Only in instances where the courts agree to 'lift the veil' will director/shareholders be required to contribute to debts in insolvency. See for lifting the veil, *Adams v Cape Industries* [1990] Ch. 433. Instances where statute imposes liability include wrongful of fraudulent trading contrary to sections 213 and 214 of the Insolvency Act 1986, see generally, P. Davies, *Gower and Davies' Principles of Company Law,* 7th Ed, (London, Sweet & Maxwell, 2003), pages 194-200,

most of the losses from misconduct would be borne by creditors and any settling up as far as the director is concerned would not be onerous.

Therefore, the extent to which the demand for the services of directors in owner-managed firms can lead to contractual settling is questionable. And the fact that normal market principles do not apply to owner-managed companies cannot be ignored. For, the 'settling up' process can only take place where an element of competition for managers exists. However, in owner-managed companies, there is no such competition for services as the owner simply appoints himself manager. An owner-manager is not likely to undertake the 'settling up' process in appointing himself a director and deciding his own salary. He is most unlikely to assess his past performance as a manager and pay himself an appropriately lower salary if his conduct was not good. Indeed, it is unlikely that he will attach much blame to himself for any past corporate mishaps. Further, even if some directors undertook this process, the settling up model hardly seems a sufficient monitoring mechanism in itself. In essence the incentive to behave well is removed in owner-managed companies because salary is not determined by an independent assessment of conduct. Therefore the discipline of the market for managers is not a sufficiently plausible regulatory strategy for owner-managed companies.

2.5 3 The Market for Corporate Control.

Another market that is said to exert control on directors' conduct is the market for corporate control. Manne's basic claim is that the market for corporate control is "extraordinarily important" to the corporate governance system and that it makes a vital contribution to the regulation of directors[139]. He argues that if the managers of a corporation act against the best interests of the corporation the value of the company's shares will fall and it will become vulnerable to takeover, in so far as the lower share price presents an opportunity for other entrepreneurs to obtain the company at a reduced price. If a takeover should then occur it, would, in all probability, lead to existing mangers loosing their jobs. Consequently Manne asserts that operation of the 'market for corporate control' discourages managers from putting their own interests above those of the company[140].

It is clear that Manne's argument that the market for corporate control eschews self-dealing' by corporate managers relies on three matters fro its it potency. First, if the market is to function as envisaged, it is necessary for shares in companies to be freely tradable, second, it is also necessary that the market accurately reflects directors' conduct , and third, a buyer prepared to takeover the troubled company exists.

The first condition for the functioning of the market is a substantial impediment to its functioning in relation to private companies, however leaving this issue to one side for the moment, there are significant doubts over the likelihood of the second and third conditions being met in many cases.

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[139] H. Manne, *Our Two Corporation Systems: Law and Economics,* in H. Manne, (ed) *The Economics Of Legal Relationships,* (New York, West Publishing, 1975).
[140] *Ibid.*

The efficiency with which markets translate managerial misconduct into a lower share price can be doubted. Information asymmetry is a substantial impediment to the functioning of such a market. Managers are unlikely to advertise their misconduct and those who are knowingly acting against the corporations' best interests can go to great lengths to hide their actions. In such circumstances, accurate information will only be available if substantial transaction costs are in incurred. Thus, there are numerous examples of markets being unaware of any misconduct in companies before they spectacularly collapsed. The Maxwell Group, Enron and Worldcom are just a few well know instances where the first the markets knew of incompetence or fraud by directors was shortly before the companies went into insolvency. In such companies, one must presume that either those charged with monitoring management were complicit in a cover-up or that transaction costs prevented adequate inquiry into management's activities. Either way, the information came out to late for any takeover bid to be either a practical or advisable course of action.

However, even where the market functions and the value of shares falls due to undesirable conduct, a hostile take-over is unlikely to succeed unless the price offered for shares includes a premium above the market value of the shares[141]. This may discourage would be bidders from attempting such a course of action, especially when one considers that the bidder would be trying to take over a failing company.

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[141] See J. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offereor's Role in Corporate Governance.* (1984) 84 Col L. Rev 1143.

This brings us to a consideration of the third factor, the existence of a bidder willing to take over a company suffering from its managers' actions. Manne asserts that any bidder would gain from taking over a company with a reduced share price in so far as the reduced share price is below the 'true' value of the company. Thus, if the company is taken over and the old management removed, the value of the shares in the company will rise and the new owner will have gained a healthy return on his investment[142]. However, whilst takeovers undoubtedly offer the prospect of making a healthy return on an investment if a company that is failing due to mismanagement is 'rescued', the decision to take over such a company is complex, with many factors other than potential gains needing to be considered by a would-be bidder.

The high transaction costs associated with a corporate take-over, such as bankers', lawyers' and accountants fees, are all likely to discourage a take-over bid whose only aim is to stop managerial misconduct[143]. It is also too simplistic to suggest that the prospect of financial gain from managerial misconduct will always prompt the take over of a company as a going concern. I would suggest that the response of a would-be bidder to a falling share price will depend upon the source of the financial advantage he believes he can obtain from the corporations troubles. Where the would-be bidder feels he could obtain the biggest return by taking over the company over as a going concern he is likely attempt to acquire the business as a

[142] *Supra*, note 139
[143] Eisenberg, *The Structure of Corporation Law, supra* note 117, p. 1498.

complete legal entity. If, however, he feels his biggest return lies in obtaining the physical assets of the company at a reduced price he may well decide not to take over the company as a going concern, but to wait until it goes into insolvency and attempt to purchase the assets of the firm he values at a reduced price from the administrators. The particular nature of the assets that the would-be bidder values will heavily influence this decision. For example, physical assets are likely to be cheaper to obtain in insolvency, whereas intangible assets, such as brand loyalty or customer base, or simply the potential value of the company as a whole are likely to be better purchased through a take-over bid. In many cases the greatest gain may lie in taking over the company and ensuring good management, however to assume that this is the case for every company whose share price falls due to managerial misconduct is probably over-optimistic. After all, this market is concerned with companies who have suffered from managerial misconduct and the decision to take-over such a troubled firm is likely to be complex, as many factors are relevant to the decision to launch a takeover bid, not just the value of shares[144]. Thus, even if there were readily available information about managers' activities, it is far from certain that a take-over would occur.

The market for corporate control is also limited by the fact that it can only function effectively where shares are freely transferable. Thus where shares cannot be easily transferred, the opportunity for takeover does not

[144] See, M. Jensen, *Take-Overs: Their Causes and Consequences*. (1988) 2. J. Econ. Persp. 21.

arise. Therefore, a negligent or dishonest owner-manager will be untroubled by the prospect of take-over because he, as the sole or majority shareholder, has absolute control over the company's shares. If he does not wish to sell his shares, he will not sell them, thus any take-over that may occur can happen only with his consent. Indeed, the absence of a market for controlling shares in private companies has lead Manne to concede that illiquidity of shares in private companies "prevent[s] any smooth functioning of a market for corporate control"[145].

Therefore there are sound reasons for doubting whether the market for corporate control, as well as those for directors' service and the product market can provide a satisfactory mechanism for controlling undesirable conduct by directors in most companies. The prospects for effective control may be greater in public companies and large private companies and indeed, it is probable that these 'market monitoring theories' are addressed to such companies. However, they simply are not applicable to small private companies and particularly to owner-managed companies.

2.6 Concluding Remarks.

Therefore, there are obvious failings with the two forms of control on directors' conduct considered so far that, at the very least, creates a *prima facie* 'need' for public regulation. In respect of shareholder monitoring, passivity and ignorance are rather obvious drawbacks in larger companies

[145] Manne, *The Economics of Legal Relationships, supra* note **Error! Bookmark not**

that have been recognised for many years. However, despite this, shareholder monitoring still lies at the heart of the government's policy towards controlling undesirable conduct by directors. As such many legal rules that aim to prevent undesirable conduct by directors are designed to facilitate shareholder monitoring rather than replace it with a mechanism for state regulation. However, there does seem to be some recognition that enduring problems with shareholder monitoring necessitates alternative regulatory strategies. In public companies alternative private regulatory strategies, such as enhancing the role of non-executive directors have been pursued as well as public regulation in the form of disqualification.

However, the failure of shareholder monitoring in large companies is not the main problem against which disqualification is aimed. Rather it is primarily aimed at owner-managed companies where shareholder monitoring fails *ab initio*. For, in such companies the unity of ownership and control leaves directors free of internal regulatory constraints on their conduct and renders mandatory rules such as fiduciary duties largely meaningless. This situation creates a clear need for regulation in so far as it exposes creditors to increased risk from negligence, recklessness or dishonesty.

It ought to be noted however, that allowing owner-managers to incorporate is seen as a desirable method of wealth creation by the State. Thus, it can only be presumed that the risks created by the obvious failure of shareholder monitoring in owner-managed companies are not sufficiently

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defined., p 526.

serious to merit a change in that policy by preventing entrepreneurs from incorporating. As such, the need for section 6 disqualification cannot be narrowly viewed as a simple consequence of a breakdown in shareholder monitoring, rather, it ought to be seen as a consequence of the State's broader policy of allowing free access to the benefits of incorporation, particularly limited liability. For, this policy creates not only conditions in which undesirable conduct can flourish (as has been shown in this chapter) but also creates an *incentive* for directors to engage in undesirable acts by allowing entrepreneurs to avail themselves of limited liability. It is this combination of the conditions for undesirable conduct and an incentive to engage in undesirable acts that creates an overwhelming need for some form of regulation in relation to directors of owner-managed companies. It is to the role of limited liability in disqualification that the next chapter therefore turns.

Chapter 3: The Role of Limited Liability in Disqualification.

"We have sought to...severely penalis[e] those who abuse the privilege of limited liability by operating behind one-man, insufficiently capitalised companies"

The Cork Report[146].

3.1 Limited Liability in the UK and its Abuse.

A certain amount of undesirable conduct by directors, if it is defined as a 'breach of commercial morality or negligence to a marked degree'[147], is an inevitable consequence of the free availability of limited liability in the UK. The Companies Act 1985 allows any person to incorporate a private limited company quickly and very cheaply[148] and what is more, there is no requirement for private companies to have anything other than a nominal amount of capital[149]. Such free availability of limited liability does nothing to prevent rogues, excessive risk takers or incompetents from obtaining the

[146] *Report of the Review Committee on Insolvency Law and Practice*, (Chairman Sir Kenneth Cork), Cmnd 8558, (London, HMSO, 1982), para 1815.
[147] *Re Sevenoaks Stationers (Retail) Ltd* [1991] 3 All ER 578.
[148] Following the insertion of section 1 (3A) into the Companies Act 1985, private limited companies can be incorporated with only 1 member. The registrars' fee for incorporation is currently £20, and takes no longer than 5 working days. If, however, incorporators are prepared to pay a higher fee of £80 they can benefit from same day incorporation provided that the relevant documents are deposited with the registrar by 3pm. See <www.companies-house.gov.uk>. The availability of 'off-the shelf' companies allows individual to obtain corporate status without the inconvenience of actually registering a company himself.
[149] However, sections 117 and 118 of the Companies Act 1985 require public companies to have a minimum capital allocation of £50,000.

benefits of incorporation. It is therefore unsurprising that limited liability should be 'abused'. Indeed, the lax requirements of the Companies Act almost encourage such abuse; for the perception that the miracle of incorporation divests a businessman of all personal responsibility for his acts is bound to attract a certain number of fraudsters.

The common law, for its part has sought to deal with some fraudulent uses of the corporate form through lifting the veil, although the circumstances in which it will do so are limited[150]. Statute also seeks to restrain the worst abuses of limited liability through personal liability provisions such as sections 213 and 214 of the Insolvency Act[151] and the sanctions contained in part X of the Companies Act 1985. However, in circumstances short of such fraud and misrepresentation etc, any person may incorporate a private company, limit their liability to a nominal sum and run the company as they like. However, many of the controls which are imposed on directors' conduct apply only *ex post facto*, as in the case of the Insolvency Act provisions[152]. The justification for such light controls on

[150] A comprehensive survey of the circumstances in which the court will lift the veil was given by the Court of Appeal in *Adams v Cape Industries Plc.* [1990] Ch. 433. Generally, those circumstances fall into to 2 categories; first cases where incorporation is used to evade limitations imposed on person's conduct by law (as in *Gilford Motor Co. Ltd. v Horne* [1933] Ch. 935), and second where it is used to evade such rights of relief as a person may hold against an incorporator (as was the case in *Jones v Lipman* [1962] 1 WLR 832).

[151] Personal liability imposed on directors who are shown to have engaged in fraudulent or wrongful trading respectively. See further 4.8.1 below.

[152] Actions under sections 213, (fraudulent trading, 214 (fraudulent trading, 245 (avoidance of a floating charge, 238 (setting aside of transactions made for an undervalue) and 239 (setting aside transactions made at a preference) rely on action by an 'office-holder' and therefore can only be commenced during insolvency proceedings, which, by definition, will be *after* wrongful conduct has taken place. Much the same can be said of directors' duties to creditors in insolvency as creditors rely on a office holder to take action for the breach of such duties in most cases..

directors during solvency appears to be the belief that free access to limited liability encourages entrepreneurship and economic growth[153].

Disqualification under section 6 is, however, an apparent acknowledgement that allowing some individuals' access to limited liability can have undesirable results, consequently the 'privilege' ought to be withdrawn from them. This link between limited liability and disqualification is of crucial importance to the need for section 6 and hence to its objective. For, whilst the breakdown of shareholder monitoring creates circumstances in which undesirable conduct can flourish, it is the special circumstances of limited liability that justifies the use of disqualification.

3.1.1 Unincorporated Entities and Disqualification.

It is perfectly possible, indeed likely, that unfit conduct of the sort condemned in disqualification cases can occur in unincorporated entities such as partnerships and sole-traderships. Partners, for example, can continue to incur debts when their firm is insolvent in *exactly the same way* that owner- manager directors can do with their companies[154]. However, the is no provision prohibiting persons from entering partnerships even if they are unfit. In circumstances where a partnership firm is wound up as an unregistered company a disqualification order can be made a against a

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[153] J. Freedman, *Limited Liability: Large Company Theory and Small Firms* (2000) 63 MLR 317 and A. Hicks, *Corporate Form: Questioning the Unsung Hero* [1997] JBL 306, see also DTI White Paper, *Our Competitive Future: Building the Knowledge Driven Economy*, Cm 4176, (London, DTI, 1998).

[154] See for example *Re C S Holidays Ltd* [1997] BCC 172 where Chadwick J stated at page 178:'If it is established...that a director has caused a company trade when he knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation, that director may well be held unfit...'

partner where the court decides that the partners conduct makes him 'unfit'[155].However, whilst an order will prevent an 'unfit' partner from being involved in the management of a company (in accordance with section 1 of the Disqualification Act), such an order *cannot* prevent him from entering another partnership because a solvent partnership does not fall within the definition of a 'company' contained in the Disqualification Act.[156]. Consequently there is no provision to prevent unfit persons from conducting a business as a partnership, or indeed as a sole trader.

A proposal remedy this apparent anomaly by extending the *prohibition* of disqualification to unincorporated business was made during the passage of the Insolvency Bill 2000[157], which already proposed significant amendments to the Disqualification Act[158], but was quickly rejected. The amendment to the Bill sought to alter section 1 of the Disqualification Act so as to prevent disqualified persons from engaging in any form or trade of business that provided services to the public[159], and was intended to close what its sponsor called the 'clear gap in law' that allows disqualified persons to manage unincorporated businesses even after they have been declared 'unfit' to be concerned in the management of

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155 Company Directors Disqualification Act 1986, s6(4)-(4C) (as amended by Insolvent Partnerships Order 1994, schedule 8).

156 Company Directors Disqualification Act 1986, s 22(2)(b),. See also *Re Chartmore Ltd* [1990] BCLC 673 at 67.

157 Hansard [HC], Standing Committee B, 7th November 2000, col 104.

158 The Bill proposed the introduction disqualification undertakings and other amendments to the 1986 Act. See further, 7.2, below.

159 The amendment proposed that a new subsection (c) be inserted into section 1(1) of the 1986 Act stating "he shall not act as the principle of any trade or business engaged in providing services to consumers".

incorporated entities[160]. However, the amendment was opposed by the minister responsible for the Bill on the ground that it would be "inappropriate for the Bill to go further by restricting a person's right to [trade on his own account]"[161]. The main purpose of disqualification, said the minister, was "to provide the pubic with protection from those who abuse the privilege of limited liability"[162] and as unincorporated firms do not benefit from this privilege, it was not right to extend the prohibition of disqualification to them. However, the minister did declare 'sympathy' for the main argument made in favour of the amendment, i.e. that creditors of unincorporated firms can also suffer significant loss from unfit conduct.

From these exchanges it is clear that protecting the public from undesirable conduct by entrepreneurs *per se* is not the aim of section 6 disqualification. Rather it is aimed at such conduct only where the unfit individual benefits from limited liability. The most obvious explanation for this distinction between misconduct in incorporated and unincorporated entities is that in the incorporated business limited liability allows the entrepreneur to partition his personal assets from his business assets thereby limiting his liability to make good the company's debts in the event of insolvency. As such, it arguably exposes creditors to increased risk of suffering financial loss in the event of business failure[163]. However, the

[160] *Supra*, note 157.
[161] *Supra* note 157.
[162] *Ibid.*
[163] On asset partitioning see H. Hansmann, and R. Kraakman, *The Essential Role of Organizational Law*, (2000) 110 Yale L.J. 387. Hansmann and Kraakman describe statutory limited liability as an example of 'defensive asset partitioning', which they claim increases

simple fact of asset partitioning cannot be seen as the sole justification for the apparently special need to regulate managers of incorporated entities. For, it must be stressed that partners and sole traders *can* partition their assets, despite their unincorporated status, by creating limited liability through contracts with individual creditors[164] and, indeed owner-managers may give up their limited liability[165]. Furthermore, whilst it reduces the pool of assets available to settle creditors' claims in insolvency, a statutory position of unlimited liability does not guarantee that the claims of creditors will be met. So it is difficult to view the simple fact of asset partitioning as a convincing justification for the application of section 6 disqualification to incorporated entities alone. After all, it is perfectly possible to create limited liability in a partnership by contract but disqualification does not prevent an unfit person from becoming a partner[166].. Rather, the real difference made by incorporation is that it gives incorporators the *statutory right* to partition their assets without the agreement of their creditors. It is this *right* to invoke limited liability that is the real 'privilege' of limited liability, rather than the simple fact of partitioning and which is crucial to the need for disqualification. Statutory limited liability exposes creditors of incorporated entities to unique risks of reckless or negligent conduct by directors, from which many creditors will find it difficult to protect themselves and which

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the value of corporate assets as security for debt. They therefore reject the claim that it increases the risk of default for corporate creditors.

[164] The ease with which incorporated status can be acquired in the UK makes it rare for partners to attempt to create general imitated their liability through contract. However instances of firm creating limited liability are not unheard of, see, R. I'Anson Banks, *Lindley and Banks on Partnership*, 18th Edn, (London, Sweet and Maxwell, 2002), page 380, note 46.

are particularly dangerous on owner-managed companies where directors' conduct is free in internal regulatory controls.

However, before the precise effects of statutory limited liability are discussed and its relationship with disqualification analysed, it is useful to sketch out a little of the history of limited liability and the debate surrounding its desirability.

3.2 The Rise of Statutory Limited Liability[167].

Statutory limited liability was first made available by the Limited Liability Act 1855 and, following the Joint Stock Companies Act 1856 was made available to any company with 7 or more members[168]. As is the case with the companies Acts before and since, the 1856 Act was drafted to suit the needs of large companies with divided ownership and control and, as such, it is highly unlikely that either the 1855 or 1856 Acts intended to extend limited liability to 1 or 2 person owner-managed firms where the 'power' it gives can be exercised free of the constraint of shareholder monitoring. However, it was noted at the time of the 1856 Act that it was relatively easy for an individual to obtain limited liability by finding 6

[165] By, for example, giving personal guarantees for company credit. See further 3.4 below.
[166] *Supra* note 156 and accompanying text.
[167] For a full account of the history of limited liability see J, Freedman, *Small Business and the Corporate Form : Burden or Privilege?* (1994) 57 MLR 555, O. Kahn-Freund, *Some Reflections on Company Law Reform*, (1944) MLR 54. See also D. Perrot, *Changes in Attitude to Limited Liability – the European Experience*, in T. Orhnial (ed), *Limited Liability and the Corporation* (London, Croom Helm, 1982). Perrott discusses the fluctuating popularity of limited liability from Roman times to the twentieth century.
[168] The Limited Liability Act 1855 originally restricted statutory limited liability to companies with 25 or more members.

'nominee' members to take shares along side him[169]. Whether the courts would accept such a scheme was, however, unclear until the infamous case of *Salomon v Salomon*[170]. The ratio of this case hardly requires repetition here, but its legitimisation of the *de facto* one-man company with limited liability has profoundly influenced the use of limited liability in the UK, and indeed in the rest of the common law world[171]. Since *Salomon,* small owner-managed companies have come to dominate limited liability[172].

It is interesting to note the slowness of the legislature in recognising the implications of the decision in *Salomon* (it was not until the enactment of the twelfth company law directive that one-man companies were expressly allowed by statute[173]). For, the prevailing model of the company in the Companies Acts has manifestly failed to grasp the sea-change brought about by *Salomon*. Indeed, it is only with the 'think small first' approach advocated by the Company Law Review Steering Group that the legislation may catch up with *Salomon*[174]. However, the Steering Group was not

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[169] A leading textbook published at the time of the 1855-56 Acts was shrewd enough to include advice as to how individual traders may avail themselves of limited liability. See E W Cox, *New Law and Practice of Joint Stock Companies*, 4th edn (1857), Law Times Office, 1857), noted in D. Campbell and S. Griffin, *ENRON and the End of Corporate Governance,* in S. MacLeod and J. Parkinson, (eds), *Global Governance and the Quest for Justice*, vol 2, (Oxford, Hart Publishing, 2004).
[170] [1897] A.C. 22.
[171] For a US perspective on *Salomon v Salomon* see, B. Cataldo, *Limited Liability with One-Man Corporations and Subsidiary Corporations*, (1953) 18 Law & Contemp. Probs 473.
[172] Research, carried out for the Company Law Review, showed that as of the 31st March 1999, 70% of registered companies had only one or two shareholders, and 90% had less than 5 shareholders. See Company Law Review, *Modern Company Law for a Competitive Economy, Developing the Framework* (London, DTI, 2000) para 6.9.
[173] 89/667/EEC, implemented by SI 1992/1699.
[174] See generally, Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*, (London, DTI, 2001), chapter 2. See also, Freedman, *Limited Liability and Small Firms*, *supra* note 153, page 326. Freedman notes that the Steering Group posed the leading question 'Is it agreed that it is not desirable to restrict access to limited liability', to which it received an enthusiastic 'yes' from its employees.

concerned with the lack of internal controls on directors of small companies and the increased opportunity for undesirable use of limited liability it created. Rather it proceeded on the basis that easy access to limited liability was desirable to stimulate economic growth and saw its task as being to propose reforms which 'lightened the regulatory load' on small limited liability companies rather than to evaluate the utility of the doctrine in owner-managed companies[175].

3.2.1 Criticism of Limited liability.

The introduction of statutory limited liability in 1855 did not meet with universal approval[176] and its extension to one-man companies in *Salomon* has been described as a 'calamitous decision'[177]. However, despite such reservations, limited liability for large and small companies has become an entrenched feature of British company law and, according to the current author of *Gower's Principles of Modern Company Law*, "nobody seriously advocates the reversal of *Salomon*".[178] Rather, a broad consensus seems to have been established that free access to limited liability is an

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[175]Company Law Review Steering Group, Modern *Company Law for a Competitive Economy: The Strategic Framework*, (London, DTI, 1999), chapter 5 (see particularly paras 5.2.12 & 5.2.13).

[176]For example, *The Times* editorial of the 25th May 1824 claimed that "Nothing can be so unjust as for a few persons abounding in wealth to offer a portion of their excess for the information of a company, to play with that excess – to lend the importance of their whole name and credit to the society, and the should the funds prove insufficient to answer all demands, to retire into the security of their unhazarded fortune, and leave the bait to be devoured by the poor deceived fish". Cited in Halpern, Trebilcock and Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, (1980) 30 U. Toronto L.J. 117. See also E W Cox who claimed that limited liability would lead to "enormous evils". Cox, *New Law and Practice of Joint Stock Companies*, quoted in Campbell and Griffin, *supra* note 169.

[177] Kahn-Fraud , *Some Reflections on Company Law Reform, supra* note 167.

[178] P Davies, *Gower and Davies' Principles of Modern Company Law*, 7th Edn, (London, Sweet & Maxwell, 2003) page 177.

essential tool for encouraging entrepreneurship by increasing the incentive to engage in business activity[179]. As such, it has been described as an element of a *laissez faire*[180] policy towards entrepreneurial activity. However, Campbell and Griffin have challenged the compatibility of limited liability with *laissez faire* and argue that limited liability imposed by statute is actually the antithesis of such an approach.[181] They argue statutory limited liability is not the result of market transactions but of a statutory intervention that ousts the market by allowing one party to unilaterally partition his assets, regardless of whether he would be able to obtain limited liability status through bargaining with his creditors. As such they submit that it cannot be viewed as an incidence of *laissez faire.*

3.3 The Hazard of Statutory Limited Liability.

3.3.1 The Case Against Risk Shifting.

Critics of statutory limited liability assert that it is an inefficient rule because it allows shareholders to reap the benefits of risky activities without bearing all of their costs[182]. This, they claim, leads to uncompensated transfers of risk and significant moral hazard because by allowing entrepreneurs to unilaterally cap their liability the rule allows transfers of

[179] See references, *supra* note 153.
[180] For example, *Farrar's Company Law*, 4th Edn (London, Butterworths, 1998), noted in Campbell and Griffin, *supra* note 169.
[181] *Supra* note 169.
[182] See for example, J. Landers, *A Unified Approach to Parent Subsidiary and Affiliate Questions in Banckrupcy* (1975) 42 U. Chi. L.R. 499. See also Halpern, Trebilcock and Turnbull, *supra* note 176, T. Gabaldon, *The Lemonade Stand: Feminist and Other Reflections on the Limited Liability of Corporate Shareholders* (1992) Vand. L.R. 1387.

risk on to creditors[183] and, as such, creates an incentive to engage in overly risky conduct. This moral hazard is widely recognised as being particularly acute in owner-managed companies because 'incorporated individuals' have a greater incentive to invest only a minimal amount of their total assets in their corporate *alter* ego and therefore to engage in very risky activity knowing that they will not be liable to make good any debts incurred[184].

It has therefore been claimed that limited liability creates (or at least exacerbates) an agency problem between corporate owners/controllers and creditors[185], in so far as the ability to cap liability for debt creates an incentive to engage in conduct that harms the welfare of creditors. It is argued that this 'agency problem' would not exist to the same degree in a situation of unlimited liability where the entrepreneur is not able to unilaterally cap his liability. Eucken, for example, states that:

> "The purpose of the unlimited liability of the entrepreneur in a competitive economy is to make him careful in the disposition of his resource and in investing and producing, and automatically to eliminate him if unsuccessful. Unlimited liability is part of a

[183] The nominal capitalisation of English and Welsh companies, (most of which have capital of less than £100 (see *Companies in 2003-2004*, (London, DTI, 2004), table A7.)) shows the extent to which entrepreneurs take advantage of the opportunity to put a very low cap on their liability, and as such transfer risk of loss to their creditors.
[184] See for example, F. Easterbrook, and D. Fischel, *The Economic Structure of Corporate Law*, (Cambridge, Mass, Harvard University Press, 1991), chapter 2 and Halpern, Trebilcock and Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, *supra* note 176.
[185] Landers, *supra* note 182.

> competitive system, and its destruction by legal policy endangers the functioning of this system"[186]

The argument is essentially that personal liability of entrepreneurs naturally reduces their incentive to engage in reckless, negligent and even dishonest conduct because they will bear the costs of such conduct should they be unsuccessful. For, if the entrepreneur is both rational and welfare-maximising he will not hazard his entire fortune on reckless or negligent corporate gambles. Rather, the fear of personal bankruptcy will make him careful in the conduct of his business. As such he will weigh the costs and benefits of entrepreneurial activity and undertake only activities where the benefits outweigh the costs, and will only solicit credit where he has calculated that the likelihood of him being able to repay the credit is higher than the likelihood that he will not be able to repay from the proceeds of his business venture. For if this is not the case he would be liable to repay from his personal assets. As such, a moral hazard is less likely to arise where an entrepreneur has unlimited liability for his business acts. However, it must be noted that a rule of unlimited liability does not mean that moral hazard never arises, for where the entrepreneur's debts have exceeded the total value of his assets, he has nothing to lose from engaging in very risky conduct and a moral hazard will arise. However, the likelihood of a moral hazard arising must be less under a rule of unlimited liability as the entrepreneur will have an incentive to protect his personal assets by limiting

[186] W. Eucken, *The Foundations of Economics* (Berlin, Springer-Verlag, 1992), cited in Campbell and Griffin , *supra* note 169.

his exposure to debt and the point where debt exceeds available assets will be reached much later than is the case in a situation of limited liability. For, in the typical English company with less than £100 of capital, a moral hazard must arise very shortly after the company begins trading, if not before.

3.3.2 The 'Compensation Theory'.

However, supporters of limited liability, such as Richard Posner, deny that statutory limited liability creates a moral hazard. They contend instead that creditors will not passively accept transfers of risk affected by a rule of statutory limited liability but will demand compensation from entrepreneurs for their increased risk of suffering loss should the company default[187]. Such compensation can, for example, take the form of higher charges for credit to companies that benefit from limited liability[188], which reflects the extra risk transferred. The effect of such compensation, it is claimed, is to prevent a moral hazard from arising. It is has therefore been argued that statutory limited liability actually leads to efficient *sharing* of risk between companies and their creditors[189].

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[187] R. Posner, *The Rights of Creditors of Affiliated Corporations* (1967) 43 U. Chi. L.R. 499. Posner's argument relates to creditors who have the ability to enter into contracts with debtor shareholders/entrepreneurs, so called 'voluntary creditors'. The argument does not apply as Posner acknowledges to creditors who cannot contract, 'involuntary creditors'. On the position of involuntary creditors in disqualification see 'A Note on Creditors who Cannot Contract', 3.X below.

[188] Posner, *ibid,,* see also R Posner, *Economic Analysis of Law*, 2nd Edition (Boston, Little Brown, 1977) and F. Easterbrook, and D. Fischel, *The Economic Structure of Corporate Law*, (Cambridge, Mass, Harvard University Press, 1991), chapter 2.

[189] Easterbrook and Fischel, *supra* note 188, pages 50-52. However, Easterbrook and Fischel's argument is not that the necessity to pay for risk taking will prevent risk transfers. Instead, they argue that limited liability leads to risks being 'swallowed'.

Posner claims that the creditor's demand for compensation eschews the incentive to engage in negligent or reckless conduct because of creditors' ability to adjust the compensation he demands to the risk posed by particular debtors. Therefore, the higher the risk creditors face from an entrepreneur's use of limited liability, the more compensation they will demand from him and vice-versa. As such, it is claimed that entrepreneurs *will* be forced to pay for their activities under a rule of limited liability and that, as such, they will be cautious in the risks they take and weigh the benefits of a particular activity against the compensation that will have to be paid for the freedom to engage in it. Therefore, as welfare maximising entrepreneurs will only engage in conduct where the expected benefits of the activity out weighs its costs, it is claimed that creditors' demand for compensation ought to prevent overly risky conduct from occurring. For where the compensation that has to be paid for the freedom to engage in an activity is higher than its expected benefit, the act will not take place. In short, an optimal level of risk taking out to result from a rule of limited liability[190].

In a market where transaction costs were zero and no information asymmetries existed, it is certainly likely that creditors would seek to compensate themselves for the increased risk they face from statutory limited liability in the manner envisaged by Posner. Under such ideal conditions each creditor would correctly assess the risk he faced from transacting with a particular company and calculate the rate of return

[190] Posner, *supra* note 172.

necessary to offset that risk. In the context of owner-managed companies this would mean that owner-managers would be forced to pay an appropriate price for any activities they wished to undertake. This in turn would prevent uncompensated transfers of risk, in which case the claim that the benefit of limited liability to owner-managers is exactly offset by a detriment to creditors would be unfounded. However, assuming for the time being that creditors are able to compensate themselves for the effects of limited liability, Posner's thesis, whilst answering a common criticism of limited liability, suggests that under perfect conditions the main benefit that is claimed for limited liability would be illusory. For, if creditors demanded compensation that equated to the risk transferred by the rule of statutory limited liability, that rule would be unlikely to lead to a significantly increased risk taking and, as such would not increase the risk faced by creditors who deal with entrepreneurs with limited liability as compared to their dealings with entrepreneurs who do not have limited liability. As such the apparently unique need for public regulation of directors with limited liability would be unfounded.

3.3.3 Does Limited Liability Increase Entrepreneurial Activity?

Suppose an entrepreneur, **A,** wishes embark upon a new business venture but needs to borrow £1 million to finance his plans and that he approaches a bank to advance him the £1 million in the form of a loan. If the bank is welfare maximising it will demand a 'price' (i.e. compensation) for its credit that compensates it for the risk that it faces in advancing the loan to

A. In fixing this 'price' the bank will essentially consider two variable factors which will be termed **X** and **Y**. **X** represents the probability that **A**'s proposed venture will succeed. In assessing this probability the bank will take into account a number of relevant factors, such as the strength of **A**'s business proposal, the profitability of the sector **A** proposes to enter as well as the likely conduct of **A** etc,. **Y** represents the assets that will be available to repay the loan should the business venture not succeed. The bank will demand a price for its credit that is equal to or greater than, the combined values of **X** and **Y**[191]. Thus, the higher the value of **X** (the probability that the venture will succeed) and the higher the value of **Y** (the assets available to satisfy the banks claim), the lower the 'price' for its credit the bank will demand from **A**, and vice-versa.

Assuming that **A** is also a welfare maximiser, once he is informed of the bank's proposed terms he will weigh the price demanded by the bank for its credit (as well as other costs associated with his proposed venture) against the benefit he expects to obtain from the venture. Where the cost of the venture (including the cost of credit) is greater than the perceived benefit of the venture **A** will not undertake the business venture. Where the benefit is higher than the aggregate costs he will[192]. Thus, optimal risk-taking by **A** will be secured.

In the absence of transaction costs and information asymmetry this outcome will apply regardless of the liability rule that underlies the

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[191] See Posner, *ibid,* page 501.

[192] R.H. Coase, *The Problem of Social Cost,* in R.H. Coase, *The Firm, The Market and The Law,* (London, University of Chicago Press, 1991).

transaction between **A** and the bank. Consequently, Posner's model suggests that so long as the bank can adjust its terms in line with the relative values of **X** and **Y**, the same outcome will be secured regardless of the liability rule that underlies the transaction between **A** and the bank[193].

3.3.3.1 A with Unlimited Liability.

Where the default rule underlying the transaction between **A** and the bank is a rule of unlimited liability, the value of **Y**, i.e. the assets available to pay the bank should the venture fail, will be determined by the full extent of **A**'s assets, both corporate and personal. As such, the value of **Y** is likely to be higher in a situation of unlimited liability than a situation of limited liability. For under limited liability **A** is able to partition his personal assets from his corporate assets. Similarly, the value of **X** will be increased by unlimited liability. For, if Eucken's thesis is accepted, the personal liability of **A** for his business is likely to, (i) make him more cautious in the risks he takes (or at least balance the costs and benefits of risks more carefully) and (ii) reduce the likelihood that he will be reckless, negligent or dishonest in the conduct of his business affairs. This natural reduction in agency problems brought about by unlimited liability ought to reduce the banks assessment of the risk of advancing the loan to **A**, and consequently lead it to charge (relatively speaking) a *low* rate for credit. Thus, the higher values of **X** and **Y** the lower the risk posed by lending to A is, and the lower the rate of interest on the loan will be. As such the cost of credit to **A** ought to be *lower* if under a rule of unlimited liability.

[193] Posner, *supra* note 188.

However, unlimited liability increases risk of personal bankruptcy that **A** faces from his venture. Consequently, the 'personal' cost to **A** of his venture will be *higher* than under a rule of limited liability and act as a disincentive to engage in entrepreneurial activity. As **A** bears the risk associated with business failure,(i.e. the risk that would be born by the bank under limited liability), the higher personal cost of the transaction will equate to the lower cost of credit. In short the risk of the transaction merely passes from the Bank to **A,** and in so far as the bank would demand compensation from **A** that matched the risk, the reduction in the cost of credit ought to be of the same value as the increase in the personal cost to **A.** Nonetheless, in a situation of unlimited liability the cost to **A** of his business activity will be the aggregate of the *lower* cost of credit and the *higher* personal cost.

*3.3.3.2 **A** with Limited Liability.*

It is claimed that the increased 'personal' cost to **A** of engaging in entrepreneurial activity with unlimited liability decreases his incentive to engage in such activity, at least when compared to a rule of limited liability. For, the higher the perceived risk of the venture, the more likely that risk-averse (and even risk-neutral) individuals will be deterred from undertaking business activity[194]. As such, it is contended that a rule of limited liability would increase the likelihood that **A** would undertake his business venture because it would allow him to limit his exposure to risk by partitioning his

[194]Posner, *ibid* .

assets[195]. As such **A** would be able to transfer the risk he faced from his venture to the bank and the perceived personal costs to **A** of his proposed venture (in terms of the risk of bankruptcy) would be decreased. However, the transfer of risk would affect the bank's calculation of the risk that it faces from **A**. For, whilst the personal cost of entrepreneurial activity to **A** would be reduced by limited liability, his transfer of risk will come at the price of reducing in the value of both **X** and **Y**. For, the value of **Y**, (the assets available to satisfy the banks claim in the event of default) would be reduced by a rule of limited liability because asset partitioning would obviously reduce the pool of assets available to repay the bank in the event that the **A**'s venture fails. Further, limited liability will also decrease in the value of **X** (the likely success of **A's** venture) by making **A** risk-preferring, and, as such, increasing the chances of negligent, reckless and dishonest conduct on his part (if Eucken's thesis is accepted). Consequently, under a rule of limited liability the bank would demand higher price for credit and, in a perfect market, that higher price would be proportional to the amount of risk transferred. However, the bank would be likely find it difficult to obtain full compensation for the risk of undesirable conduct by **A** because it would face the residual risk that after the conclusion of the loan contract, **A** would increase the risk of default by engaging in unforeseen (delinquent) activities[196]. To protect itself from this risk the bank would have to seek to restrain the conduct of **A** through complex contractual provisions or through

[195] Posner and Easterbrook and Fischel, both *supra* note 188.
[196] Posner, *supra,* note 188, pages 503-504.

monitoring[197] or, in the most risky transactions, by demanding that **A** give up his limited liability by personally guaranteeing the loan to the bank.

Nonetheless, it is clear that if the bank were able to accurately adjust its charges for credit to reflect the rule of limited liability the reduced 'personal' cost to **A** from engaging in entrepreneurial activity would be offset by the higher cost of credit which would force **A** to pay for the freedom to engage in that activity. In the worst cases **A** may even be forced to give up his limited liability completely.

Therefore, if the compensation model worked as envisaged by Posner, limited liability would not lead to increased entrepreneurial risk-taking. For, under rules of both statutory limited and unlimited liability the overall 'cost' of entrepreneurial activity ought to remain constant. Under unlimited liability the cost of credit will be lower, but the personal cost of business activity will be higher; under limited liability personal cost will be lower but the cost of credit will be correspondingly higher. In short, the theory suggests that parties will contract away from the either legal rule to the same level of optimal risk taking. Posner himself recognises this when he states that:

> "If corporation law did not provide for limited shareholder liability, then in situations where the parties desired to limit that liability in exchange for a higher interest rate the loan agreement would contain an express provision limiting liability. Conversely, under existing law a firm asked to lend money to a corporation in which it lacks

[197] Easterbrook and Fischel, *supra* note 188.

confidence can insist...that the shareholders agree to guarantee repayment personally..."[198]

Thus, whilst the compensation theory may eliminate the risk of moral hazard that it has been claimed limited liability creates, it is also likely to eliminate the major benefit claimed for statutory limited liability i.e. increase entrepreneurial risk-taking. However, this has not induced proponents of limited liability to conclude that it is of no utility. Posner, for example claims that limited liability is nonetheless desirable because 'lenders may be superior risk bearers'[199] and therefore that limited liability has some utility in stimulating entrepreneurial activity. He advances two arguments to support this claim. First, he contends that creditors may be in a better position to appraise risk than borrowers and therefore that limited liability facilitates more efficient risk bearing. He cites the example of a shareholder in a public company as an example of a 'borrower' who lacks the skills to adequately appraise risk. Second he claims that creditors "may be risk averse and creditors less so"[200] and therefore argues that unlimited liability would discourage entrepreneurial investments. In respect of both arguments, it is noteworthy that Posner asserts only that creditors *may* be better assessors of risk and that they *may* be less risk averse than borrowers. It is equally plausible that they *may not*, in which case statutory limited liability would have few advantages. In short Posner's analysis is based on very weak assumptions. This is especially so in the case of owner-managed

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[198] Posner, *supra*, note 188, page 505. See also R. Mofsky and R. Tollinson, *Piercing the Veil of Limited Liability* (1979) 4 Del. J. Corp. Law 351.
[199] Posner, *ibid*, page 501.

companies (the companies with which disqualification is primarily concerned). Posner's first argument that creditors may be in a better situation to appraise risk is clearly inapplicable to an owner-managed enterprise because in such an enterprise the owner-manager's complete knowledge of his business venture makes him the best risk assessor. Indeed, if an owner-manager were not the best risk assessor this would indicate that he was either ignorant of important information concerning his business or that he was incompetent. In either case he would pose a high risk of default to creditors who would be reluctant to deal with him, especially on a basis of limited liability. Posner's second argument that creditors may be more risk averse than entrepreneurs would seem unlikely. More likely is that some creditors will be more risk averse than others, as some entrepreneurs will be more risk averse than other entrepreneurs. As such, 'creditors' are unlikely to be any more or less risk averse than entrepreneurs. In any case, Posner's claim is somewhat undermined by his conclusion that the liability rule underlying corporate transactions is unlikely to "have a profound affect on the credit system or to alter the balance of advantage between debtor and creditor"[201], which as I have suggested, I believe is the correct implication of the compensation theory.

3.3.4 The Compensation Theory and Disqualification.

If the impact of statutory limited liability were as benign as Posner suggests then the link between disqualification and limited liability would be

[200] *Ibid.*

puzzling, for creditors of limited liability companies ought to be at no greater risk of loss than creditors of partnerships and sole traders. Because if they were able to secure compensation for any risk transferred to them by limited liability, there would be no need for the state to 'protect' them through disqualification. Indeed, if the compensation theory functioned as envisaged, abuse of limited liability, in terms of reckless, negligent or dishonest conduct ought not to occur because high charges for credit or contracting around limited liability should prevent unfit persons from using limited liability. Or at least if unfit conduct did occur, creditors should not suffer loss from it. However, it is precisely because the impact of limited liability is not as benign as the compensation theory suggests that disqualification exists.

3.3.4.1 The Conditions for Increased Risk-Taking.

If it is accepted that creditors seek compensation for risk transfers, it follows that statutory limited liability will only lead to increased entrepreneurial risk-taking where the 'compensation theory' outlined by Posner does not function as envisaged, for as I have stated, where creditors are able to alter the terms upon which they supply credit to exactly match the risk transferred by limited liability it is unlikely to lead to a significant increase in entrepreneurial activity. It is only where creditors are unable to obtain adequate compensation that increased risk taking is likely to result, for in such a scenario entrepreneurs are able to transfer risk without having to pay compensation. This opportunity to affect an uncompensated transfer

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[201] *Ibid*, page 505. See also Mofsky and Tollinson, *supra* note 197.

of risk is the only way in which entrepreneurial activity will be increased by limited liability. For where an uncompensated transfer of risk is affected the cost of risk-taking is kept artificially low and more risk taking will result.

Thus, in the real market statutory limited liability is likely to result in more risk taking but only to the extent that real market conditions allow owner-managers to affect uncompensated transfer of risk to their creditors. This situation of sub-optimal risk-taking is what the state claims is a desirable mechanism of wealth creation[202].

3.4 The Real Market and Compensation.

If the compensation theory functioned in the real market place with statutory limited liability we would expect to see higher charges for credit for the riskiest of companies and in the most dangerous companies, contracting around limited liability. And indeed, this is exactly what happens when banks demand a high price for advancing credit to owner-managers, such as higher interest rates or contracting around limited liability, a practice, which various authors have claimed, is widespread in the UK.[203] Therefore, to the extent that personal guarantees and other forms

[202] The fact that limited liability leads to risk-taking that would not occur under market conditions has been the cause of much criticism of the doctrine. Campbell and Griffin quote J.R. McCulloch who commented at the time general limited liability was introduced that "In the scheme laid down by providence for the government of the world, there is no shifting or narrowing of responsibilities, every man being personally responsible for his actions. But the advocates of limited liability proclaim in their superior wisdom that the scheme of Providence may be advantageously modified...". Campbell and Griffin, *supra* note 169.

[203] See for example, Freedman, *Limited Liability and Small and Firms, supra* note 153. See also V. Finch, *Security, Insolvency and Risk: Who Pays the Price?* (1999) 62 MLR 633 and S. Wheeler, *Swelling the Assets for Distribution in Corporate Insolvency* [1993] JBL 256. Both Finch and Wheeler note that powerful creditors will protect themselves from the risk

of compensation are used in the riskiest of companies, it is clear that some compensation for the risk of statutory limited liability can be obtained under real market conditions. However, transaction costs and information deficits in the real market place have a significant impact on the ability of many creditors to obtain compensation for the effects of statutory limited liability and exposes them to significantly higher risk of delinquency than is the case under conditions of unlimited liability.

3.4.1 Transaction Costs and Information Deficits.

Under real market conditions creditors suffer from information deficits and transaction costs, which, if they cannot be overcome, will prevent them from properly assessing risk and securing appropriate compensation from directors[204]. Under such conditions creditors may seek compensation that is too high, too low or in the worst cases, fail to obtain any compensation at all. In the first scenario owners will bear disproportionate risk and in the second and third creditors will.

The default condition underlying market transactions between parties in the market place is that each party is fully liable for his bargain. The default rule applies unless the parties agree a different liability rule. This is not the case, however, for transactions involving incorporated entrepreneur's

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of loss by utilising a range of security devices. The Cork Committee also noted the tendency of banks to demand security (such as personal guarantees) for the majority of commercial loans. See *Report of the Review Committee on Insolvency Law and Practice* , Cmnd 8558 (1992), chapter 34. It has been argued that banks in the UK are more likely to contract around limited liability than is the case in other EU countries, see M. Binks, *Small Businesses and their Banks in the Year 2000*, in J. Curran and R. A. Blackburn (eds), *Paths of Enterprise: the Future of Small Business*, (London, Routledge, 1991).

owner-managed companies where *individuals* or groups of individuals are able to invoke statutory partitioning of their assets, changing the default rule of the transaction to one of limited liability without the agreement of their counter party. The compensation theory suggests that this change in the liability rule should affect the conditions upon which credit is supplied to owner-managers so that creditors secure compensation for the risk transferred to them. However, where transaction costs and information deficits prevent the conditions of supply from shifting in line with the new liability rule, the terms of credit will become disproportionately focused on the entrepreneur's demand for credit and, assuming he does not volunteer to pay more for credit in a situation of limited liability, an uncompensated transfer of risk will be affected to the supplier. For, assuming the owner-manager does nothing to give rise to personal liability, he has little incentive to give up his privileged position and will only do so to the minimum extent necessary to induce the creditor to contract.

In such an imperfect market, the resources, expertise and bargaining power of the creditor will determine the compensation he can secure[205]. The transaction costs of information gathering, for example, will present less of an obstacle to wealthier creditors than they will to less well off creditors. Similarly, where information can only be obtained at a cost, the extent of information gathering undertaken by each creditor is likely to be determined by the value of each transaction he enters in to. For example, if the cost of

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[204] Finch notes the problems facing small creditors, *ibid.* See also L. Bebchuck and J. Fried, *The Case for the Priority of Secured Claims in Bankrup*tcy, (1996) Yale L.J. 857.

full information about the creditworthiness company X were £100, a creditor would be more likely to pay the full cost of information gathering in relation to a transaction that is worth £10,000 than he would with a transaction worth £150. The cost of information gathering in the larger transaction can be easily recovered by a small increase in interest, because the transaction costs are small relative to the total credit. However, with the small transaction the creditor would find it difficult to pass on the cost of information gathering as transaction costs represent two-thirds of the value of the transaction. Thus, the creditor may undertake only limited (cheaper) information gathering or in the worst-case scenario, no information gathering at all[206].

The expertise of the creditor is also likely to determine his willingness for pay for information. Banks, for example, have the knowledge and experience that enables them to interpret information more accurately than many trade creditors and employees. They are consequently more likely to undertake information gathering as it represents a worthwhile expenditure. The position of banks and similar creditors is further strengthened by the fact that they have the power to extract more information from company owners who put a higher 'price' on their credit. This power enables such creditors to reduce the cost of information gathering and overcome the effects of information asymmetry. Indeed, where creditors are unable to gather sufficient information from the market

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[205] On the problems faced by small creditors see generally, Finch, *supra* note 203. See also L. LoPucki, *The Unsecured Creditor's Bargain* (1994) Va. L.R. 1887.

to shift the conditions on which they are prepared to supply credit in line with statutory limited liability, the value the incorporated individual places on each type of credit may come to determine the premium (i.e. compensation) that the creditor is able to secure for his credit. Because, in an imperfect market a significant part of a creditors' ability to obtain information about the creditworthiness of an owner-manager will depend upon his ability to force the owner-manager to disclose information to him. In such a situation it is likely that suppliers of scarce credit will be more able to overcome information asymmetry than suppliers of plentiful credit, because scarcity increases the incentive for owner-managers to accede to creditors' requests to disclose information. If such requests are acceded too, they will remedy information asymmetries.

Indeed, the effect of scarcity of credit in the real market place is demonstrated by the fact that it is quite common for owner-managers to disclose significant information to banks (whose credit is relatively scarce) but not for them to disclose much to employees (whose 'credit' is plentiful). Consequently, banks are more successful at obtaining compensation from owner-managers[207] than employees, trade creditors and other suppliers of plentiful credit.

However, I should stress that the effect of scarcity and information asymmetry on bargains between debtors and creditors is not restricted to situations of statutory limited liability. For, in a situation of unlimited

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[206] A rational creditor will not undertake any information gathering where its lowest cost is equal to or greater than his expected gain from the bargain.
[207] See, Freedman, Finch both *supra* note 203.

liability an information deficit may cause a creditor to supply credit at too low a price and therefore cause him to bear uncompensated risk. However, in a situation of unlimited liability the creditor is assisted by two factors, first, because the owner-manager is unable to partition his assets and consequently the risk to the creditor of default is reduced, and secondly, because if the owner-manager wishes to create limited liability he can only do so with the creditor's agreement. As such, the owner-manager has both an incentive to offer compensation to the creditor, to induce him to accept some of the risk of a transaction and also an increased incentive to accede to requests for information, thereby allowing the creditor to set his compensation at a level appropriate to the risk he faces. Scarcity of credit is still likely have an impact upon the amount of information disclosed and indeed, the amount of compensation offered, however, its effect would be less dramatic due the increased bargaining power of the creditor, who if he is a welfare-maximiser will refuse to agree to limited liability unless at least something approximating adequate information is disclosed and adequate compensation is obtained. Under statutory limited liability an owner-manager has no incentive to *offer* compensation or disclose information unless he is forced to do so, for he can invoke limited liability as of right. Therefore, creditors who are unable to force an owner-manager to pay compensation or force him to disclose information to them are less likely to obtain appropriate compensation in an imperfect market[208]. Consequently,

[208] Finch, for example notes the tendency amongst weaker creditors to charge uniform interest rates for credit. See Finch, *supra* note 203.

allocative inefficiency will occur and the owner-manager will be free to undertake excessively risky activity. In essence, optimal risk taking will not be secured.

3.4.2. Risk Loading.

Thus, in the real market place statutory limited liability is likely to lead to a loading[209] of risk on to certain creditors (such as trade creditors and employees) who are unable increase their charge for credit or obtain other security[210]. This externalising of risk obviously creates the scope for excessive risk taking by directors, which, it must be noted, is particularly undesirable because the sort of creditor who is unable to obtain compensation for the effects of limited liability will be the least well equipped of all a firm's creditors to absorb losses[211]. Creditors of owner-managed companies are particularly vulnerable to such excessive loading of risk as it widely recognised that, where they are able, owner-managers have a great incentive to invest only a minimum amount of their personal fortune in their companies, thereby transferring risk to third parties. This indeed, is recognised by leading proponents of limited liability[212].

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209 Freedman, *supra* note 205.
210 See Finch, *supra* note 203.
211 It has been argued by some that creditors are able to insulate themselves from the worst consequences of insolvency by using self-help measures such as supply goods under retention of title clauses. See for example, A Belcher and W. Beglan, *Jumping the Queue* [1997] JBL 1. Finch however, doubts the practical effectiveness of 'self-help' measures, see Finch, *supra* note 203.
212 Easterbrook and Fischel, supra note 188 at page 56. They suggest 'piercing the corporate veil' as an adequate remedy for the 'moral hazard' created by limited liability in owner-managed companies. See also Halpern, Trebilcock and Turnbull, *supra* note 176, who note that the risk of moral hazard is at its greatest in owner-managed firms.

Nonetheless, this loading of risk is a necessary part of the state's 'desirable' policy of free access to limited liability. Indeed such uncompensated transfers of risk are essential if the policy is to bring the increase in wealth-creating entrepreneurial activity. For as the activities of the banks show, creditors who are able will seek compensation from directors and in so doing, they will preclude increased entrepreneurial activity[213]. However, whether the extra risk taking that is permitted is desirable is far from clear, for such extra risk by definition is only possible in a situation of sub-optimal risk taking. Limited liability is therefore likely to create a lottery of risk taking at the expense of weaker creditors that may, or may not, lead to effective wealth creation.

3.4.3. The Role of Disqualification.

Disqualification is a device used by the state to control the worst excesses of this lottery. It is a measure essentially born of the inability of many creditors to protect themselves from corporate 'gambles' by reckless, negligent, incompetent or dishonest entrepreneurs. However, it must be stressed that it is not a measure designed to prevent uncompensated transfer of risk *per se* because, of course limited liability, relies on uncompensated transfers to stimulate increased entrepreneurial activity. Therefore, disqualification would appear to be designed to sanction only some examples of risk transferring.

[213] Posner and Easterbrook and Fischel, both *supra* note 188. On 'security' as a device to control opportunism by directors see generally, G. Trisantis and R. Daniel, *The Role of Debt in Interactive Corporate Governance* (1995) 83 Calif. L.R. 1073.

Posner claims that the "primary utility of corporation law lies in providing a set of standard, implied contract terms...so that business firms do not have to stipulate these terms every time they contract..."[214]. If company law does not reflect those terms then Posner claims that contracting parties will seek to contract around the law. Such contracting around the law creates transaction costs that could reduce the efficiency of business ventures. Disqualification is an attempt to prevent exactly this scenario.

We already see significant contracting around the limited liability of owner-managers by powerful creditors[215]. However, a widespread perception that limited liability was being utilised by the incompetent or dishonest could ultimately increase such contracting around the statutory rule by weaker creditors, who may for example, simply refuse credit to limited liability owner-managers. In so far as the State views the limited liability of owner-managers as desirable, any increase in contracting around limited liability would be viewed as undesirable. Consequently, the State seeks to prevent limited liability from being undermined by creditors' demands by assuring the 'commercial world' that unfit directors will be disqualified, which will 'protect' creditors from loss and 'deter' unfit conduct. Essentially, disqualification is a confidence building measure that seeks to prevent creditors from losing faith in limited liability companies,

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[214] Posner, *supra* note 203, page 506.
[215] Freedman, *supra* note 203.

particularly owner-managed companies[216]. Disqualification and limited liability are therefore inextricably linked. For, limited liability in the real market gives entrepreneurs a licence to effect uncompensated transfers of risk onto a particular class of creditor and disqualification would appear to be an attempt to rein in that licence. For, without such a control, confidence in limited liability may be severely tested and vulnerable creditors may simply refuse to deal with limited liability companies.

Therefore, it is clear that there is a need for disqualification, particularly in owner-managed companies where other controls on the conduct of directors are absent. Furthermore the link between limited liability gives a clear indication of what equates to undesirable conduct by directors, for disqualification would appear to be designed to 'protect the public' from the essentially economic harm that can result from limited liability. Thus, it is to a discussion of the sort of use of limited liability that the state seeks to eschew that the next chapter turns, however, before moving to this next stage of our analysis of section 6 it is necessary to note the position if involuntary creditors in disqualification.

3.4.4 A Note on Creditors who Cannot Contract.

The forgoing analysis of limited liability, its impact on risk taking and its role in the apparent 'need' for disqualification or some similar regulatory

[216] The National Audit Office, for example, has stated that "The disqualification arrangements are intended to promote confidence and risk-taking in the market, by assuring those who do business with limited liability companies that directors who are unfit will be disqualified" National Audit Office, Report by the Comptroller and Auditor General, *Insolvency Service Executive Agency, Company Director Disqualification – A Follow Up Report*, (House of Commons Papers, Session 1998-1999,424). (London, The Stationary Office, 1998), page 1.

device, has been made largely in the context of the relationship between entrepreneurs and voluntary creditors, i.e. creditors who enter into a legal relationship with entrepreneurs of their own volition and who, therefore, have at least the *opportunity* to insulate themselves from the effects of limited liability through the use of contract (even though in many cases their ability to do so would appear to be limited). The analysis has not thus addressed the situation of the involuntary creditor, i.e. those who bear the risks of limited liability (as discussed above), but who has no realistic opportunity to use contract in this way. Tort creditors are the most obvious example of such a group, having no realistic opportunity to use contract to address the increased risk transferred to them by incorporation.

It is widely recognised in the academic literature that involuntary creditors are uniquely disadvantaged by a rule of limited liability and several authors have advocated a rule of unlimited liability of corporate shareholders in relation to involuntary creditors[217]. Posner's, whilst advocating the retention of limited liability, nonetheless concedes that creditors who do not have the opportunity to contract with limited liability companies will not be able to recoup the risk shifted to the by limited

[217] Hansmann H, and. Kraakman, R., *Towards Unlimited Shareholder Liability for Corporate Torts*, (1991) 100 Yale LJ 1879; R. Meiners *Piercing the Veil of Limited Liability* (1979) 4 Del. J. Corp. Law 351; A. Scwartz, *Products Liability, Corporate Structures and Bankruptcy: Toxic Substances and the Remote Risk relationship* (1985) J. of Legal Studies 689;W. Bratton & J. McCahery, *An Inquiry into the Efficiency of the Limited liability Company : Of Theory of the Firm and Regulatory Competition*, (1997) 53 Washington and Lee LR 629 (arguing that the case for unlimited liability in relation to tort creditors is stronger in relation to closely held companies). For a summary of the arguments in favour of retaining limited liability in relation to involuntary creditors see B. Cheffins, *Company Law: Theory Structure and Operation,* (Oxford, Claredon Press, 1997), pages 505-508. On limited liability and tort victims see generally Note, *Should Shareholders Be Personally Liable for the Torts of their Corporations* (1976) 76 Yale LJ 1190.

liability, suggesting that 'lifting the corporate veil' should be used to prevent mischief in such cases[218].

The limitations of 'lifting the veil' as a remedy for the mischief caused by limited liability been noted earlier[219], as have the risk shifting and increased moral hazard associated with limited liability, thus in so far as involuntary creditors are exposed to exactly the same risks from limited liability as other creditors, but lack *any* prospect of protecting themselves, the case for disqualification (or similar regulation) to 'protect' them from limited liability would appear to be overwhelming[220]. Thus, to our conclusion that disqualification exists to protect voluntary creditors who are unable to satisfy their welfare goals through contract from the 'moral hazard' and risk shifting of by limited liability we might add that it also exists to protect involuntary creditors from the same mischief. Indeed voluntary creditors who cannot contract and involuntary creditors may find themselves in much the same situation. However, whilst logic dictates that concern for the position of the involuntary should be an integral disqualification's objective of 'protecting the public from abuse of limited liability' is must be noted that instances of disqualification being used to sanction conduct causing loss to involuntary credits appear to be rare. The reported cases focus on damage done to voluntary creditors by abuse of

[218] Posner, *supra* note 187 .
[219] *Supra* note 138 and accompanying text.
[220] Cheffins surmises the 'areas of concern' of limited liability in relation to involuntary creditors as increased risk of not being compensated in so far as tort damages exceed the assets of the company (i.e. risk shifting) as well as "attenuated incentive to make the expenditures necessary to implement optimal safety precautions" (i.e. moral hazard), Cheffins *supra* note 217 page 506.

limited liability as with instances of trading whilst insolvent etc[221]. That is not to say that misconduct in relation to involuntary creditors is irrelevant to such grounds of unfitness as conduct that is detrimental to voluntary creditors with also be detrimental to involuntary creditors. 'negligence' in discharging the duties of director, e.g. failing to inform oneself to the company's affairs or to generally supervise it management[222] would be detrimental to all creditors in so far as it increased the risk of insolvency.

Nonetheless, specific instances of causing harm to involuntary creditors are rare in disqualification cases[223] but this is likely to be a result of the fact that section 6 applications can only be made after insolvency and that the information leading to such applications stems from reports by Insolvency Practitioners. As such, it is unsurprising that disqualification should focus on voluntary creditors as insolvency necessarily almost invariably leaves trade creditors etc with claims against the company and the IP's duty is to satisfy such claims to the greatest degree possible. However, that disqualification has a role in protecting involuntary creditors from abuse of limited liability is clear. Therefore references to the creditors whom disqualification aims to protect in the remainder of this thesis should be interpreted as refereeing to both voluntary and involuntary creditors.

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[221] For detailed explanation of this and other grounds of unfitness see 4.8 'The Conduct Sanctioned in Disqualification Cases', below.
[222] See for example *Re Westmid Packing Services Ltd* [1998] 2 All ER 124.
[223] The author is not aware of any such cases.

Chapter 4: Sanctioning Undesirable Conduct.

"It is beyond doubt that the purpose of section 6 is to protect the public, and in particular potential creditors of companies, from loosing money through companies becoming insolvent when the directors of those companies are unfit to be concerned in the management of companies"

Dillion LJ, Re *Sevenoaks Stationers (Retail) Ltd* [1991] Ch 164, at page 176.

4.1 Introduction

Disqualification does not attempt to prevent undesirable use of limited liability by exactly mimicking the compensation model, or indeed by seeking to foster the conditions necessary for that model to function efficiently. For if it were to do so, limited liability would be less likely to bring about an increase in risk-taking. Thus, disqualification does not attempt to remedy information deficits by forcing directors to disclose information to creditors, nor does it require them to pay appropriate compensation for any risk that they actually transfer. Instead it provides general 'public interest' regulation by which the State seeks an *ex post* sanction against a director whose conduct it deems to be undesirable, or in the words of the Act, 'unfit[224].

[224] See section 7 (1) of the Disqualification Act which states that the Secretary of State may apply for a disqualification order against a person where he feels that "it is expedient in the public interest" that a person be disqualified.

However, this raises the obvious question of what the State regards as 'undesirable' use of limited liability that is contrary to the public interest. An answer to this question is essential because not only will it make clear the limits of 'desirable' risk shifting (at least as far as the State is concerned), but it is also essential for a meaningful analysis of the success of disqualification. For unless it is clear what harm the State seeks to prevent by disqualifying directors, it is impossible to discuss the extent to which section 6 likely to be successful.

The most obvious answer to the question just posed is simply to say that 'the conduct sanctioned in disqualification cases is undesirable' and contrary to the public interest, and this is certainly true. However, it is not a satisfactory answer because not only is it necessary to know the actual conduct sanctioned, but it is necessary to *why* that conduct is felt to be contrary to the public interest. There are two matters that are relevant to this issue in section 6 cases. The first concerns the identification of the 'harm' that makes certain uses of limited liability *prima facie* contrary to the public interest. The second matter concerns the degree of blameworthiness for that harm which is necessary to justify disqualification.

Both of these issues are important to the success of disqualification, but identifying the 'harm' that disqualification seeks to sanction is particularly important to this thesis for it is the key to determining how far the State is willing to tolerate the licence to take risk that statutory limited liability gives directors. An analysis of this issue is also important because the contested nature of the public interest in corporate regulation makes the task of establishing the nature of that harm more difficult than perhaps it needs to be, because it has caused some inconsistency in approach to disqualification on the part of the judiciary.

Therefore, this chapter discusses the perception of public interest regulation adopted in section 6 and argues that whilst different approaches to the degree of blameworthiness necessary to justify a disqualification undoubtedly exist, there is an obvious and settled understanding of what makes certain acts 'undesirable abuse of limited liability'. It argues that this understanding is evident in the Act itself, that it is sometimes evident in judicial rhetoric but that it is almost always evident in judicial practice.

4.2 Public Interests in Company Law.

Arguments surrounding the legitimacy of corporate power are inextricably bound up with notions of the public interest. Those who view the company as a social enterprise and follow Dahl's claim that "every large corporation...[is] an entity whose existence and decisions can only be justified insofar as they serve the public or social purposes"[225], essentially assert that corporate power should only be exercised for social good. According to such theorists any exercise of power that cannot be justified against this goal would be 'harmful'. They therefore define the public interest in company law in terms sufficient to justify intrusive public regulation of the exercise of corporate power. Such theorists often view the

[225] R. A. Dahl, '*A Prelude to Corporate Reform*' (1972) Business and Society Review 17, quoted in J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law,* (Oxford, Claredon Press, 1993), page 23.

company as resting on a concession of power by the State and consequently view the company in a framework that is conducive to state regulation[226]. On the other side of the theoretical divide sit adherents to the nexus of contracts view[227] who describe the company as a product of a complex web of private contracts and assert that the public interest role of the State is limited to providing mechanisms for the contracting parties to enforce their rights[228]. For them *regulation* which goes beyond this goal would be 'harmful'. Property rights theorists come to a similar conclusion, but base their reasoning on the supposed proprietary nature of shareholders' interest in companies, which they see as making the company a private association in which the scope for State intervention is limited[229].

The goal that public interest regulation of directors ought to pursue is therefore not a subject capable of objective definition, but is instead determined by political, economic and social considerations, not least the political, economic and social climate in which the public interest debate

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[226] Parkinson, *ibid,* page 25.

[227] See 2.2, *supra.*

[228] In viewing the company as a creature of 'market contracting', proponents of the nexus-of-contracts theory can claim that any 'public' regulation will distort the market and lead to an inefficient outcome. That is not to say that they deny outside groups have an interest in the company. Easterbrook and Fischel, for example, concede that outside groups do have such an interest, however, they assert that protection of the interest of these groups is a matter for contractual negotiation see Easterbrook and Fischel, *supra* note 188. For a critique of the nexus-of-contracts 'private' conception of the company see Ireland P, *Implicit Contract as Ideology* in D. Campbell, H. Collins, & J. Wightman, (eds), *Implicit Dimensions of Contract: Discrete, Relational and Network Contracts* (Oxford and Portland, Hart Publishing, 2003). See also D. Campbell, *The Role of Monitoring and Morality in Company Law,* (1997) 7 Aust. J. Corp Law 343, who subjects the market and contractual foundations of the theory to sustained criticism

[229] Again, see Parkinson, '*Corporate Power'*, *supra* note 225, pages 33-39. For a general overview of the public and private theories of the firm, see A. Woolfe, *The Modern Corporation: Private Agent of Public Actor?* 50 Wash. & Lee L. Rev 1673. Woolfe considers the public and private characteristics of the firm and seeks to determine its true nature. He ultimately argues that both theories are flawed but that the starting point for

takes place[230]. This is the reason why we encounter different perceptions of the public interest within capitalist economies. In Germany, for example[231] policy makers view corporate power as legitimate only when exercised for social good, which has lead to a definition of the public interest that legitimises prescriptive legal regulation of the company's structure. In the UK, on the other hand, policy makers view the company more as a private enterprise, which leads to quite a different perception of the public interest[232]. That two such different approaches have been sustained over a lengthy period of time is a testament to the contested nature of how a society views the role of the public interest in companies.

4.3 The Contested Public Interest in Disqualification.

In disqualification, conduct condemned as unfit is merely an expression of conduct that is felt not to be in the public interest. Therefore, it is unsurprising that different attitudes to 'unfitness' should be seen across the spectrum of disqualification cases and that these should appear to represent different interpretations of the public interest in corporate regulation. The difference in approach is most obvious in relation to the degree of

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analysing company law should be to begin with its public side and only then consider its private characteristics.

[230] On the role of politics of corporate governance see generally, M. Roe, *Political Determinants of Corporate Governance*, (Oxford, O.U.P., 2004).

[231] For a comparative study of the public interest in Germany and the UK see S. Donnelly, *The Public Interest and the Company in Germany*, in J. Parkinson , A. Gamble, & G. Kelly, (eds) *The Political Economy of the Company* (Oxford, Hart Publishing, 2000).

[232] As Parkinson notes (*Corporate Power, supra* note 6, pages 22-23) some authors deny that the public interest is the standard by which corporate activity should be judged in a market system of economic organisation. Some versions of the nexus-of-contracts view would adopt this ideology, however in that the public interest has many possible meanings, i would argue that 'a' public interest is relevant to all theories of the company, in that each

blameworthiness necessary to justify a disqualification in the public interest. However, it is by no means clear whether these differences lead to conflicting perceptions of the 'harm' that causes a certain use of limited liability to be classed as undesirable.

Vanessa Finch[233] has argued that two approaches to disqualification are evident across the spectrum of reported cases, which she terms 'rights' and 'privileges' approaches. Finch argues that the 'rights' approach reflects a " 'business enterprise' perspective on company law"[234] which sees managing a company as a valuable mode of wealth creation and only legitimates interference with that right (i.e. disqualification) where a high degree of blameworthiness is present for harmful conduct. As such, Finch appears to suggest that the rights approach adopts a perception of the public interest akin to that in contractual and proprietary analysis of the company i.e. one that does not legitimate paternalistic regulation to achieve socially desirable outcomes. Finch argues that judges who adopt the rights approach view section 6 disqualification as a fundamentally penal process[235] and that they emphasise the need for a high degree of blameworthiness and for retribution[236] for it to be in the public interest to withdraw the desirable right

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theory seeks to ensure that some 'good' comes from corporate activity. That 'good', be it profit maximisation or social equality must by definition be felt to be a public interest.

[233] See, V. Finch, *Disqualifying Directors: Issues of Rights, Privileges and Employment* (1993) 22 Industrial Law Journal 35 and V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge, Cambridge University Press, 2002).

[234] Finch, *ibid* page

[235] Finch, *Corporate Insolvency Law, ibid,*, page 522.

[236] See for example Hoffman LJ who declared in *Secretary of State for Trade and Industry v Gray* [1995] 1 BCLC 276 that the purpose of making disqualification in section 6 mandatory was to ensure that everybody whose conduct fell below the standard was disqualified whether 'the individual court thought this was in the public interest or not', see

of entrepreneurs to incorporate. Broadly speaking, Finch's analysis suggests that the rights approach, regards all risk-taking facilitated by limited liability as desirable, regardless of its detrimental impact on thirds parties, unless the director has acted in a manner worthy of punishment.

The privileges approach on the other hand, is said to reflect a social responsibility perspective on company law and as such "looks not merely at the interests of investors, managers, directors and creditors but to the 'legitimate needs, too, of the public interest, of the consumer and the employee'"[237]. As such Finch suggests that it is more concerned with public protection rather than 'punishing' the director for commercially reprehensible conduct and emphasises the privilege of limited liability is to be used responsibly. As such it would seem that Finch suggests a more sceptical attitude towards the 'benefits' of limited liability. Therefore, under the 'privileges' approach, uses of limited liability that adversely impact on third parties will be viewed as undesirable without the need for a high degree of culpability for any harm inflicted. Thus, the tenor of Finch's analysis suggests that the *privilege* approach adopts a 'pluralist'[238]

Finch, *Corporate Insolvency Law*, *ibid*, page 524. See also *Re Imperial Board Products*, [2004] EWHC 2096, see also *Re Crestjoy Products Ltd* [1991] BCC 268.

[237] Finch, *Corporate Insolvency Law*, *supra* note *ibid*, page 522.

[238] I use the term 'pluralist' in the sense that disqualification is concerned with broader spectrum of interests than just profit maximisation. The same term was used by the Company Law Review Steering Group to describe the theory that company law should serve a broader range of interest than simply the shareholders (See Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework*, (London, DTI, 1999)). This theory is also commonly called the 'stakeholder theory'. However, for the moment I only use the term pluralist in the general sense that it is concerned with more than profit maximisation. It is not intended to denote any specific form of 'stakeholder' theory.

interpretation of the public interest such as that we expect to see in more social democratic systems of economic organisation.

The difference between the rights and privileges approach in terms of blameworthiness is clear and unambiguous. Finch cites several examples of judges who emphasis the need for culpability and retribution in their discussion of when disqualification is merited, and others who emphasis the need to protect the public even from simple incompetence[239]. However, what is not clear is whether this difference in emphasis extends to philosophical differences as to the nature of harmful conduct.

It is certainly conceivable from Finch's analysis that the two approaches would offer very different, and mutually exclusive, interpretations of what equates to harmful use of limited liability. The 'rights' approach, would appear to be born of the philosophy that sees limited liability as a valuable method of wealth creation, and as such define 'harm' very narrowly, focusing perhaps on conduct that is economically harmful. The 'privileges' approach, on the other hand, would appear to owe much to the concession theory of the company and to emphasise the rights of creditors and others and as such define a broad spectrum of acts as harmful because they are socially undesirable. Concession theory asserts that companies are created by an exercise of state power that bestows privileges on those who own/control them[240] and creates an environment conducive to paternalistic state regulation of companies to achieve public

[239] Finch, *supra*, note 233.
[240] D. Millon , *Theories of the Corporation*, (1990) Duke L.J. 201. See also See J. Dewey, '*The Historical Background Of Corporate Legal Personality*', (1926) 35 Yale LJ 655,

interest outcomes that are felt to be morally or socially desirable, akin to the goals of the 'privileges' approach suggested by Finch. Indeed, such a broad interpretation of harmful conduct would seem inherent in Finch's claim that the privilege approach "looks...to the 'legitimate needs, too, of the public interest, of the consumer and the employee'"[241].

Concession theory has a long pedigree in disqualification. It was evident in the Cork report's recommendation that disqualification be introduced to "severely penalis[e] those who abuse the privilege of limited liability by operating behind one-man, insufficiently capitalised companies"[242], and in the declaration of the National Audit Office[243] that disqualification existed to "protect the public and commercial world from those who abuse the *privilege* of limited liability [my emphasis]". In terms of judicial philosophy, concession theory is also evident in many judicial statements which are cited as examples of the 'privileges' approach, such as that of Neil LJ in *Re Grayan Building Services Ltd*[244], where his Lordship stated that "Those who trade under the regime of limited liability and who avail themselves of the privileges of that regime must accept the standards of probity and competence to which the law requires company directors to conform".

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and Parkinson, *supra* note 225, page 27.

[241] Finch, *Corporate Insolvency Law*, *supra* note 233.

[242] Department of Trade and Industry, *Report of the Review Committee on Insolvency Law and Practice*, (Chairman Sir Kenneth Cork) Cmnd. 8558 (London, HMSO,1982), para 1815.

[243] National Audit Office, *Insolvency Service Executive Agency, Company Director Disqualification – A Follow Up Report,* (House of Commons Papers, Session 1998-1999,424) (London, The Stationary Office, 1998).

[244] [1995] Ch. 231.

Given this frequent recourse to concession theory in disqualification, it might be thought that the 'social responsibility' element in the privileges approach ought to represent the perception of harmful conduct that was intended by the Disqualification Act. However, whilst the privileges approach may be desirable as being compatible with a frequently expressed philosophy of disqualification, and represent the correct approach to blameworthiness, the claim that it represents a 'social responsibility' perspective of harmful conduct that is materially different from that adopted under the 'rights' approach ought to be rejected. For, whilst the two approaches clearly differ in their appreciation of the degree of blameworthiness necessary to justify public interest disqualification, it does not necessarily follow that they differ markedly in their interpretation of what is harmful conduct. Indeed, the argument that the approaches follow distinctive objectives is somewhat undermined by the fact that examples of judges who have adopted both approaches at various times (sometimes even in the same case) are relatively common.[245] Such an interchangeable approach to the two approaches would be highly illogical if they represented fundamentally different perceptions of the objective behind disqualification, if however, they represent only a difference in emphasis such inconsistency is less troubling.

[245] Finch ,*Corporate Insolvency Law supra* note 233, notes instances where Harman J has taken into account 'rights' and privileges' factors.

4.4 The Public Interest in British Company Law.

The established view of the 'public interest' in British company law gravitates towards economic and proprietary arguments such as those suggested for the rights approach and has not historically recognised the sort of pluralist interpretation of the public interest suggested for the privileges approach. As such, our corporate governance regime is generally understood to legitimate the goal of profit maximisation in the interests of shareholders[246]. In keeping with this responsibility, the Company Law Review Steering Group recently stated that the law "requires directors to operate companies for the benefit of shareholders".[247] Profit maximisation in the shareholders interests is justified as a public interest goal because it is claimed to be the most effective way to ensure that corporate power is used to create wealth. The rules which accord special privileges to shareholders and which deny similar rights to third parties are therefore justified as being in the public interest in so far as they help to ensure that 'desirable' profit maximisation takes place.

The notion of profit maximisation for shareholders is an integral feature of many models of the company that originate from a contractual or proprietary analysis. Alchian and Demsetz[248], for example, justify shareholders position as the beneficiaries of the directors' profit maximising duty in terms of the need for a body to monitor the directors' 'output'. They

[246] Parkinson, *Corporate Power and Responsibility, supra* note 225.
[247] Company Law Steering Group, *Modern Company Law for a Competitive Economy Developing the Framework* (London, Department of Trade and Industry, 2000), para. 2.7
[248] A. Alchain, & H. Demsetz, *Production Information Costs and Economic Organisation*' (1972) 62 American Economic Review 777.

argue that the shareholder/monitor also needs an incentive to discharge his function and this is achieved by giving him privileged proprietary rights to the profit of the enterprise.

However, that is not to suggest that the perception of the public interest in UK company law is static in its approach to the rights of third parties. Rather the notion of what form of corporate governance is in 'the public interest' has evolved as the values of society have changed. Thus, the profit maximising duty has been interpreted in different legislative contexts over many generations. Profit maximisation with no regard to third parties, such as the rights of employees, has not been acceptable for many years, if it ever was. Each generation has interpreted the duty in the light of the legislative constraints it feels are necessary to ensure that corporate power is exercised in the most beneficial way. Thus, in modern times profit maximisation has remained the basic goal of directors but it has been interpreted in the light of a legal framework that seeks to protect specific outside interests, for example, certain rights of employees, health and safety standards[249], environmental protection[250] etc. However, it cannot be said that these developments represent a coherent move towards 'social responsibility' in company law such as that suggested by the privileges approach. Indeed, merely hemming in profit maximisation with legislation to protect certain third parties is a minimalist response to concerns about their rights. Of course, specific legislation to deal with employment rights

[249] See for example the provisions of the Health and Safety Act 1974 , The Management of Health and Safety at Work Regulations 1999 (SI 1999/3242).
[250] See for example the provisions of the Pollution Prevention and Control Act 1999.

and environmental protection would always be needed even if a pluralist notion of the public interest were adopted. However, if concerns over the rights of third parties were thought to outweigh the benefits of profit maximisation, that duty itself would be changed[251]. The fact that it has not indicates a continuing belief in profit maximisation, albeit within a more restrictive legislative context.

Of course in one instance, legislative change has affected the duty more directly. Section 309 of the Companies Act 1985 obliges directors to have 'regard' to the interests of employees of the company and as such represents a tacit acceptance of that employees have an interest in the running of companies. However, the section is weak and ensures that the duty is not enforceable by employees by stating that it is a duty owed to the company and is only enforceable by it[252]. The proposed requirement that directors 'have regard' to the interest of a wider class of third party interests, proposed in the white paper *Modernising Company Law*[253], suffers from the same singular defect. Thus, it is clear that the shareholder orientation of the law is likely to be preserved for the foreseeable future.

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[251] By, for example, adopting a stakeholder type duty under which, in the words of the Company Law Review Steering Group, " it should be possible, or even obligatory, for directors to operate companies for other purposes, where the direct economic interests of those with business relationships with the company (such as the needs of employees, or suppliers, or the local community), or the wider public interest, demanded it". Company Law Steering Group, *Modern Company Law for a Competitive Economy, Developing the Framework*, (London, Department of Trade and Industry, 2000) para. 2.7.

[252] See Parkinson, *supra* note 225, chapter 3.

[253] The white paper proposes to include a clause in the codified statement of duties that requires directors to 'have regard' to the company's need to foster good relationships with suppliers, customers and employees.; the impact of the company's operations on the environment; the need to maintain high standards of business behaviour and the need to be fair between members, see White Paper, *Modernising Company Law*, Cmnd 5553-II.

As such it would be difficult to reconcile any 'social responsibility' approach to the regulation of directors in section 6 disqualification with the State's prevailing policy. For, there is no rule which says that corporate power should only be exercised to achieve socially desirable outcomes, as the Company Law Review Steering Group's conclusion that the profit maximising duty should not be abandoned in favour of a more pluralist, stakeholder shows[254]. Recent policy statements from the government also show no sign of such a shift[255].

Consequently, the more pluralist interpretation of the public interest in disqualification would be anomalous if it was used to condemn conduct that offended *socially* desirable goals set by the judges. For, there has been no proposal to alter the 'market' orientation of company law rules. However, if section 6 disqualification is examined closely it is clear that it does no such thing.

4.5 Social Responsibility in Disqualification.

Disqualification is certainly concerned with wider considerations than profit maximisation. This is obvious from even a cursory glance at schedule 1[256] of the Act which cites a wide variety of matters as 'relevant' to

[254] Company Law Steering Group, *Modern Company Law for a Competitive Economy. Completing the Structure*, (London, Department of Trade and Industry, 2000), chap 3.
[255] For example, the approach evidenced in the consultation document *"Rewards for Failure" Directors Remuneration – Contracts, Performance and Severance", supra* chapter 2 .
[256] Schedule 1 of the Act direct the Courts attention to the following matters when assessing whether a disqualification is desirable;
" 1. Any misfeasance of breach of fiduciary duty in relation to the company.
2. Any misapplication, retention or conduct giving rise to an obligation to account for company money.

a court's consideration of unfit conduct. Many of the matters referred to in the schedule appear to have little relevance to a director's duty to act bona fide in the best interest of the company[257], and much more relevance to public policy considerations. Thus, the schedule lists a director's failure to comply with various accounting and disclosure requirements as relevant to unfitness, his failure to 'supply goods paid for', as well as his breach of several provisions of the Insolvency Act 1986 designed to prevent dispositions of assets prior to liquidation which are harmful to creditors. More general matters such as 'the extent of a director's responsibility for a

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3. The extent of a director's responsibility for the company entering into a transaction liable to be set aside under Part XVI of the Insolvent Act[256].
4. The extent of a directors failure to comply with the following provisions of the Companies Act 1985,
    a. section 221(duty to keep annual accounts);
    b. section 222 (where and how records are to be kept);
    c. section 228 (register of directors and secretaries);
    d. section 352 (keeping up the register of members);
    e. section 353 (location of register of members);
    f. section 363 (duty to make annual returns);
    g. sections 399 and 415 (duty to register charges created).
5. The extent of a director's failure to comply with (a) section 227 of the CA 1985 or (b) section 233."

The matters that are mentioned in part 2 of schedule one are matters that are only to be taken into account where a company has become insolvent and are, therefore, more specific to section 6. These matters are:

"6. The extent of a director's responsibility for the company becoming insolvent
7. The director's responsibility for the company not supplying goods and services paid for.
8. The director's responsibility for the company entering into any transaction or giving any preference that is (a) liable to be set aside under section 127 or sections 238-240 of the Insolvency Act 1986[256]; or (b) challengeable under section 242 or 243 of the Insolvency Act 1986[256].
9. The extent of the director's responsibility for any failure to comply with section 98 of the Insolvency Act[256].
10. Any failure to comply with any of the following provisions of the Insolvency Act 1986
    a. section 22 (statement of affairs in administration);
    b. section 47 (statement to the administrative receiver);
    c. section 66 (statement in a Scottish receivership);
    d. section 99 (duty to attend wind up meetings);
    e. section 131 (statement in a court winding up);
    f. section 234 (duty to deliver up company property)
    g. section 235 (duty to co-operate with liquidator).

company becoming insolvent' are also included. However, the *bona fide* duty is not ignored by the schedule, as a director's breach of his fiduciary duties is cited as a relevant matter along with 'any misapplication or retention of the company's assets'.

Despite the inclusion of fiduciary duties in schedule 1 it is clear from that schedule that section 6 disqualification is intended to benefit both shareholders and other interest groups, for conduct that harms the welfare of groups such as customers and other creditors are obviously intended to be sanctioned by section 6. However, it does not necessarily follow that section 6 adopts anything that could be characterised as a 'social responsibility' perception of the public interest. It is clear from the analysis of limited liability and disqualification that section 6 aims to control uses of limited liability that adversely impact upon creditors and which could undermine confidence in limited liability if left unregulated. The matters cited in schedule 1 are perfectly compatible with this aim and with the market interpretation of public interest that characterises English company law.

4.6 Public Interest Regulation, the Market and the Private Law.

In a predominantly market and private law system of economic organisation, such as that in the UK, 'public interest' regulation is only legitimate where there has been a failure of 'private law' and 'market' regulation[258]. 'Market failure' occurs where parties are unable to reach a

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[257] *Re Smith and Fawcett* [1942] Ch. 304.
[258] A. Ogus, *Regulation Legal Form and Economic Theory*, (Oxford, Clarendon Press, 1994).

welfare maximising bargain through market transactions and private law failure occurs where a welfare maximising bargain is reached but is unenforceable because either party is unable to avail himself of the private law remedy he has, or that remedy is itself unavailing. Thus, in such a system the goal of public interest regulation would essentially be to restore the desirable market and private law outcome through public interest regulation. If the goals of public interest regulation were to achieve socially desirable outcomes that would not result from market transactions, this model would obviously not be applicable.

4.6.1. Loss and the Public Interest.

In section 6 cases disqualification is used to sanction conduct that has harmed the welfare of creditors, most usually by causing financial loss to them. The fact that such conduct has taken place indicates that there has been 'market' and 'private law' failure that has resulted in allocative inefficiency. For, loss shows either that creditors have failed to resolve agency problems through *ex ante* bargaining with directors or that they have failed to use *ex post* private law powers to prevent loss.

Therefore, there is clear scope for public interest regulation to remedy an allocative inefficiency that cannot be remedied by private law means in section 6 cases. As such it would appear easy to apply 'market' criteria for public interest regulation to instances of conduct that causes loss to creditors, particularly in owner-managed companies. Consequently, the desire to protect creditors from the exploitation of limited liability cannot of itself be characterised as a paternalistic interference in a predominately market system of economic organisation because where optimal risk taking is not secured through bargaining between creditors and owner-managers because of information asymmetries etc, there is *prima facie* market failure that leads to allocative inefficiency.

However, the 'market failure' that occurs in director-creditor relationships, is as I have discussed in chapter 3, largely the result of statutory limited liability, which the State has chosen to create because of its belief that limited liability is a desirable method of wealth creation. Thus, it must be emphasised that disqualification does not seek to prevent all allocative inefficiencies that arise from limited liability by, for example, exactly mimicking the compensation model because the 'benefits' of limited liability rely upon such inefficiencies. As such, disqualification is selective in the market and private law outcomes that it chooses to enforce. Nonetheless, it does seek to sanction conduct that would not occur under idealised market conditions i.e. risk-taking that results in loss to creditors, but only where there is some element of blameworthiness present. Of course, there is clear disagreement between the judges as to the level of blameworthiness necessary to justify disqualification, but this is a disagreement about the circumstances in which disqualification is desirable. It is not a disagreement as to the essential purpose of disqualification and therefore the nature of the harm that it seeks to eschew. Therefore, it is submitted that regardless of whether a particular judge adopts the rights of privileges approach, the essential objective of disqualification is settled and that objective is broadly economic in that section 6 seeks to 'protect the public' from loss caused by blameworthy exploitation of the opportunity to effect uncompensated transfers of risk allowed by limited liability.

The central role of loss in section 6 disqualification is clear from several cases in which the objectives of disqualification have been considered. For example, in the case of *Re Sevenoaks Stationers (Retail) Ltd*[259], Dillon LJ stated, in a passage that has been identified as emphasising the public protection (i.e. privileges), approach[260], that:

> "It is beyond doubt that the purpose of section 6 is to protect the public and in particular potential creditors of companies, *from loosing money through companies becoming insolvent* when the directors of those companies are unfit to be concerned in the management of companies [my emphasis]"

The importance of preventing loss is clear in this passage and, indeed, it would be difficult to interpret this passage as legitimating a social responsibility perspective on company law which "looks not merely at the interests of investors, managers, directors and creditors but to the 'legitimate needs, too, of the public interest, of the consumer and the employee'"[261]. Rather, it clearly indicates that loss to creditors from insolvency is the 'harm' that disqualification seeks to protect the public from.

The essentially economic focus of disqualification is also reflected in the test of unfitness that has been developed in the courts and which Finch attributes to the 'rights' approach. The test uses language of *commercial* accountability and responsibility such as that of Hoffman J in *Re Dawson*

[259] [1990] BCC 765.
[260] By Finch, *Rights and Privileges, supra* note 233
[261] Finch, *ibid.*

Print Group[262], where it was stated that a director's conduct would only be held unfit where it would be:

> "regarded in the commercial world as breach of *commercial morality* such that it should require a conclusion that the director responsible is unfit to be concerned in the management of companies"[my emphasis][263].

The choice of the phrase *commercial* morality in this and subsequent cases indicates that responsibility and accountability are viewed very much in terms of a desire to sanction conduct that inhibits efficient market transactions. A sentiment expressed by the NAO when it stated that ""The disqualification arrangements are intended to promote confidence and risk-taking in the market, by assuring those who do business with limited liability companies that directors who are unfit will be disqualified"[264].

The concentration on loss to creditors as the essence of a harmful use of limited liability is also clearly evident in schedule 1. Part 2 of the schedule, for example, cites a 'director's responsibility for insolvency' and any conduct by him which is intended to unfairly reduce the assets of the company before insolvency proceedings[265] as relevant to unfitness. More generally disqualification has been used to sanction instances of outright

[262] [1987] BCLC 601.
[263] *Ibid* at pages 604-605. Dillon LJ in *Re Sevenoaks* approved this statement, *supra* note 259 at page 779. See also *Re Lo-Line Electric Motors Ltd* [1988] Ch 477 where Browne-Wilkinson V-C stated at page 486 the : "Ordinary commercial misjudgement is not in itself sufficient to justify disqualification. In the normal case, the conduct complained of must display a lack of commercial probity, although I have no doubt that in an extreme case of gross negligence would...be appropriate".
[264] National Audit Office, Report by the Comptroller and Auditor General, *Insolvency Service Executive Agency, Company Director Disqualification – A Follow Up Report*, , (House of Commons Papers, Session 1998-1999, 424) (London, The Stationary Office, 1998), page 1.
[265] Schedule 1 part 2 rules 6 and 7, *supra* note 256.

fraud or dishonesty[266], the misuse of company bank accounts[267], trading at the risk of creditors[268] and where directors fail to ensure that goods that have been paid for are delivered[269]. All of these are *prima facie* examples of where disqualification sanctions unfit conduct that causes loss to creditors. As such they can be viewed as the product of an economic interpretation of the public interest, in that conduct that causes loss to creditors has evidently not been secured through bargaining.

Thus, there is significant evidence that indicates a settled appreciation of the harm that makes certain uses of limited liability undesirable, which, indeed, is borne out by closer analysis of common forms of misconduct sanctioned in cases brought under section 6 of the Disqualification Act[270].

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[266] See for example *Re Moorgate Metals Ltd* [1995] BCC 143 where an attempt to procure a false complaint from a customer about good purchased from a supplier was held to be evidence of unfitness.
[267] See for example *Re Hitco 2000 Ltd* [1995] BCC 161
[268] *Re CS Holidays Ltd* [1997] BCC 172. Chadwick J stated at page 178 that "If it is established in proceedings under section 6 of the Act that a director has caused a company to trade when he knew or ought to have known that there were no reasonable prospects that the company would avoid going into insolvent liquidation, that director may well be held unfit to be concerned in the management of companies".
[269] Schedule 1 part 2 paragraph 6, *supra* note 256. For a case example see *Secretary of State for Trade and Industry v Tjolle* [1998] 1 BCLC 333.
[270] Any survey of the disqualification cases reveals that certain types of conduct' are very frequently cited as evidence of unfitness. Many of those matters are specifically mentioned in the schedule 1 list of matters 'relevant to a disqualification application, (see note 256, *supra*), but others, such as a failure to pay tax are not. The types of misconduct cited in the following section as examples of 'common' forms of unfit conduct are therefore drawn from those cited in the leading publication on directors' disqualification, i.e. *Mithani: Directors' Disqualification,* and comprise matters mentioned in schedule 1 as well as other common specific instances of unfitness. See A. Mithani, *Directors Disqualification* (Looseleaf Publication) (London, Butterworths, 1998), chapter 2 paras XX.X – XX.X.

4.8 The Conduct Sanctioned in Section 6 Cases.

4.8.1 Excessive Remuneration.

A good illustration of the economic focus of section 6 can be seen in the courts' treatment of allegations that a director is unfit because he has 'drawn excessive remuneration' from his company. At first sight such an allegation may seem to be a good example of the State using section 6 to further paternalistic goals by seeking to keep directors pay within 'reasonable' limits. However, excessive remuneration has been held to constitute unfit conduct only in cases where it shown to cause actual or potential loss to creditors[271]. Thus, it has been held that excessive remuneration by a director who is also a sole shareholder will be unfit where it is merely a device to affect an unlawful return of capital[272] or where a director knows that that a company is insolvent or failing to meet its debts[273] i.e. where they are likely to result in uncompensated loss to creditors. However, where a company is solvent and pays its debts promptly, the level of a director's remuneration is seen as a matter for shareholders[274] and will not be a matter of unfitness whatever its level.

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[271] See for example *Re Mooregate Metals Ltd* [1995] BCC 143 where Warner J stated "To my mind [the directors] helped themselves to remuneration and to benefits at the expense of the company and of its creditors to an extent that was in all the circumstances irresponsible", at page 151.

[272] *Re Halt Garage (1964) Ltd* [1982] 3 All E. R. 1016.

[273] *Re McNulty's Interchange Ltd* (1988) 4 BCC 533.

[274] See *Re Halt Garage Ltd, supra* note **Error! Bookmark not defined.**, at page 1039, where it was states that "They [the creditors] have to accept the shareholders' assessment of the scale of remuneration, by they are entitled to assume that, whether liberal or illiberal, what is paid is genuinely remuneration and that the power is not used as a cloak for making payments out of capital to the shareholders". See also the recent DTI consultation paper *"Rewards for Failure" Directors Remuneration – Contracts, Performance and Severance,*

4.8.2 Trading Whilst Insolvent to the Detriment of Creditors.

Another frequently cited 'matter of unfitness' that has a clear focus on economic loss to creditors is the allegation that a director caused or permitted 'trading whilst insolvent'. This is a matter of unfitness which is akin to 'wrongful trading' under section 214 of the Insolvency Act[275]. As far as disqualification is concerned, it has been held that unfitness lies in causing a company to continue to incur debts beyond the point at which it was obvious that it could not avoid insolvent liquidation. Thus, Chadwick J in *Re C S Holidays Ltd*[276] stated:

> 'If it is established...that a director has caused a company trade when he knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation, that director may well be held unfit...'[277]

This formulation is extremely close to the test of liability under section 214 and is clearly intended to protect the economic well being of creditors, however, it has been established that disqualification is concerned with a director's conduct as a whole and, that liability for trading whilst

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(London, Department of Trade and Industry, 2003), in which the Secretary of State for Trade and Industry, Patricia Hewitt, declared at page 5 that the Government has:
"made clear that setting directors pay...is a matter for those companies and their shareholders. *It is for shareholders as the owners of the company* to ensure that remuneration levels and structures *provide the right incentives and that directors are held to account for company performance* [my emphasis]".

[275]On section 214 see generally, D. Prentice, *Creditors Interests and Directors Duties.* (1990) 10 O.J.L.S. 265. Section 214 of the Insolvency Act 1986, permits a liquidator to apply to court requesting that a director be held liable to contribute to the assets of the company if it can be shown that at sometime before the winding up of the company the director knew, or ought to have concluded that there was no reasonable prospect that the company would avoid insolvency and that the director did not take reasonable steps to minimise loss to creditors. Section 214 was introduces following a recommendation firm the

insolvent is wider than under section 214[278]. The guidance notes[279] on unfit conduct issued to Insolvency Practitioners, for example, identify a number of matters that can amount to unfitness under this category, such as the amount by which company debts increased after a *de facto* insolvency, whether directors moderated their remuneration whilst the company was having trading difficulties, whether cash injections were expected as well as whether the directors had any "valid reason" to believe that the companies trading fortunes would change[280]. Any one of these matters may amount to unfit conduct even if it would not fall within the scope of section 214[281]. Directors have however, been granted a degree of latitude when judging the trading prospects of their company. Hoffman J (as he then was), has expressed the opinion that the courts ought to recognise that directors of troubled companies tend to 'cling to hope'[282]. However, as Hoffman J is a prominent adherent to the 'rights' approach, it is not certain that all judges will be prepared to give directors the benefit of any doubt. Nonetheless, the emphasis on preventing financial loss in this particular category of unfitness is clear.

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[276] *Ibid.*
[277] *Ibid* at page 178.
[278] *Re Bath Glass* [1988] 4 BCC 130.
[279] In solvency Service, *Guidance Notes for the Completion of Statutory Reports and Returns*, (London, Insolvency Service, 2001).
[280] *Ibid,* page 12.
[281] Mere trading whilst the company is technically insolvent is therefore not sufficient. See: *Re Delta Distribution* [2002] 1 BCLC 99.
[282] *Re C U Fittings* [1989] BCLC 556.

4.8.3 Breach of Duties

Schedule 1 of the Disqualification Act cites a director's breach of his duties towards his company as a matter indicating potential unfitness and many examples of a director being found unfit because a breach of his duties can be found in the reported cases. For example, directors have been held unfit because of; a failure to declare an interest in a contract to which a company is a part,[283]; causing a company to enter into 'sham' transactions[284]; causing or permitting the misuse or misappropriation of the company's money[285]; evidence that a director allotted shares to himself to retain control of a company[286];a director's failure to 'manage the company properly'[287], causing 'transactions that were not in the best interests of the company',[288] causing or permitting transactions which were intended for the personal benefit of directors[289] and causing what were described as 'improper transactions'[290]. Indeed, many other matters of unfit conduct represent potential breaches of fiduciary duties, such as drawing excessive

[283] see *Re Dominion International Group Pc (No 2)* [1996] 1 BCLC 572 (a breach of the 'duty to disclose', (*Aberdeen Railway Co v Blaikie Bros* (1854) 1 Mac 461). See also Companies Act 1985 section 317)

[284] *Re Landhurst Leasing Plc* [1999] 1 BCLC 286

[285] By, for example, procuring the company to pay for work carried out on a private dwelling pace, *Re Synthethetic Technology Ltd* [1993] BCC 549

[286] *Re Looe Fish Ltd* [1993] BCLC 1160.

[287] This would appear to equate to a breach of the duty of care and skill , It was cited as evidence of unfitness in 70 cases.

[288] An apparent breach of the duty to act *bona fide* in the best interests of the company (*Re Smith and Fawcett* [1942] Ch.304).

[289] An apparent breach of the duty to act bona fide and/or the no conflict duty. See for example the case of *J.J. Harrison (Properties) Ltd v Harrison* [2002] 1 BCLC 162, where Chadwick LJ stated at page 173 that "...the powers to dispose of the company's property, conferred. upon directors by the articles of association, must be exercised by the directors for the purposes, and in the interests of the company".

[290] Cited in 30 cases.

remuneration from the company[291] and the misuse of company bank accounts, which often included allegation of unexplained cash withdrawals and the issuing of cheques with out regard to whether they could be honoured[292].

The 'unfitness' in a breach of fiduciary duties appears to lie in reducing the company's prospects of successful trading through a failure to manage the business properly or through the appropriation of the company's assets. As such, the focus on economically undesirable conduct that can adversely impact upon the company's creditors is clear in this particular category of unfit conduct.

4.8.4 Transactions at a Preference or Undervalue.

Another prominent category of unfit conduct included in schedule 1 that is clearly intended to sanction conduct that causes economic harm to creditors, is 'causing or permitting transactions at an undervalue or a preference'.

Sections 238 and 239 of the Insolvency Act 1986 give 'office holders'[293] the power to request a court with competent jurisdiction to set aside any transaction which they believe was made at an undervalue or at a preference[294]. The aim of the court in making an order to set a transaction

[291] A mater cited as evidence of unfitness in 78 cases, see table 1, *supra*.
[292] See *Re Hitco 2000 Ltd* [1995] BCC 161.
[293] 'Office holders' are defined by section 7(3) of the Disqualification Act as; the official receiver; a liquidator, an administrator or an administrative receiver.
[294] Section 238 (4) defines a transaction at an undervalue as a transaction where a company enters into a transaction with a person and the company "makes a gift to that person or otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration, or (b), the company enters into a transaction with a person for a

aside is to 'restore the position that would have existed had the transaction not been made'[295] by ordering direct recovery from those who have benefited from the transaction[296]. This is obviously a highly beneficial measure for creditors, which provides a direct remedy for loss that result from this type of unfit conduct.

In the context of disqualification, the meaning of a transaction at a preference was considered in two cases, *Re M C Bacon Ltd*[297] and *Re Living Images Ltd*[298], where it was held that a preference is given when, (i) in making a particular transaction the company/director has a desire to improve the position of a particular creditor in the event of insolvency and, (ii) that desire influenced a transaction between the creditor and the company. However, it was established in *Re Kaypack (No 2)*[299] that in accordance with the wording of paragraph 8[300], evidence that a director is responsible for a transaction at a preference or an undervalue is not automatically evidence of

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consideration the value of which, in money or moneys worth, is significantly less than the value, in money or moneys worth, than the consideration provided by the company" Section 239 (3) defines a preference as "the company doing or suffering anything to be done ...which has the effect of putting [a] person into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done".

[295] Section 238 (3).

[296] Section 241 (1) (d), see foe example *Phillips v Brewin Dolphin Bell Lawrie Ltd* [2001] 1 All ER 673, where a transaction at an undervalue could not be reversed so the court ordered the beneficiary of the transaction to pay the amount of the undervalue to the liquidator. This power extends to directors if it they who benefit from a preference or undervalue transaction: See *Re Exchange Travel (Holidays) Ltd (No 3)* [1996] 2 BCLC 524. A wide variety of other sanctions are set out in section 241, including: an order to transfer property (e.g. *National Westminster Bank plc v Jones* [2001] 1 BCLC 55), sale of property and transfer of the proceeds to the liquidator as well as the release or discharge of ant security or charge granted by the company.

[297] [1990] BCLC 324.

[298] [1996] 1 BCLC 348.

[299] [1990] BCLC 440.

[300] Paragraph 8 stares that "The extent of a directors responsibility" for entering into a transaction at a preference or undervalue shall be taken into account. It therefore indicates

unfitness, if his actions were *bona fide* intended to be in the best interests of the company[301].

The desire to sanction dispositions of assets that harm creditors in section 6 cases has led to a flexible approach to actual or potential breaches of section 238 & 239 as evidence of unfitness. Thus, it has been held that a transaction does not have to have been previously set-aside in proceedings under section 238 or section 239 in order to be relied upon in section 6 cases[302] because the disqualification court can determine the nature of the transaction for itself. Likewise, if a transaction has been set aside in separate proceedings and remedies already proscribed under section 238 or section 239, this does not prevent a court from determining that the transaction also constitutes unfit conduct for the purposes of disqualification[303]. Further, it was held in *Re Sykes (Butchers) Ltd*[304] that it may be possible for the Secretary of State to rely upon a transaction that does not amount to a preference or undervalue within the meaning of the Insolvency Act but which is nonetheless 'commercially reprehensible' in section 6 proceedings. Ferris J held in that case that disqualification was not concerned solely with specific breaches of the Companies Act 1985 or the Insolvency Act 1986, but with a director's conduct generally. On the facts of the case it had been held that a director had not granted a preference within the meaning of

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the circumstances of each transaction should be considered in relation to the 'unfitness' of the director.

[301] See for example *Re ECM (Europe) Electronics Ltd* [1991] BCC 268, where a director's state of mind at the time of the transaction was given considerable importance in determining unfitness. See also *Re New Generation Engineers Ltd* [1993] BCLC 435.

[302] *Official Receiver v Sutton* (Unreported, 31 October 1990).

[303] *Re Grayan Building Services* [1995] BCC 554.

section 239 but nonetheless it was held that his conduct demonstrated a lack of 'commercial probity' that indicated unfitness.

This approach cannot be attacked as erring from the objectives of section 6 because if a director takes advantage of his position to cause loss to creditors, then his conduct ought to be sanctioned regardless of whether that conduct is prohibited by specific legislation. However, courts should be cautious in adhering to the objectives of section 6 as sanctioning conduct that does not cause loss would produce no benefit. Whether, particular conduct does or does not cause loss however can only be determined on the facts of each case.

4.8.5 Other Instances of Loss Causing Conduct.

Similar conclusions to those reached above can be repeated in respect of many categories of unfit conduct included in schedule 1 or prominent amongst the reported cases. Misuse of company bank accounts[305], for example, which often consists of allegations that cheques have been issued without regard to whether they could be honoured[306], is a form of misconduct that can have detrimental impact upon creditors, as are

304 [1998] 1 BCLC 110.
305 Mithani, A. *Directors Disqualification* (Looseleaf Publication) (London, Butterworths, 1998), chapter 2 paras 579-592.
306 See for example *Re Hitco 2000 Ltd* [1995] BCC 161. Such conduct will be regarded as particularly unfit whereby cheques have been issued in order to induce the supply of goods and services.

categories such as fraud and misrepresentations[307], a failure to 'provide goods paid for' to customers[308], and making unauthorised loans from the company to directors or connected persons contrary to section 330 of the Companies Act 1985[309]. The failure to co-operate with an Insolvency Practitioner of Official Receiver[310] is also a form of misconduct that, in most cases, has been used by the courts to sanction conduct that can cause loss to creditors[311]. However, in some circumstances it seems that the category has been extend beyond its proper limits[312].

4.8.5.1 Phoenix Misconduct.

A further prominent type of misconduct sanctioned in section 6 cases is what is often referred to 'phoenix' misconduct. 'Phoenix' misconduct was particular concern of the Cork Committee and was a matter that

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307 Following the guidelines set down in *Re Sevenoakes Stationers Limited* [1990] BCLC 668, proven allegations of fraud and general dishonesty tend to attract a lengthy period of disqualification. See for example *Re Moorgate Metals Ltd* [1995] 1 BCLC 503.

308 This category includes instances where directors permit a company to accept deposits or advance payments in circumstances where it is obvious that the company will not be in a position to supply the goods or services. See for example, *Re Western Welsh International System Buildings Ltd* [1988] 4 BCC 449. In such circumstances a director may also be open to an allegation of trading at the risk of creditors, see *supra* 4.81.

309 See for example, *Re Tansoft Ltd* [1991] BCLC 339.

310 The failure to co-operate with an office holder is a 'relevant matter' set out in paragraph 10 of schedule 1, see also Mithani, *supra* note **Error! Bookmark not defined.**, chapter 2.

311 The sorts of failure to co-operate that have been cited as unfit conduct include, a sustained refusal to answer questions posed by an office holder (see for example *Secretary of State for Trade and Industry v McTighe* [1997] BCC 224), knowingly misleading an office holder (*Re Living Images* [1996] BCC 112), swearing a false statement of affairs (*Re Moorgate Metals Ltd* [1995] BCC 143), failure to restore company property to the liquidator (*Re Probe Data Systems (No 3)* [1991] BCC 428) and even wrongly claiming that property belongs to another director (*Re Synthetic Technology* [1993] BCC 549).

312 See for example *Re Howglen, Secretary of State for Trade and Industry v Reynard* [2002] 2 BCLC 625, in which a director's obstructive conduct during court proceedings was cited as evidence of unfitness.

disqualification was specifically intended to address[313]. The Company Law Review Group has described the 'phoenix' phenomenon as:

> "the continuance of a failed company by those responsible for the failure, using the vehicle of a new company. The new company...uses the old company's assets, often acquired at an undervalue and exploits it good will and business opportunities. Meanwhile the creditors are left to prove their debts against an empty shell."[314]

However, setting up a phoenix company does not represent undesirable use of limited liability *per se*, as it is perfectly possible that the rescue of a failed business (particularly where the failure was not caused by the directors actions) could benefit creditors and customers in the long term, provided of course that the business is successful the second time around. This has been recognised in disqualification cases where a distinction has been drawn between 'good' and 'bad' phoenix operations[315]. Bad phoenix companies have been described at those motivated by self-interest and which involve dishonest behaviour[316]. However, given the strong condemnation of such companies in disqualification, it is surprising that there is no express statutory prohibition on taking-over the business of a failed company. The only control on such conduct is the prohibition on

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[313] Department of Trade and Industry, *Report of the Review Committee on Insolvency Law and Practice*, (Chairman Sir Kenneth Cork) Cmnd. 8558 (London, HMSO, 1982), para 1741.
[314] Company Law Review Steering Group, *Modern Company Law For a Competitive Economy, Final Report*, Volume I, (London, DTI, 2001), para 15.55.
[315] *Official Receiver v Zwrin* (26th July 2001, unreported).

certain persons re-using a company's name in section 216 of the Insolvency Act[317].

Nevertheless, instances of 'bad' phoenix misconduct are obviously likely to result in loss to creditors and are rightly subject to a sanction. However, it is important to state that care should be taken to avoid applying disqualification too widely and there by deterring desirable ('good') phoenix operations. Where, for example, disqualification follows acts such as transferring assets from failed companies at an undervalue, or where they have been deliberately removed to defeat creditors' claims[318]loss causing conduct has been sanctioned. However, in some of the cases, it is less clear that the distinction between good and bad phoenix conduct is respected. For example, it is often alleged that a phoenix operation is objectionable because the new company has no 'reasonable prospect of success'[319], usually alleged where no material change is made in the conduct of the new business. Such broad allegations should be treated with caution and all relevant circumstances considered, including the cause of the original company failure, to avoid a 'chilling' effect on desirable activity that ultimately

[316] *Ibid.* However, a director can still be disqualified in circumstances where his conduct is not dishonest, see, *Re Linvale Ltd* [1993] BCLC 654, where on the facts a director was disqualified for 'honest' but reckless phoenix misconduct.
[317] Section 216 prohibits any person from being concerned in the promotion, formation or management of a company that bares the same name, or a similar name as an insolvent company with which that person was involved within the 12 months of the insolvency. The prohibition lasts for five years, although leave can be obtained from it during this period. Section 217 provides that a person who acts in breach of the section 216 prohibition can be held jointly an severally liable for the debts of the company incurred whilst that person was involved in its management. The Company Law Review proposed reform of the section 216 rule such that its focus would shift to assets transfers, see Company Law Review group, *Final Report*, paras 15.65 –15.72.
[318] See, for example, *Secretary of State for Trade and Industry v McTighe* [1997] BCC 219 and *Re Keypak Homecare Ltd* [1990] BCLC 440.
[319] See for example *Re Travel Mondial (UK) Ltd* [1991] BCC 224.

causes greater loss to creditors. However, the courts have demonstrated a willingness to consider each case on its merits and this should be welcomed[320], but given the large amount of discretionary control over the interpretation of 'unfitness' that now lies in the hands of the Secretary of State, the use of disqualification to sanction phoenix conduct may be a potential barrier to effective use of disqualification[321].

Nonetheless, this and the other the categories of unfit conduct considered so far provide strong support for the contention that disqualification seeks to protect creditors from economic harm, even though some concerns over the use that is made of disqualification can be expressed. However, before it can be claimed that loss lies at the heart of the courts assessment of unfitness it is necessary to consider two very common forms of misconduct.

4.8.5 Disqualification for Breaching Publicity and Accounts Requirements.

Schedule 1, paragraphs 4 (f) and 5 of the Disqualification Act require a court to 'have regard' to a director's failure to comply with a number of accounting, reporting and filing requirements, in determining whether a person is 'unfit' to be concerned in the management of

[320] See for example *Re Lo-Line Electric Motors Ltd* [1988] Ch 477, where a director successfully demonstrated that despite being a phoenix company with a similar *modus operandi* to the failed company the new business did have reasonable prospects for success. Unfortunately for the director, he was disqualified on other grounds.
[321] See further chapter 7 below.

companies[322]. In accordance with the Act the failure to comply with 'accounting and disclosure' obligations is a prominent form of misconduct[323].

In general terms, the accounting and disclosure provisions of the Companies Act have been described as a 'shield' protecting members *and creditors* from corporate mismanagement[324]. The provisions are, as was discussed in chapter 2[325], one of the main regulatory responses to the division of ownership and control, but they are of use to creditors in so far as they help creditors to assess the risk of dealing with limited liability companies and therefore limit their exposure to risk.

As far as disqualification is concerned, the Court of Appeal has held that the publicity and information provisions were "introduced by Parliament to raise standards" of responsibility and that those who make use of limited liability "must be punctilious in observing the safeguards set down by Parliament *for those who deal with their companies* [my emphasis]"[326]. As such, persistent[327] lapses in fulfilling those obligations have been held to display a lack of commercial morality sufficient to justify

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[322] For example, it was held in *Re Bath Glass Ltd* [1988] 4 BCC 130, that a failure to comply with sections 242-244 of the Companies Act (requiring that accounts be delivered to the registrar of companies within set times) could be cited as evidence of unfitness even though these sections are not mentioned in Schedule 1.

[323] Mithani, *supra* note **Error! Bookmark not defined..**

[324] Davies P, *Gower and Davies Principles of Modern Company Law*, 7th Edition, (London, Sweet & Maxwell, 2003), page 533. See also J. Freedman and M. Godwin, *The Statutory Audit and the Micro Company – An Empirical Investigation* [1993] JBL 105.

[325] See 2.3 , *supra.*

[326] Nicholls V-C in *Re Swift 736 Ltd* [1993]BCC 312 at 315.

[327] Isolated lapses are not generally sufficient to justify disqualification, see *ibid* and *Secretary of State for Trade and Industry v Hickling* [1996] BCC 678 at 693. However, much depends upon the circumstances of the case, see *Re CSTC* [1995] BCC 173, where a single lapse was held to be sufficient evidence of unfitness. Failure to comply with

disqualification[328]. The importance of the protection of creditors in this category of misconduct is therefore clear, for the unfitness in not complying with disclosure requirements lies in the harm that it can cause to 'those who deal with companies'. The implication being that creditors are more at risk of harm (which must mean financial loss as the relationship between debtors and creditors is financial) where accounting and disclosure requirements are persistently not complied with. Thus, this particular category of misconduct also seeks to sanction conduct that can inflict economic harm on creditors.

4.8.6 Crown Debts.

Disqualification for non-payment of Crown money, or for 'trading to the detriment of the Crown', is a prominent type of unfit conduct that can, *prima* facie, can present certain problems within the context of the essentially economic goals of disqualification, or at least with the goals so far outlined. This category of misconduct involves allegations that a director caused debts to the Crown to increase because of insolvent trading, or that the director caused 'transactions to the detriment of the Crown', such as repaying loans to some creditors in preference to debts owed the Crown[329]. The substance of these allegations is however the same, i.e. that the Crown was not paid revenue due to it for one reason or another. The term 'Crown

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disclosure requirements may also be excusable if it is due to factors beyond a directors control, see *Re ECM (Europe) Electronics Ltd* [1992] BCLC 814.

[328] Some decisions however, suggest that in circumstances where the preparation and filing of accounts would not have been beneficial to creditors a failure to prepare such accounts should not be treated seriously in disqualification proceedings, see *Re Cargo Agency Ltd* [1992] BCLC 686. In contrast a director, who was also a chartered accountant was disqualified in the case *Re Caldrose Ltd* [1990] BCC 11 for failing to compile accounts even though they would have been of no practical use to creditors.

debt' has therefore been described by Lord Justice Dillon in *Re Sevenoaks Stationers Ltd*[330], as a 'term of art' that: "denotes debts due from the company to the Crown in respect of PAYE, national insurance contributions and VAT, but not debts due to the Crown in respect of other matters (such as development grants)".

Non-payment of tax obviously causes direct financial 'loss' to be incurred by a creditor of the company i.e. the Crown. However, the Crown is not like most other creditors of the company because the company's obligations to the Crown are imposed and not, as the case with other creditors (save tort creditors), voluntarily assumed. Therefore given that the focus of disqualification appears to be on commercial creditors (as is evident from important aspects of section 6 such as the test of *commercial* morality[331]) the special nature of the loss inflicted on the Crown presents certain problems for 'Crown debts' as a matter of unfitness.

An awareness of the potentially uneasy relationship between the non-payment of tax and the broad thrust of section 6 has been recognised by the judges who have made clear efforts to reconcile the use of non-payment as evidence of unfitness with the general focus of protecting private creditors from loss.

Throughout, the late 1980's the non-payment of Crown debts had been treated as more serious evidence of unfitness than non-payment of

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[329] See for example, *Re Northstar Multimedia Ltd*, 13th June 2001 (unreported).
[330] [1991] BCLC 325 at page 328. See also *Re GSAR Realisations Ltd* [1993] BCLC 409 where Ferris J stated that "Crown monies....are sums due [to the Crown] in respect of unpaid PAYE, tax, and national insurance contributions and other sums due in respect of unpaid VAT".

ordinary creditor debts[332]. However, this trend was reversed in case of *Re Sevenoakes*[333], in which Dillon LJ held that non-payment of Crown debts should be treated with the same degree of seriousness as non-payment of ordinary creditor debts and that, the existence of Crown debts was not evidence of unfitness *per se.* Rather, he held that there needed to be non-payment *as well as some aggravating factor* to sustain an allegation of unfitness[334]. Since *Re Sevenoakes*, a number 'aggravating factors' have been identified which turn mere non-payment into sufficiently unfit misconduct. One well-established factor is evidence of a deliberate policy of not paying Crown debts to finance insolvent trading[335]. Another is evidence of a policy of preferring other creditors to the Crown by only paying creditors who press for payment[336]. This type of conduct is equally applicable to ordinary creditors as well as the Crown, however, it is of particular relevance to Crown debts because a number of judges have been impressed by the argument that the Crown cannot, or does not, habitually 'press' for payment in the manner that ordinary creditors may[337]. In such cases directors are often condemned for 'taking advantage of the Crown' or 'taking advantage of the Crown's forbearance'. Other factors that have been

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[331] See, *Re Dawson Print Group Ltd*,[1987] BCLC 601.
[332] See, *Re Wedgecraft Ltd* (7 March 1986, unreported), see also, *Re Stamford Services Ltd* [1987] BCLC 607 and *Re Churchill Hotel (Plymouth) Ltd* [1988] BCLC 341.
[333] *Re Sevenoakes Stationers (Retail) Ltd* [1990] BCLC 668.
[334] *Re Sevenoakes, ibid.*
[335] *Re J & B Lynch (Builders) Ltd* [1988] BCLC 376. Such conduct may be regarded as particularly serious where Crown debts make up a large proportion of the total: see, *Re D J Matthews (Joinery Design) Ltd* (1988) 4 BCC 513. Nevertheless, there is no minimum period of non-payment necessary to sustain an allegation of unfitness: *Re Verby Print for Advertising Ltd* [1998] 2 BCLC 23.
[336] *Secretary of State for Trade and Industry v McTighe* [1987] BCC 224.
[337] *Ibid.*

held sufficiently serious include, a deliberate decision not to pay VAT when the company is solvent[338], negligence in ensuring that Crown debts were paid to a 'marked degree'[339] and a failure to adhere to an agreed schedule for the payment of arrears to the Crown[340].

In so far as these extra elements indicate a general lack of competence or honesty by directors then the desire to protect *commercial* creditors from loss can be seen to lie at the heart of this category of conduct, for dishonest or negligent directors obviously pose a greater risk of making undesirable use of limited liability. However, the courts' attempt to ensure that disqualification is not seen to be used by the State in a self-interested way is by no means completely successful. There is, for example, no guarantee that dishonesty in respect of the Crown's imposed tax obligations indicates dishonesty in respect of freely assumed obligations. Further, if the aim of disqualification for not having paid tax is to sanction dishonesty or recklessness these matters could be sanctioned as other types of misconduct. Supposed 'preferring' of other creditors over the Crown, for example, can be sanctioned as a 'transaction at a preference' and not as 'non-payment of Crown debts'. The fact that 'non-payment' is nevertheless included in these allegations indicates that the mere fact of non-payment *does* have some bearing upon a finding of unfitness, despite the emphasis on 'extra elements'. Therefore, the justification that it is not 'non-payment' but 'dishonesty' which is sanctioned in these cases is not wholly convincing,

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338 *Official Receiver v Dhiren Doshi* (1st March 2001, unreported).
339 *Re Lo-Line Electric Motors Ltd, supra,* note **Error! Bookmark not defined.**.
340 See, for example, *Re Park House Properties Ltd* [1997] 2 BCLC 530.

even though it supports this thesis' contention that preventing loss is at the core of unfit conduct. However, , for present purposes it is sufficient to conclude that loss lies at the heart of the unfitness in a 'Crown debts' allegation. The further implications of the prominence of Crown debt misconduct will be considered below[341].

4.9 Loss and Section 6.

It is therefore submitted that sufficient evidence can be cited to sustain the conclusion that the purpose of section 6 disqualification is to protect creditors from *financial loss*. This is clear from the schedule 1 list of 'relevant matters' and from various judicial statements, some of which explicitly identify protection from loss as the purpose of section 6 and others that talk of 'commercial morality'. Most importantly however, it is evident from the approach of the courts to unfitness. It is certainly the case there is no evidence to suggest that section 6 is used to foster socially desirable conduct of the sort associated with a pluralist interpretation of the public interest in corporate regulation. Rather, the perception of the public interest adopted in section 6 is broadly economic and is therefore not anomalous within a 'shareholder-orientated' system of company law. However, that is not to say that disqualification follows exactly the model of 'public interest' regulation in market orientated system of economic organisation. For, whilst there is clear market and private law failure where directors engage in

[341] See 5.4.1, below.

conduct likely to inflict uncompensated loss; disqualification does not attempt to exactly mimic market controls by sanctioning *all* instances where directors' conduct presents a risk of loss to creditors. This is because limited liability relies on uncompensated transfers of risk, and therefore the risk of loss, to bring about an increase in risk taking. Consequently, disqualification is selective in the loss-causing conduct that it seeks to sanction.

The need for some level of blameworthiness on the part of the director for his conduct is the obvious method by which the State may seek to select certain conduct for sanction. Thus, loss-causing conduct accompanied by negligence, recklessness or dishonesty could be cited as undesirable. Although, there is some degree of conflict as to whether negligence is sufficient to justify disqualification, as Finch's analysis shows. However, there is one simple characteristic of section 6 disqualification that has not been considered so far in this chapter but which is highly relevant to the economic nature of section 6 and, indeed, the way the State distinguishes desirable from undesirable conduct.

Whilst blameworthiness is relevant to the selective mimicking of market and private law controls on directors conduct, it is not the principle means by which the State distinguishes acceptable from unacceptable risk of loss. More important is the fact that the State only seeks to sanction directors' conduct after an insolvency, i.e. *after* conduct is linked to a *proven* instance of economic harm. Indeed, the post-insolvency nature of section 6 disqualification serves to highlight the relevance of protecting creditors from loss to the sanction because insolvency almost invariably inflicts loss upon the company's creditors. Disqualifying those whose conduct has contributed, if not directly caused, this harm is therefore a clear attempt to protect from future instances of such financial harm and deter conduct by other directors that can lead to same result.

The economic objective of section 6 disqualification therefore means that its success ought properly to be judged by the extent to which it reduces loss to creditors; in terms of protecting them from a repeat of conduct that is linked to an insolvency and the extent to which it deters such conduct amongst directors generally. Significant doubts will be expressed about the extent to which disqualification prevents or reduces loss. Furthermore, whilst it has been demonstrated in this chapter that the major categories of unfit conduct sanctioned in the cases studied demonstrate the importance of loss to unfit conduct, it does not necessarily follow that the pattern of unfit conduct sanctioned in section 6 cases equates to an effective disqualification regime. It will be argued instead that the actual benefit to creditors from the pattern of unfit conduct sanctioned, are open to doubt and that there are other features of section 6 that limit its effectiveness.

. Therefore, subsequent chapters of this thesis discuss, in cost-benefit terms, various aspects of the disqualification regime under section 6 in order to form a judgement as to the success of the sanction.

Chapter 5: The Remedy of Disqualification.

"Ensuring that the business community and consumers are protected from the activities of rogue directors is vital".

Melanie Johnson MP, Competition and Consumer Affairs Minister, 29th May 2003[342].

5.1 Introduction: Why a Cost-Benefit Analysis of Disqualification?

When ministers state that the aim of section 6 disqualification is 'protective', they emphasise the essentially economic objectives against which the sanction should be judged[343]. For, 'protection' from the activities of rogue directors necessarily means preventing the harm, in the form of uncompensated financial loss, which undesirable conduct inflicts upon the public and the business world. The success of disqualification must therefore depend upon the amount of such loss that it prevents. This would not be the case if the objectives of disqualification included fostering socially desirable conduct or punishing errant conduct. For, in such cases section 6 would have a wider objective than merely reducing loss, such as

[342] Department of Trade and Industry, press release *"Crackdown of Directors who Deft Disqualification Orders"*, 29th May 2003.
[343] The same reasoning is evident in the National Audit Offices' analysis of disqualification. See, National Audit Office, *Report by the Comptroller and Auditor General, Insolvency Service Executive Agency, Company Director Disqualification – A Follow Up Report*, , (House of Commons Papers, Session 1998-1999, 424) (London, The Stationary Office, 1998), para 3.2.

retribution or an increase in 'social welfare'. However, disqualification is not offered by the state as a means to punish directors, even though it has been described as 'very nearly penal'[344]. Neither, is the sanction intended to foster socially desirable conduct amongst directors. Thus, reducing loss must the objective against which section 6 should be assessed. Of course, the view that an evaluation of a regulatory system in cost-benefit or wealth maximising terms can provide a definitive answer to whether a particular form of regulation is 'good' regulation has been disputed[345]. Many commentators assert than such 'efficiency' is one of several measures that should be used when evaluating whether a particular regulatory system is satisfactory[346]. However, given the clear aim of disqualification to protect the public from abuse of limited liability, which has a clear economic objective (i.e. loss reduction from misconduct), a quantitative analysis of the general efficiency[347] of the disqualification regime must be an essential part of any critical analysis of the success of the regime.

It would be unrealistic to expect section 6 to eliminate *all* loss from undesirable conduct and, indeed, it would not be desirable to set this as its

[344] *Re Crestjoy Productions Ltd* [1990] BCC 23 at page 26.
[345] See, for example, R. Dworkin, *Is Wealth Value?*, (1980) 9 JLS 191; A. Kronman, *Wealth Maximisation as a Normative Principle*, (1980) 9 JLS 227; R. Baldwin , *Rules and Government*, (Oxford, OUP, 1995). For a review of 'efficiency' in wealth maximising terms see, A. Posner, *Utilitarianism, Economics and Legal Theory*, (1970) 8 JLS 103.
[346] For example Baldwin proposes that the efficiency of a regulatory system should be assessed by reference to a number of factors, such as whether the system is supported by legislative authority, whether it is accountable, whether it is 'fair' as well as a judgement as to whether the system is efficient. See, Baldwin, '*Rules and Government*', *ibid.*
[347] In the sense that the policy provides clear benefits over and above any loses which flow from the system. In this sense the analysis accepts basic principles of allocative efficiency ,

goal because as well as being impossible to achieve, the cost of attempting the total elimination of loss would be prohibitive. A more realistic and desirable goal would be to expect section 6 to deliver a benefit greater than its cost[348] for it to be regarded as a successful form of regulation. By this measure section 6 would be regarded as successful if its aggregate benefit, in terms of reduced loss from undesirable conduct, were greater than its aggregate costs[349]. Such a cost-benefit analysis has been described as an "indispensable part of any rational regulatory policy making"[350], and it is submitted that it is essential to any analysis of section 6 because section 6 can only be beneficial if it brings about an increase in welfare.

The costs of section 6, like any form of regulation, are many and varied. The section will create 'administrative costs' in terms of the cost associated with formulating and applying the regulation. It will also create litigation costs in terms of the costs incurred in the course of legal proceedings to disqualify unfit individuals. Compliance costs will also be generated, in terms of the costs to directors of meeting the standard of behaviour expected by the regulation. Finally the section may have unwanted and unintended consequences and thereby create 'indirect costs'.[351]

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see generally, A. Ogus, *Regulation Legal Form and Economic Theory*, (Oxford, Clarendon Press, 1994).
[348] See generally A. Ogus, *Regulation : Legal Form and Economic Theory* (Oxford, Claredon Press, 1994), chapter 8.
[349] Thus, this thesis adopts the 'Kaldor-Hicks' test of efficiency, see generally B.Cheffins, *Company Law: Theory, Structure and Operation* (Oxford, Claredon Press, 1997), page 15.
[350] Ogus, *supra* note 348, at page 153.
[351] See Ogus, *supra*, note 348.

The balance between such costs and the benefit of disqualification will determine its effectiveness and, indeed, desirability. Therefore, the current and following chapters discuss the likely quantitative and qualitative costs and benefits of section 6 disqualification in order to form a value judgement about the desirability of the sanction. The current chapter begins this analysis by focusing on the cost benefit implications of the sort of regulation provided by section 6, the limitations of the benefit that the section is capable of providing and discusses cost-benefit issues raised by the previous chapter.

5.2 The Cost of Section 6.

5.2.1 Rules v Standard.

When policy makers decide to regulate a particular activity, they can do so either by proscribing a specific set of rules to control that activity or use a general standard[352]. Rules will be used where the regulator wishes to eschew specific undesirable acts and, as such, identify undesirable conduct with some precision. Standards, on the other hand, are more general and will be used where the regulator seeks to ensure that conduct matches some desirable level. The choice between regulating via a specific set of rules or general standard has cost implications for any regulatory regime and disqualification under section 6 is no exception to this rule. Each approach has different cost implications is because the two approaches differ, first, in the degree of certainty they provide, second, in the 'scope' of the regulation and third, in the flexibility of either approach.

5.2.1.1 Certainty.

Regulation of an undesirable activity by a specific set of rules has the advantage of bringing certainty to both the regulator and the regulated class that can reduce compliance and enforcement costs. The certainty provided for by rules reduces compliance costs for the class subjected to regulation because a set of rules which define undesirable acts in some detail will allow the regulated class to ascertain, and then avoid, undesirable acts easily and at a low cost. Consequently, compliance with the regulation is likely to be high where rules are used which, in turn, will lead to lower enforcement costs to be incurred by the regulator[353]. It has also been suggested that a specific set of rules is will bring reduced litigation costs because certainty will lead to increased out-of-court settlements, as the outcome of prosecutions would be easier to predict.

A standard based approach to regulation is unlikely to bring these benefits because of its generalist nature. The lack of certainty in a standard is likely to increase the cost to the regulated class of ascertaining and then avoiding undesirable conduct. Consequently, compliance with a standard will be lower than that which could be expected with a set of rules as some members of the regulated class may be deterred from adapting their conduct

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[352] On the choice between 'rules' and 'standards' see I. Ehrlich, & R. Posner, *An Economic Analysis of Rule Making*, in A. Ogus, (ed), *Regulation, Economics and the Law*, (Cheltenham, Edward Elgar Publishing, 2001).

by the cost of gathering information on prohibited conduct.[354] As such, the frequency of litigation is likely be higher under a standard, as would the costs of litigation, because of a decreased incentive to settle cases before trial and indeed, because of the need for judges to determine the parameters of prohibited conduct.

5.2.1.2 Scope.

A further advantage of a set of rules over a standard is that rules could have fewer damaging side effects than standards i.e. bring fewer indirect costs. Standards that are set too wide or which have an unclear scope may have the effect of deterring desirable conduct as well as undesirable conduct, and therefore cause inadvertent costs to be incurred[355]. In the context of disqualification, a broad or undefined standard could have a 'chilling effect' on desirable business activity as well as undesirable activity. A specific set of rules would avoid this possibility by clearly separating undesirable conduct from desirable conduct and eschewing the possibility of sanction for desirable conduct.

5.2.1.3 Flexibility.

However, in terms of flexibility, standards have some cost advantages over rules. A problem with regulating through a set of rules is that rules are potentially rigid and inflexible. They are therefore less likely to provide a complete response to undesirable activity, as it is often extremely difficult and expensive to formulate a comprehensive set of rules

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[353] *Ibid*, page 262-266.
[354] *Ibid.*

that specify all possible forms of undesirable conduct[356]. In the context of disqualification, all possible types of 'unfit' conduct by directors would be difficult to distil into a set of comprehensive rules, and attempting such a process would be very costly, requiring extensive inquiry into past, present and future conduct of directors. As such, any rule-based approach is likely to suffer from 'underinclusion'[357] because the cost of attempting to codify all forms of undesirable activity would be prohibitive in all but the simplest regulatory scenarios. Further, codification of undesirable conduct may not always be possible due to information deficiencies.

Therefore, a rule-based approach to regulation could only be expected to identify some of the most serious or common forms of undesirable conduct. In other words, it would attempt to reduce only some aspects of an undesirable activity, which could lead to sub-optimal regulation. A standard based approach, on the other hand, has the advantage of being flexible and capable of providing a 'remedy' for all forms of undesirable conduct. A further benefit of a standard is that the transaction costs to the regulator of formulating a standard would obviously be lower than in setting a complex list of rules. There are, of course, costs associated with fleshing out the standard through the higher number of contested enforcement proceedings, but these could be partly shifted on to private parties through cost rules in contested proceedings.

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[355] *Ibid*, page 263, See also R. Posner, *An Economic Analysis of Legal Procedure and Judicial Administration*, (1973) 2 J.Leg. Stud. 399.
[356] Ehrlich and Posner, *supra* note 352, page
[357] Ehrlich & Posner, *An Economic Analysis of Legal Rulemaking*, *supra* note 352, pages 267-268.

Standards also have a further advantage over rules in that they are capable of adapting to changes in attitudes towards undesirable conduct and therefore require less frequent revision than rules. However, the adaptability of standards can be over-stated because the flexibility of a standard depends upon the attitudes of the agencies charged with the task of enforcing it as much as it does upon the formulation of the standard itself[358]. Therefore, conservative attitudes on the part of the enforcement agency to the interpretation of the standard could lead it to be just as inflexible as a rule. Indeed, general standards ultimately mean no more or no less than what enforcement agencies choose them to mean and are susceptible to manipulation in a way that rules are not. Misinterpretation is therefore a persistent danger in the use of standards, for if a legislature enacts a standard as the principle means of regulating some activity, control over that regulation is effectively given over to the body with responsibility for enforcing the standard[359]. Unless the regulator is made properly accountable for the exercise of its power, there is no guarantee that such a body will use the standard for the purpose it was originally intended.

5.2.2 The Best of Both Worlds: Section 6 and Schedule 1.

When enacting section 6, Parliament seemingly attempted to secure the benefits of a standard in terms of flexibility with some of the benefits of certainty that rules can bring. Thus, section 6 disqualification is a hybrid form of regulation that uses the very general standard of 'unfit conduct' in

[358] See, further below and chapter 7.

section 6 itself, which is then supplemented by the more specific schedule 1 list of 'relevant matters'.

However, if the intention of Parliament in enacting the schedule 1 list was to reduce litigation and compliance costs, there is little evidence to suggest that it has been successful because the schedule itself often lacks clarity and is of only limited scope. For one thing, schedule 1 gives only a non-exhaustive list of the *sort* of conduct that a court *may* take into account in determining unfitness, should it wish to do so. Similarly, some of the matters listed in the schedule are vague and do not spell out the precise elements of conduct cited as relevant to unfitness. Paragraph 6 of schedule 1, for example, merely states as a relevant matter "The extent of a director's responsibility for the company becoming insolvent". This is certainly more specific than the general standard of 'unfit conduct', but tells us nothing of the level of culpability for the insolvency on the part of the director necessary to justify disqualification. Other matters cited in the schedule are more specific such as paragraph 4, which cites the breach of several specific provisions of the Companies Act 1985 as relevant matters. Nonetheless, whilst the schedule may give some greater certainty than section 6, it is unlikely to have reduced the costs of the section 6 standard significantly because it is a non-exhaustive list of unfit conduct. Indeed, several prominent forms of unfit conduct are not mentioned in the schedule[360] and have necessitated extensive judicial rule making. The schedule also provides

[359] Ehrlich & Posner, *An Economic Analysis of Legal Rulemaking*, *supra* note 352, pages
[360] Such as Crown debt misconduct, trading whilst insolvent to the detriment of creditors and taking excessive renumeration.

no guidance as to the level of blameworthiness necessary to justify a disqualification.

Indeed, the wealth of precedents concerning the meaning of 'unfit conduct' is a testament to the high cost of the judicial rulemaking necessitated by the vague nature of the section 6 standard. As such, the compliance costs faced by directors who wish to comply with section 6 are high due to the need to understand a vast and fluctuation body of case law. It should be noted that the costs of litigation and compliance will have reduced as the higher courts have fashioned some degree of clarity as to the meaning of unfit conduct[361], but they remain higher than would be the case under a rule-based approach to disqualification. These high litigation costs caused by the choice of standard is likely to have contributed to the State's desire to reduce court involvement in disqualification proceedings. The *Carecraft*[362] procedure and the recent introduction of disqualification undertakings, for example, were reforms designed specifically to reduce the cost of disqualification under section 6[363].

Furthermore, the generality of the standard in section 6 has allowed scope for conflicting approaches to unfitness to develop which must increase the likely costs of the sanction by increasing the frequency of litigation, making compliance more expensive and indeed increasing the cost of erroneous disqualification. The early judicial confusion over the treatment of

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361 See, for example, *Re Sevenoaks Stationers Ltd* [1991] 3 All ER 578, *Re Westmid Packing Services Ltd* [1998] 2 All ER 124, *Re Swift 736 Ltd* [1993] BCC 312, *Re Grayan Building Services Ltd* [1995] BCC 554.
362 *Re Carecraft Construction Co Ltd* [1993] 4 All ER 499. See further 7.2 below.
363 See further chapter 7.2 below.

'crown money' misconduct is a good example of such confusion. Similarly, the conflicting 'rights' and 'privileges' approaches[364] are likely to have increased litigation costs and the 'cost of error'. Not least, because where conflicting bodies of opinion develop over the correct interpretation of a standard the number of erroneous applications of the standard will be increased. Thus, if the 'rights' approach were to be the correct one then any disqualification made without evidence of culpability would be erroneous and represent a cost of disqualification due to 'over-regulation'. If, on the other hand, the 'privileges' approach were to be correct, any instance where a negligent director was not disqualified would represent a cost caused by 'under-regulation'. Thus, whichever approach is correct, or indeed if some third approach were held to be correct, the fact that different approaches to the degree of blameworthiness necessary to justify disqualification exist increases the likelihood of error and its associated cost.

However, the adoption of standard as the basis for regulation has not been universally negative. It is certainly true, for example, that the section 6 standard provides a flexible legal rule that is capable of sanctioning all instances of undesirable conduct and is therefore less likely to lead to under-regulation and associated costs. Similarly, the cost to the State of formulating the section 6 standard will have been low. However, with the flexibility of section 6 and lower formulation costs of the section comes uncertainty that has necessitated expensive judicial rule-making.

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[364] *Supra*, chapter 4.3.

Thus, on balance the costs of choosing to regulate undesirable conduct by directors by means of a standard are likely to have been high, certainly in terms of litigation costs and compliance costs in so far as inconsistencies and complex precedents prevent directors from discovering the nature of unfit conduct and avoiding it. Further, the lack of certainty in the standard has allowed conflicting approaches to disqualification to develop, which is likely to have increased the costs associated with erroneous decisions in disqualification cases. As such, it is essential that the section be capable of delivering clear benefits if the costs considered so far are to be justified.

5.3 The Benefits of Section 6.

Section 6 does not attempt to benefit creditors by compensating them for losses caused by undesirable use of limited liability. Thus, the section does not provide for the personal liability of those who have been found unfit and disqualified. Instead it provides what has been described as 'prohibitive remedial action'[365], which is intended to protect creditors by preventing future instances of unfit conduct during the period of disqualification and through deterring unfit conduct by directors generally. As such, the benefits of disqualification are rather indirect because the sanction does *nothing* to reduce the losses that creditors suffer from misconduct. It relies instead upon future protection and *general* deterrence. Indeed, it must be noted that the most direct financial effect section 6 has on

[365] By Lord Woolfe in *Re Blackspur Group Plc* [1998] 1 BCLC 676, at page 680.

creditors is to impose a *cost* on them. This is because the costs incurred by office holders in fulfilling their statutory reporting obligation under section 7 of the Disqualification Act are not reimbursed by the State, but form part of the office holder's fee deducted from the company's assets[366]. As such, the cost of reporting suspected unfit conduct is ultimately born by creditors. Thus, disqualification imposes a direct *cost* on creditors yet provides them with no direct benefit. Therefore, as far as creditors are concerned section 6 disqualification is a much less desirable sanction for 'unfit' conduct than other provisions of the company and insolvency law, which provide for the personal liability of directors who have committed undesirable acts[367].

5.3.1 Civil Recovery.

Many prominent forms of unfit conduct sanctioned in section 6 cases mirror acts for which personal liability can be imposed on directors under provisions introduced specifically to 'protect' creditors by increasing the assets available to settle their claims in insolvency. Undervalue and preference transactions[368] are such examples, for sections 238 and 239 of the Insolvency Act 1986 empower a court, on the application of a liquidator, to reverse such transactions. This can be either by ordering the return of

[366] The guidance issued to Insolvency Practitioners state that no payment will be made to IPs in respect of the time taken to fulfil their statutory obligations to report. See *Guidance Notes for the Completion of Statutory Reports and Returns*, (London, Insolvency Service, 2001), para 5.3 .
[367] E.G sections 213, 215, 245, 238 and 239 of the insolvency Act 1986.
[368] Cited as evidence of unfitness in almost 15% of the disqualifications included in the survey of unfit conduct in 2000-2001, see chapter 4, *supra*, table 1.

property to the company[369], or by ordering the beneficiaries of such transactions to 'make good' any losses suffered by the company.[370] The same is true of wrongful trading under section 214, where directors can be held personally liable for losses inflicted on creditors[371]. Similarly, any detriment inflicted on creditors by non co-operation with an office holder[372] can be remedied under section 236 of the Insolvency Act 1986, which gives a court extensive powers to order delivery of property to office holders and to direct the payment of any debt due. Furthermore, liquidators can rely upon other company law provisions, such as the *ultra vires* rule[373] and fiduciary duties[374] which, though not specifically designed to protect creditors, can be used to effectively recover loss inflicted on creditors by undesirable acts. Thus, from the point of view of the 'protection' of creditors of an insolvent company, civil recovery is more effective than disqualification under section 6, because it 'protects' them from loss to the extent that civil recovery can be made. However, it should be emphasised that civil recovery affords no protection from future instances of undesirable conduct other than through a deterrent effect[375]. Thus, it would seem that the best level of protection would be afforded to creditors when section 6 was used in conjunction with civil recovery provisions, because both present and

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[369] Section 241 Insolvency Act 1986. See for example *National Westminster Bank v Jones* [2002] 1 BCLC 55.
[370] See, for example, *Phillips v Brewin Dolphin Bell Lawrie Ltd* [2001] 1 All ER 673.
[371] See, for example, *Re Produce Marketing Consortium Ltd (No 2)* [1989] BCLC 520.
[372] A matter of unfitness cited in almost 16% of the survey cases. See *supra* Chapter 4 table 1.
[373] See B. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford, Claredon Press, 1997), page 527.
[374] See, *West Mercia Saftywear Ltd v Dodd* [1988] BCLC 250 and *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016.

future protection would be assured. As such, it is extremely important that disqualification should not seen be as an alternative to civil recovery because any increase in disqualification and the expense of civil recovery would leave creditors with less protection.

There is no firm evidence to suggest that office holders view disqualification as an alternative to civil recovery. However, the fact that the costs of complying with reporting obligations under the Disqualification Act are not reimbursed by the State certainly make it conceivable that disqualification could have a detrimental impact on civil recovery in complex cases. For the costs incurred in fulfilling statutory duties to investigate and report unfit conduct could make civil recovery less likely in cases where cost considerations are significant to the decision to institute recovery proceedings.

5.3.2 The Civil Recovery Scheme.

The State has experimented with bringing civil recovery proceedings in cases where a disqualification order has been made, but where liquidators did not pursue civil recovery. The Forensic Insolvency Recovery Service established a pilot civil recovery scheme in July 2000 with the intention of seeking recovery against directors who had contributed to corporate failure "by their negligence, misconduct or misappropriation of corporate assets to the detriment of creditors".[376] The scheme brought together the Insolvency

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[375] See further 8.4 below

[376] See the '*Dear Insolvency Practitioner*' letter, Issue Number 14, September 2003, chapter 3, page 3.9. Available at *http://www.insolvency.gov.uk/information/dearip/dearipmill/ fullissue14.doc.*

Service, Insolvency Practitioners and solicitors. Participants in the scheme agreed to work on a conditional fee basis in order to maximise the benefits of the scheme for creditors[377].

The scheme is undoubtedly a welcome attempt to marry the protective benefits of recovery and disqualification and it was extended following the conclusion of a 2 year pilot in 2003. However, if the results of the 2-year pilot are indicative, the scheme is unlikely to significantly improve the benefits which flow from section 6 disqualification. For, in the first two years of the scheme just thirty cases were identified as being suitable for civil recovery and in only 18 of those cases were recovery proceedings actually begun[378]. During the same period almost 3,000 disqualifications were made under section 6.[379] Therefore the benefits for creditors of insolvent companies from section 6 and State sponsored civil recovery are low. As such the benefits of section 6 disqualification remain limited to future protection from unfit conduct (for a specified period of time) and general deterrence.

The limitations on the benefit that section 6 is capable of providing to creditors are a result of the nature and construction of section 6 itself, not least because it is a purely post-insolvency sanction. Nonetheless, it is crucial that whatever benefits section 6 is capable of bringing can be practically demonstrated. Therefore, the worth of section 6 will depend upon

[377] *Ibid.*
[378] *Ibid*, chapter 3 page 3.11.
[379] *Companies in 2001-2002*, (London, The Stationary Office, 2002), table D1.

the deterrent effect it has and the amount of unfit conduct it is likely to prevent.

An assessment of these benefits is the subject matter of the next chapter. However, before the practical benefits of disqualification are discussed it is useful to consider the implications of the use of the disqualification sanction. For, in addition to the limitations in section 6 itself, its effectives is also undermined by instances where the sanction is applied in a manner that is unlikely to bring a significant benefit to creditors.

5.4 The Use of Section 6.

5.4.1 Crown Debts.

It will be recalled that the previous chapter that a common category of unfit conduct is the failure to discharge tax obligations,[380] and that the courts have sought to reconcile this form of unfit conduct with the objective of 'protecting consumers and the business community from loss'[381]. However, despite the fact that the courts have held that non-payment is a matter of unfitness only where it is accompanied by other conduct that could harm the economic welfare of (private) creditors, concerns about the use to which it is being put in practice can be raised due the elevated number of cases in which it is cited. For, there is some evidence that non-payment may be targeted as a matter of unfitness and general doubt as to the benefit to creditors of sanctioning non-payment.

[380] See chapter 4, table 1, *supra*.
[381] *Supra,* 5.4.7.

5.4.1.1 The Treatment of Crown Money Misconduct in Section 6 Proceedings.

The Insolvency Service guidance for Insolvency Practitioners (IPs) on the completion of statutory reports and returns contains a substantial section dealing with non-payment of Crown money. Section 4.1 of the *Guidance Notes*[382] entitled "Schedule 1 CDDA – Matters for determining unfitness of directors" specifically draws IP's attention to Crown debt misconduct under the heading "Relevant matters if the company has become insolvent" [383], despite the fact that Crown debt misconduct is not mentioned in schedule 1 of the Act. Indeed, the decision to draw IPs' attention to the existence of Crown debt in its own right is interesting in light of the decision in *Re Sevenoaks* that unfitness lies in finding dishonesty, recklessness or negligence rather than in simple non-payment of tax. Although, it should be noted that the *Guidance Notes* do advise IPs that the courts have held that non-payment of Crown debts is not in itself evidence of unfit conduct, and state that in order to make a specific allegation in relation to Crown debt the IP must demonstrate that 'the Crown has been treated worse than the general body of creditors' or 'that the forbearance of Crown departments has been abused'. However, by way of encouragement for IPs, the *Notes* declare that the Crown is an 'involuntary creditor' and that an absence of pressure to pay on the part of the Crown 'should not be regarded as a mitigating factor'[384].

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[382] Insolvency Service, *Guidance Notes for the Completion of Statutory Reports and Returns*, (London, Insolvency Service, 2001).
[383] *ibid*, page 13.
[384] *Ibid.*

Thus, whilst the statement of the law is accurate, the *notes* appear to accord a degree of prominence to Crown debts, which is at best out of step with Schedule 1, and elements of the case law and at worst plainly misleading. For there is a clear implication in section 4.1 that Crown debt is a matter of unfitness in schedule 1, when this is not the case. Thus, the lay-out of the *notes* indicates a desire by the State to draw IPs attention to the existence of Crown debts which is bound to have a positive effect on the number of Crown debt allegations made by IPs and therefore on the number of times it can be alleged in disqualification proceedings. As such, a subtle targeting of this for of misconduct is evident. Indeed, it is even conceivable that the generally accurate statement of the Crown debt 'test' could serve the State's purpose by increasing the likelihood that IPs would produce good quality reports of Crown debs misconduct which would contain evidence sufficient to make out the allegation.

Thus, the *Guidance Notes* certainly demonstrate a desire to draw attention to the non-payment of Crown money as a matter of potential unfitness above that which is arguably justified by the Act. The result is likely to be a high number of reports from which can spring a high number of allegations in proceedings.

As far as more overt targeting of Crown debts by the Insolvency Service at the later investigation stage is concerned, we can be less certain of the approach adopted due to the lack of detail in the public domain about how the IPs' reports are processed. All that can be said is that a high input of Crown debts allegations are encouraged. However, whether there is a creditors. However, due to the development of the *Carecraft* procedure[386] and the introduction of disqualification undertakings, most section 6 cases do not result in contested disqualification proceedings. Thus, we cannot be certain that the approach outlined in *Re Sevenoaks*, is being adhered to and that Crown debts are only cited as a matter of unfitness where it has a detrimental impact on creditors. Thus, significant doubt surrounds the benefit that sanctioning such conduct brings.

The Secretary of State insists that Crown debts are only cited where the 'test' in *Re Sevenoaks* is complied with and that section 6 is not operated in a self-interested way as a tax enforcement measure[387]. However, the subtle targeting of this form of conduct in the *Guidance Notes* and the elevated number of cases in which it was cited in survey, must cast doubt on these claims. If mere Crown debt were being cited in cases, it would bring little benefit in terms of loss reduction. However, even if it were not the actual benefit brought by citing this indirect form undesirable conduct is unlikely to deliver a great benefit to creditors and represents a drag on the efficiency of section 6 disqualification.

5.4.2 The Utility of Disqualification for a Breach of Accounting, Auditing and Disclosure Requirements.

In addition to doubt surrounding the benefit that sanctioning Crown debt is likely to bring, concern can also be expressed about the frequency

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[386] *Re Carecraft Construction Ltd* [1994] 1 WLR 172 . The *Carecraft* procedure allowed 'uncontested' disqualification cases to be disposed of under a summary procedure. See further 7.2 below.

[387] See the response to 'Research Question Put to the Insolvency Service', appendix 2.

with which a failure to comply with accounting and disclosure requirements are cited in section 6 cases. Because whilst those provisions are intended to benefit creditors, in practice they are likely to be of little use, especially in small companies which are exempt from many accounting requirements. As such sanctioning breaches of these requirements in section 6 is unlikely to bring any benefit to creditors, which is significant given the large number of cases in which it is cited as evidence of unfitness.

Accounting and attendant disclosure obligations have long been an integral part of UK company law[388]. In the specific context of creditors (the aspect with which disqualification appears most concerned) effective disclosure requirements ought to reduce information asymmetries by increasing the amount of information available to creditors and therefore reduce the transactions costs of information gathering. This would enable creditors to better equate the terms on which they advanced credit to companies/directors with the risk of default they posed. In short, disclosure ought to lead to less uncompensated transfer of risk.

However, in reality the provisions of the Companies Act are likely to be of limited use to creditors, for they require disclosure of only limited financial information about the company and limited biographical information about directors[389]. Such information is only one aspect of the

[388] See generally, Cheffins, *supra* note 373 pages 508-512.
[389] Aside from accounting requirements directors are required to submit an accurate register of members (section 356) and directors (sections 288 & 289), copies of directors contracts of service (section 318), and directors dealings in the companies securities (section 325). Although not required to be registered with Companies House, directors are obliged under

information gathering that creditors need to undertake when bargaining with directors, particularly owner-managers. The Companies Act does not, for example, require disclosure of directors' past appointments and the fate of companies in which they were held, which is equally important to accurate risk pricing by suppliers of credit. Thus, disclose does not remedy all information asymmetries and, it must be noted, neither does it eliminate transaction costs. For even the information disclosed is only available from Companies House after the payment of a fee[390].

The utility of the Companies Act provisions is further weakened by the generous amount of time permitted for the filing of accounts. Section 244, for example, allows private companies a period of 10 months from the end of their accounting period in which to lay annual accounts before members and then file them with the registrar. The period for public companies is seven months, although the stock exchange listing rules require listed companies' accounts to be published within period of 6 months[391]. Nevertheless, the financial information which is available to creditors is often out-of-date and therefore of limited use, particularly in the case of private companies. For example, a random sample of 50 private companies undertaken in July 2004 showed that financial information relating to the year 2002 was the most recent information available in

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section 234 to prepare a directors report in accordance with Schedule 7 of the Act. Which increasingly contains non-financial information.

[390] See www.companies-house.gov.uk

[391] Financial Services Authority, *Listing Rules* (London, FSA, 2003), paras 12.40 & 12.42.

respect of 26 companies[392]. The Company Law Review Group has proposed reducing the period given to private companies to 7 months[393], but this is only likely to have a small impact on the worth of the information available.

Another area of concern is the exemption from certain accounting and publicity requirements given to small and medium sized companies[394], as sanctioned by the EC's fourth Company Law Directive. Small companies are, for example, exempted by section 246(5) from the obligation to deliver profit and loss accounts and a director's report to the registrar. Further, section 246 and schedule 8 modify the requirements of schedules 4 and 7, permitting small companies to compile less detailed accounts for disclosure than is normally the case. The C.L.R. proposed the abolition of these abbreviated accounts[395], but nonetheless proposed to continue with different accounting regimes for small and medium sized companies[396] and it proposed to expand small companies' exemption from the auditing requirements of the Companies Act by raising the exemption thresholds, a recommendation that has now been implemented[397].

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[392] This small survey was undertaken using information publicly available on the Companies House web site: http://ws6info.companieshouse.gov.uk/info/

[393] See: Company Law Review, *Modern Company Law for a Competitive Economy: Final Report* (London, DTI, 2001), para 4.39.

[394] The criteria for small and medium sized business is set down in section 247 CA 1985. To qualify for the exemption a company must have met the conditions specified in the current and previous financial years.

[395] Company Law Review Group, *Final Report, supra* note 393, para 4.38.

[396] *Ibid*, para 4.28.

[397] *Ibid*, para 4.45. The CLR's recommendation was accepted by the government and following consultation (see Department of Trade and Industry, *Raising The Thresholds: Consultation Document on Proposals to Increase the Audit Exemption Threshold and the Threshold Defining Medium Sized Companies*, (London, DTI, 2003)) the exemption thresholds in section 249A of the Companies Act were raised. The turnover threshold was raised from £1millon to £5.6 million (the maximum permitted under EC law and the balance sheet total from £1.4 million to £2.8 million. See: The Companies Act 1985 (Accounts of Small and Medium Sized Enterprises and Audit Exemption) (Amendment)

Therefore, the net effect of the exemptions given to small and medium sized companies is to render the 'accounting and disclosure' requirements of marginal utility to creditors who wish to assess the potential costs of contracting with a particular company or director. The DTI statistical publication *Companies in 2003-2004*[398] shows, for example, that full annual accounts comprised only 12.9% of those registered during 2003-2004 and that audit exempt accounts accounted for 56.9% of all those registered[399]. Therefore, only limited and often out-of-date information is available in relation to most companies and it is only available after the payment of a fee to Companies House. That is to say nothing of the fact that company accounts can be easily falsified. This a particular risk with unfit directors and in small companies where internal checks and balances on directors are absent[400].

It is surprising then that the latest edition of *Gower and Davies Principles of Modern Company Law*[401] should boldly state that "There is no doubt that members and creditors (actual or potential) are afforded ample opportunities to obtain a great deal of financial and other information about the companies concerned. What is questionable is whether they make the best use of this information…"[402]. This statement may be true for members of large companies, however, it is certainly not true for creditors of small

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Regulations 2004, (SI 2004/16) rule 4. The qualification thresholds for small company exemptions from certain accounting requirements were likewise raised, (see rule 2 SI 2004/16).

398 (London, The Stationary Office, 2004).

399 *Ibid*, table F2.

400 See chapter 2 *supra*.

companies who are actually afforded little opportunity to obtain full financial information about most companies. The situation for shareholders may be a little improved, but in owner-managed companies disclosure to shareholders is a futile exercise.

However, Davies' claim is leant some support by Cheffins, who actually argues that the accounting and auditing requirements in the UK are too strict and that policy makers ought to consider abolishing such requirements in relation to small companies[403]. His argument is predicated on the contention that there is only 'meagre' evidence that creditors suffer from information deficits and that the cost of accounting and disclosure obligations are therefore not justified[404]. However, Cheffins' arguments are difficult to justify given the significant opt-outs granted to small companies and the clear need for rigorous disclosure in small companies. For, it is clear from the discussion of limited liability in chapter 3 that creditors do suffer from a lack of information and that this exposes them to increased risk of moral hazard in small companies with limited liability. As such I would argue that the watering down of disclosure and accounting obligations is particularly *dangerous* and exactly the opposite approach to which should be adopted. For, it inhibits effective bargaining by creditors who are widely recognised as being at most at risk of misconduct[405].

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[401] P. Davies, *Gower and Davies Principles of Modern Company Law*, 7th Edition, (London, Sweet & Maxwell, 2003).
[402] *Ibid,* page 561-562.
[403] Cheffins, *supra* note 373, pages 508-521.
[404] *Ibid*, pages 515-20.
[405] See for example F. Easterbrook, and D. Fischel, *The Economic Structure of Corporate Law*, (Cambridge, Mass, Harvard University Press, 1991), page 56 and P. Halpern, M.

What then does the weakness of the accounting and disclosure requirements say of the frequency with which disqualification is used to sanction a breach of 'accounting and disclosure' obligations? In short it would seem unlikely that sanctioning breaches of these provisions in section 6 cases brings a significant benefit to creditors. For, whilst this particular use of disqualification may be borne of a desire to protect creditors, the accounting and disclosure requirements are likely to be of little use to creditors in assessing the risks associated with particular companies. Therefore, sanctioning such breaches is unlikely to provide a great benefit to creditors, because even absolute compliance with the Companies Act would not greatly benefit a creditor of the typical small companies. However, that is not to say that a benefit could never be achieved from using disqualification to enforce disclosure requirements, just that *enforcing the weak provisions of the Companies Act 1985* is not likely to produce any benefit. The situation with an effective set of accounts and publicity requirements (e.g. one that imposed tough requirements on small companies) may well be different.

Instances where disqualification is used to sanction 'accounting and disclosure misconduct' do not, therefore, represent a particularly beneficial use of the sanction. That is not to say that disqualification delivers no benefit in either case, just that the benefits are likely to be low and certainly be lower than is the case with other matters of unfit conduct that have a more

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Trebilcock and S. Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, (1980) 30 U. Toronto L.J. 117.

direct detrimental impact on creditors, such as trading whilst insolvent. As such, disqualification is likely to be a more effective sanction if investigative resources were concentrated upon conduct that has a more obvious negative impact upon creditors.

5.5 Concluding Remarks.

The first stage of our cost-benefit analysis has revealed that the costs associated with section 6 are likely to have been high and that the benefits it is capable of delivering are limited. The high number of precedents in disqualification stands testament to the cost of fleshing out the general standard in section 6 and is likely to have caused high compliance costs to be incurred by directors who wish to comply with the section. A further consequence of the vagueness of the standard has been to allow the development of conflicting approaches to disqualification, which has significant cost implications, most notably in terms of erroneous disqualifications. However, on the positive side the standard in section 6 provides flexible regulation that is capable of adapting to all possible permutations of undesirable conduct. Similarly, the cost to the State of formulating the standard will have been low, although it will have incurred litigation costs due to the need to flesh it out through contested proceedings. The cost of litigation to the State may not however, have been high as the cost has been partially shifted on to private parties through the application of the normal 'loser pays all' rule to section 6 cases.

Nonetheless, the significant costs associated with the section makes it very important that it delivers clear and significant benefits if it is to be a successful form of regulation. The benefits that section 6 delivers come from a protective and a deterrent effect; however, the actual benefits that the section is capable of delivering are limited, particularly in terms of protection. This is because the section can only be applied after an insolvency, therefore it is capable of providing only *future* protection and does nothing to 'protect' creditors from a first incidence of unfitness, either by pre-emptive regulatory intervention or by seeking to restore losses incurred by creditors due to unfitness. In this respect disqualification provides less of a benefit to creditors than other legal provisions, which allow for direct recovery of loss from directors who commit undesirable acts. Indeed, the only effect that disqualification has on creditors of an insolvent firm is to impose a cost upon them because it is they who ultimately bear the costs incurred by 'office holders' in fulfilling their statutory reporting obligations.

In addition to the limitations in the benefits associated with disqualification under section 6, concerns as to the practical benefits that are likely to flow from disqualification can also be expressed. For, concerns over the benefit that is likely to flow from sanctioning two common forms of unfit conduct can be expressed. In terms of 'Crown debt' the advice given to IPs in the *Guidance Notes*, and the frequency with which it is cited in disqualification cases raises questions first about the extent to which the 'correct' approach to this form of misconduct is being followed and second about the practical benefit to creditors of sanctioning this particular form of misconduct. In respect of 'accounting and disclosure' misconduct it has been argued that despite the fact disqualification is predicated on a desire to protect creditors, it is unlikely to bring any practical benefit to them due to the weakness of the provisions that relate to the small owner-managed company of the average disqualification. Thus, in addition to its general limitations, section 6 is often used in a manner that provides little benefit to creditors either in terms of future protection or general deterrence.

Therefore, having noted the limitations on the benefits section 6 can provide and discussed some significant costs of the sanction, the next chapter will discuss the practical benefits and costs of the sanction drawing upon empirical research carried out by the National Audit Office for its 'follow-up' report.

Chapter 6: The Efficiency of the Disqualification Regime.

"There are direct financial benefits from disqualifying directors."

National Audit Office: Report by the Auditor and Comptroller General, Company Director Disqualification – A Follow Up Report. Page 37.

6.1 Introduction

In its second report into the disqualification system, the National Audit Office (NAO) claimed that disqualification under section 6 produced direct financial benefits for creditors by preventing future instances of unfit conduct[406]. In addition to this saving, the report concluded that disqualification benefited the public by deterring unfit conduct and that it therefore fulfilled its purpose of promoting confidence and risk taking "by assuring those who do business with limited liability companies that directors who are unfit will be disqualified"[407]. The report's conclusions represented a significant vote of confidence in the State's use of disqualification, suggesting as they did that the sanction was succeeding in

[406] National Audit Office, Report by the Comptroller and Auditor General, *Insolvency Service Executive Agency, Company Director Disqualification – A Follow Up Report*, , (House of Commons Papers, Session 1998-1999, 424) (London, The Stationary Office, 1998) para 3.2.

[407] *Ibid.* For a similar statement about the purpose of section 6 see Lord Woolfe in *Re Blackspur Group Plc* [1998] 1 BCLC 676, who declared at page 680 that: "The purpose of the [Company Directors Disqualification Act] 1986 is the protection of the public by means of prohibitory remedial action, by anticipated deterrent effect on further misconduct and by the encouragement of higher standards of honesty and diligence in corporate management...".

meeting it's goals through the provision of future protection and general deterrence[408].

The report based its conclusions on the results empirical research into the operation and likely effect of disqualification conducted specifically for the purpose of the NAO's investigation of section 6, and given the experience of the NAO in evaluating the performance of regulatory mechanisms such as disqualification, (not to mention the resources at its disposal to investigate the effect of such a statutory provision), the report's positive conclusions about the effect of section 6 disqualification might reasonably be taken as establishing the success of the statutory regime set up by the Disqualification Act. The NAO appeared to believe that the section 6 regime was *capable* of reducing actual an potential loss to creditors from the abuse of limited liability, and its research was presented as proof that it did so in practice. However, despite the bold conclusions of its report, the NAO's research raises as many questions about the efficiency of disqualification as it answers and, indeed, there is a strong case to be made that the report's conclusions are not supported by the evidence it cites. .

Much of the analysis that follows is therefore made within the context of the empirical research carried out in disqualification by the

[408] See also Lord Woolfe in *Re Blackspur Group Plc* [1998] 1 BCLC 676; "The purpose of the [Company Directors Disqualification Act] 1986 is the protection of the public by means of prohibitory remedial action, by anticipated deterrent effect on further misconduct and by the encouragement of higher standards of honesty and diligence in corporate management...", at page 680.

NAO[409] and is intended as a critique of the NAO's conclusion in so far as the evidence produced by its research does not support those conclusions.

However, the chapter begins by discussing the retrospective approach of the courts to disqualification discusses the impact that their approach has on the protective benefits of disqualification. It then analyses NAO's attempt to quantify the protective benefits of disqualification , which play a central part in the reports claim that 'significant' benefits that flowed from the current disqualification system. It is argued that the NAO did not follow the logic of a formal cost-benefit analysis of the current disqualification regime when evaluating the results of its research and that, had it done so, it's conclusions may have been very different.

6.2 Protecting the Public, Commercial World and Promoting Confidence and Risk Taking in the Market.

6.2.1 Protecting Whom?

Post insolvency disqualification of the sort provided by section 6 is only capable of protecting the public from 'unfit directors' where it prevents a *future* instance of misconduct that would have caused loss to creditors. Where no misconduct is prevented, or where misconduct would not have caused loss, disqualification provides no direct protective benefit. The likelihood of a person subject to disqualification proceedings repeating harmful (i.e. loss-causing) misconduct should therefore be central to the

[409] National Audit Office, *'Follow Up' Report, supra*, note 406.

decision to disqualify. Any other approach to unfitness would not maximise the protective benefits of disqualification, because, where there is no prospect of future harmful misconduct, there is no need for the protective effect of disqualification and no benefit would flow from its imposition.

Unfortunately this logic has not been grasped by the courts, who as a general rule, do not take into account evidence of the likelihood of a director engaging in future harmful misconduct when deciding whether to disqualify[410]. The approach adopted has been described as a 'tunnel vision'[411] approach whereby the court must consider whether the director's conduct *fell* short of the standard required by the legislation and disqualify if it did. As such, the unfitness test looks to the past and not to the future.

The 'tunnel vision' approach may be permissible within the wording of section 6 (1), which states that a person shall be disqualified where his conduct "makes" him unfit to be a director. However, it does not accord with the protective intention behind disqualification because to ensure that disqualification provides protection, the likely future conduct of a director should be an equal consideration to his past acts. The 'tunnel vision' approach in short, is not conducive to an effective disqualification regime because it results in disqualification where there is no need of protection.

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[410] *Re Pamstock Ltd* [1994] 1 BCLC 716 where the court held that it would be obliged to disqualify a director "...even though the misconduct may have occurred some years ago and even though the court may be satisfied that the respondent has since shown himself capable of behaving responsibly" at page 737. See also *Re Grayan Building Services Ltd* [1995] 1 BCLC 276. However, evidence of extenuating circumstances, or evidence that misconduct is not likely to be repeated can be taken into account by a court when setting a period of disqualification. See *Re Barings Plc* [1998] BCC 358

[411] *Re Pamstock, ibid.*

The courts willingness to take into account evidence that misconduct will not be repeated at the stage where a disqualification period is set only highlights the problem. It has been held, in the words of Sir Richard Scott, that such evidence "goes to the question of the extent to which the public needs protecting against his acting [as a director]"[412]. However, if the evidence shows that unfit conduct is unlikely to be repeated then there is no need for disqualification in the first place. Therefore, the period for which the public need to be protected is zero. In short, Sir Richard's claim that evidence of future good conduct is not relevant to the decision to disqualify, but is relevant to a period of disqualification, is highly illogical and does not focus disqualification on the sort of case that would enable it to most effectively fulfil its protective goal.[413]

Of course, the rejection of future conduct as a relevant factor in the decision that a person ought to be disqualified, but its acceptance as relevant to the period of the disqualification order raises questions as to whether the real intention behind disqualification is exclusively protective. However, the State does not offer disqualification as a measure to punish directors,[414].. Indeed, instance where it is used more as a means of punishment than protection could be a significant cause of the low protective benefit indicated by the NAO report.

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412 *Re Barings Plc* [1998] BCC 538 at page 590. The statement was approved by Lord Woolfe MR in *Re Westmid Packing Services Ltd* [1998] 2 All ER 124 at page 133-134.

413 The punitive effect of disqualification under section 6 is discussed further at 8.1, below.

414 See, for example, the evidence of the then Minister for Competition and Consumer Affairs to Standing Committee B when it was considering amendments to the Disqualification Act proposed by the Insolvency Bill 2000. The Minister declared "The main purpose of the Company Directors Disqualification Act 1986 is to provide the public

6.2.2 The Amount of Future Protection Secured by Section 6.

The research carried out for the NAO as part of its 'follow-up' report, estimated that 15% directors who are involved in one corporate failure are likely to be involved in another[415]. As the NAO itself commented, this finding suggests that a clear need for protection from the activities of a group of directors who are involved in multiple insolvencies exists, at least where those insolvencies are caused, in whole or in part, by 'unfit conduct'. However it is equally clear that any regulation intended to protect the public from 'serial rogues' should be carefully targeted, because the vast majority of directors of insolvent companies do not appear to go on to be involved in a second insolvency, and as such, do not need to be subject to 'protective' measures. In this way the pitfalls of the 'tunnel vision' approach are demonstrated because the backward focus of the test will obviously not concentrate disqualification on the 15% of directors from whom protection is really required. The emphasis on past conduct is far to general to do this. Therefore, assuming that the 15% statistic is applicable to disqualified directors (as the NAO did[416]), the approach of the courts to disqualification could reasonably be expected to have given rise to a situation where only a minority of disqualifications bring any protective benefit, Indeed, according further research carried out by the NAO *fewer* than 15% of disqualified

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with protection against those who abuse the privilege of limited liability". See: Hansard [HC], (Session 1999-2000), Standing Committee B, 7th November 2000, col 119.

415 To reach this conclusion the NAO examined the Insolvency Service's database of 400,000 directors who had been involved in a business failure between 1990-1997 and recording the number of directors who had been involved in two or more insolvencies during the period. *'Follow Up Report'*, *supra* note 406, paras 3.8 –3.9.

416 As the NAO felt it was, see *ibid* appendix 2, para 17.

directors are actually prevented from being involved in another insolvency by disqualification.

As part of its study of the record of directors of insolvent companies, NAO complied statistics on the period after an initial insolvency when directors were most likely to be involved in a subsequent corporate failure. This research revealed that the likelihood of a director being involved in a further business failure is at its highest in the 2 years following an initial insolvency[417]. However, the report noted that very few directors were disqualified during this high risk period as, at the time of the report, it took an average of 3 years to disqualify a director. The average duration of a disqualification order at the time was 5 years. Therefore, at the time of the report the NAO concluded that the 'average' disqualification only prevented those insolvencies that *would have occurred between 3-8 years after a first insolvency*[418]. Consequently, the NAO's concluded that only 6% of disqualified directors (those who would have been involved in subsequent business failure during the 3-8 year period) were prevented from so being by disqualification. As such, the NAO estimated that the 1,267 disqualifications in 1997-98 prevented only **75** future insolvencies[419], with each single disqualification in 1997-1998 preventing only 0.06 insolvencies[420].

This finding suggests that the actual amount of protection from. harmful misconduct secured by post-insolvency disqualification is low and directly contradicts the report's own conclusion, which was largely, though

[417] See *ibid*, fig, 31.
[418] *Ibid*, appendix 2, para 21.
[419] *Ibid*, para 3.10.

somewhat bizarrely, based on the figures stated above. Of course, the NAO's calculations, if accurate, certainly show that disqualification achieves some benefit, i.e. in the 6% of disqualification cases where future misconduct is prevented (although we must assume that such misconduct would be harmful, which is by no means certain) . However, that benefit from a minority of disqualifications should be balanced against the loss of potentially successful entrepreneurs caused by the many unnecessary disqualifications. Because, of the 94% of disqualified directors who would not go on to be involved in a future business failure during the period of their disqualification, it is likely, although the NAO did not analyse the point, that several would have gone on to be involved in a successful business. The precise percentage can only be speculated upon, but the cost of disqualifying such individuals should be balanced against the benefit achieved from disqualifying the 6% of 're-offenders'. The NAO however, failed to note the losses from over-regulation that disqualification causes. Of course, the apparent inefficiency of disqualification that this analysis appears to revile rests on the correctness of the NAO's statistics. However, given that the NAO derived its figures from the study of a database containing records of over 400,000 insolvencies, the results of its research cannot easily be dismissed, especially as the database is not available for public inspection and no other comprehensive survey of it, or of directors involved in serial insolvencies, has been conducted.

[420] *Ibid*, para 3.9.

The most obvious ground for challenging the conclusion reached above is therefore not on the validity of the statistics regarding 'serial rogues' but their applicability to 'unfit' directors. Indeed, although it proceeds on the basis that its statistics are applicable to this class of director, the report does suggest that instances of directors being involved in multiple insolvencies is likely to higher amongst those deemed unfit than it is amongst directors generally. This argument has a strong logic behind it and I am in no position to challenge it. However, even if we were to assume that disqualified directors were four times as likely to be involved in future insolvencies (a proposition for which no evidence known to the author exists), then only 24% of disqualifications would produce a protective benefit . Even an eight-fold increase in the likelihood of subsequent insolvency amongst 'unfit' directors would still mean that only a minority of disqualifications produced protective benefits (and then only if every subsequent insolvency was caused by misconduct). In short, fancifully and completely unsupported assumptions are needed to produce a scenario in which even a bare majority of disqualifications produce real protection. Therefore, the NAO's conclusion that only a small minority of disqualifications protect the public, based on extensive empirical research, *is* a reasonable basis on which to cast doubt upon the extent to which disqualification fulfils its objectives. Furthermore, the contradiction between the evidence produced by the NAO and the conclusion it sought to draw from it is an entirely legitimate basis for analysis given that the NAO report sought to prove the worth of disqualification.

6.2.3 The Direct Benefits to Creditors from Disqualification.

The miss-match between the evidence produced by the report and it's conclusions is further illustrated by the NAO's attempt to quantify the protective benefits of section 6. In order to produce an accurate estimate of the savings from the insolvencies disqualification produced, the NAO studied the debts left by failed companies where there had been unfit conduct in 1997-98 and calculated that the average debt left was £150,000[421]. Assuming that similar debts would have been left in subsequent insolvencies, the NAO estimated that the cost saving to creditors from the 75 insolvencies prevented by 1,267 disqualifications was **£11 million**[422]. This conclusion is cited in the report as further evidence of the 'significant benefits' that flow from post-insolvency disqualification.

However, elsewhere in its report the NAO noted, with great acclaim, that the Insolvency Service had spent **£22 million** securing the 1,267 disqualifications[423]. Surprisingly, the NAO failed to compare its estimated saving with the cost of the disqualification system and draw the obvious conclusion that the disqualification system is completely *inefficient* on a simple cost-benefit analysis. £22 million spent to achieve benefits of only £11 million leaves a deficit of another £11 million and hardly looks like a

[421] According to the NAO's follow up report no comprehensive source of data was available as to the average debt left by insolvent companies. The NAO therefore conducted its own research to come up with the £150,000 figure. It did so by randomly selecting 88 insolvencies (42 compulsory and 46 voluntary) out of a pool of 450 companies that failed in 1997-98. See 'Follow Up Report', *supra* note 406, Appendix 2 paras 10 -13. The veracity of the statistics is discussed further below.
[422] *'Follow Up Report', supra* note 406, paras 3.10-3.11.
[423] *Ibid*, paras 1.13 –1.14.

sensible use of public funds, yet the National Audit Office failed to draw this rather obvious conclusion.

Furthermore, the actual cost of disqualification would be even higher than the NAO figures suggest if the losses from over-regulation were taken into account. It would take only small number of successful businesses to be stifled by disqualification to significantly reduce or wipe out the supposed £11 million creditor saving - another rather obvious conclusion that the NAO failed to draw from its own calculations.

The failure to even note the obvious imbalance between the NAO's own calculation of the costs and benefits of disqualification is troubling and indicative of a short-sighted approach to section 6 in the report. However, drawing wider conclusions as to benefit of disqualification from the report depends up an acceptance of the NAO's calculations.[424] As the NAO states, no comprehensive pool of data was available at the time of the report as to the debts left by insolvent companies. The same is true today. The NAO drew its figures from a pool of 88 insolvencies that occurred during 1997-98.[425] The survey is not large so caution should be exercised in drawing too wide a conclusions from it[426]. However, the survey result was thought sufficiently accurate to be used by the NAO (a body with some experience

[424] The 'direct cost' of the sanction in terms of the publicly disclosed Disqualification Unit annual budget is less open to doubt, although there many other costs of disqualification not included in this figure.

[425] See note 421, *supra.*

[426] The same note of caution should also be sounded about the NAO's conclusions as to likelihood a person being involved in 2 or more insolvencies. However in so far as the NAO's calculations in this respect are the result of the examination of 400,000 directors on the Insolvency Service database it is suggested that the NAO's conclusions as to the likelihood of a person being involved in subsequent insolvencies are more reliable than those relating the to average debt left by insolvent companies.

in assessing the benefits brought by various government policies) and in so far as the figure is used by the NAO as a basis for its claim that there are 'direct' benefits then it is submitted that it a legitimate form of analysis to comment that on the NAO figures section delivers no direct benefit and indeed those figures cast significant doubt on the general worth of disqualification under section 6.

6.2.4 The Current Picture on the NAO Measure..

According to the calculations made by the NAO, the cost inefficiency of the disqualification regime has persisted to the present day. In 2003-04, for example, 1,367 directors were disqualified under section 6, either by a court or by offering an undertaking[427]. The average length of disqualification in that year had increased to 5.5 years and the time lag between insolvency and disqualification had fallen to an average of 2 years[428], largely due to the introduction of disqualification undertakings in 2001. These improvements have caused an increase in the relative protective effect of each disqualification (according to the NAO measure). For example, the percentage of directors prevented from being involved in an insolvency during the period of their disqualification has increased from 6% to 8%[429]. This improvement is largely due to the shortening of the time it takes to secure a disqualification order. The protective effect of each single disqualification has consequently risen to 0.08 insolvencies prevented per

[427] *Companies in 2003-2004*, (London, The Stationary Office, 2004), table D1 .
[428]See Insolvency Service, *Annual Report and Accounts 2002-2003*, (House of Commons Papers, session 2002-2003, 846).

disqualification. Thus, according to the NAO model it can be estimated that disqualification in 2003-2004 prevented **109** (0.08 x 1,367) future insolvencies. To obtain a realistic estimate of the creditor saving from these disqualifications it is necessary to adjust NAO figure of £150,000 average debt per insolvency where unfit conduct is evident for inflation, which would be approximately £170,000 at today's prices[430]. Consequently, the estimated creditor saving from disqualification in 2003-04 (on the NAO measure) is **£18.5 million**. However, this is still a smaller sum than that spent on securing the 1,367 disqualifications, which stood at over **£25** million[431].

The introduction of disqualification undertakings and other improvements in the system are likely to account for the increased savings from disqualification, but, on the strength of the NAO's calculations, it remains cost *inefficient*. Furthermore, according to the NAO's figures, over 90% of directors disqualified during 2003-2004 are still not likely to have been involved in another business failure during the period of their disqualification. Therefore, whilst the improvements in the disqualification system are to be welcomed, the protective effect of disqualification remains low and the claim that disqualification provides 'direct' savings to creditors continues to be risible (again, according to the NAO measure). For the supposed 'direct' saving produced by section 6 disqualification is less than

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[429] According to the NAO research (see, '*Follow Up Report*', *supra* note 406, fig. 31), 8% of directors would be involved in a business failure 2-7.5 years after an initial insolvency.
[430] Using RPI index annual inflation rates from 1998-2003. Office for National Statistics, *Consumer Prices from 1750 – 2003*, (London, ONS, 2003).

the direct cost of its administration. Furthermore, the small number of insolvencies prevented by disqualification shows that it has an extremely marginal impact on the losses that the commercial world suffers from insolvency. For example, in 2003-2004 over 15,700 insolvencies were recorded in England and Wales[432]. Therefore the benefit of a sanction that is likely to prevent as few has 109 insolvencies, representing less than 1% of all insolvencies recorded, must be questioned.

The system is, however, *less inefficient* than it was at the time of the last NAO report, and given the positive gloss put on the 'benefits' of disqualification then, it is likely that the NAO and others would be even more enthusiastic about the system today. However, the truth is that according to NAO's own model disqualification remains hopelessly inefficient in providing tangible protection, and what is more could cause further ('secondary') loss by stifling potentially successful entrepreneurs (i.e. those who would not be involved in secondary insolvencies). However, in terms of the latter, it must be noted that the Act contains a mechanism, in the form of leave of disqualification orders or undertakings, by which such losses could be stemmed. Thus, conclusions as to the amount of secondary loss caused by disqualification cannot be made without consideration of the effect of 'leave'.

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[431] Insolvency Service, *Annual Report and Accounts 2003-2004*, (House of Commons Papers, session 2003-2004, 812).
[432] *Companies in 2003-2004*, *supra* note 427, table C1.

6.3 Leave of Disqualification and the 'Cost' of Section 6.

It was noted at the outset of this thesis that disqualification under section 6 is not unilateral in so far as section 1(1)(a) of the Act provides only that a person subject to a disqualification order 'may not be involved in the promotion, formation or management of a company *unless he has leave to do so*'[433]. Leave granted in accordance with the provisions of section 17 of the Act therefore has the potential to alleviate *some* of the problems that arise where individuals are disqualified even though they would not have gone on to be involved in subsequent business failure. The justification that is often made for the power to grant leave however tend to focus on the loss that can flow from the wide nature of the prohibition in section 1(1)(a), rather than on the 'chilling' effect where individuals who pose no risk to the public are disqualified[434]. Nonetheless, both aspects of disqualification can lead to secondary loss, and leave is a potential remedy for each.

In terms of section 1(1)(a) itself, the argument that the nature of the prohibition imposed could lead to loss stems from, the fact that following the case of *Re Polly Peck International (No2)*[435] and the amendment of section 1 by the Insolvency Act 2000[436], the section does not allow for

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[433] Leave of section 1(1)(b)(the prohibition on acting as an insolvency practitioner) would not, however appear to be possible due lack of similar wording in the sub-section.
[434] *Ibid*, para 3.
[435] [1994] 1 BCLC 574. Prior to this case it was thought that courts were free to impose 'partial disqualification orders, See for example *Re Rolus Properties Ltd* (1998) 4 BCC 4
[436] The original version of section 1 (1) read:
(1) In the circumstances specified below in this Act a court may, and under section 6 shall, make against a person a disqualification order, that is to say an order that he shall not, without leave of the court –
(a) be a director of a company; or
(b)be a liquidator or administrator of a company; or
(c)be a receiver or a manager of a company's property; or

partial disqualification orders in the sense that an individual can be banned from undertaking certain aspects of corporate management. Thus, a person subject to a disqualification order is prohibited from being a director, receiver of a company's property or from taking part, *in any way*, in the promotion, formation or management of a company whether he poses a danger to the public in all of these capacities or not.

. The consequences for disqualified individuals of the wide prohibition imposed on the by the Act have been described as "drastic" [437] and its potential mischief is clear. In short, it is likely that in many cases disqualification proscribes a remedy for misconduct that goes far beyond the that necessary to protect the public from the particular danger that a director poses. The power to grant leave, however is an important way in which the harsher side-effects section 1 can be mitigated. The potential flexibility that leave brings in cases where there is only a need to protect the public from certain aspects of an individuals' conduct is clear and as such it has the potential to *enhance* the effectiveness of disqualification. If there were no provision for leave the court or Secretary of State, for example, could often be faced with the difficult choice between imposing a disqualification order that goes beyond the measures necessary to protect the public, or not

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(d)be in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of a company,

for a specified period beginning with the date of the order.

The amended section removes any possibility of partial disqualification by combining each of the grounds (a)-(d) in the single sentence "he shall not be a director of a company act as receiver of a company's property or in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of a company," disqualifying the individual and leaving the public exposed to 'unfit' conduct. However with leave, it is possible to strike a balance as the individual can be disqualified in order to secure protection, but given leave if he wishes to fulfil a role in which he does not pose a danger. Thus, protection can be secured but the costs of 'over-regulation' avoided[438].

Leave is also a potentially useful device to prevent disqualification creating loss by stifling successful entrepreneurship by the majority of directors who would not go on to be involved in an insolvency during the currency of their disqualification. As such, it could be argued that the disqualification system has, in the form of leave, an in-built mechanism to prevent disqualification creating the sort of collateral loss described in this, and the previous, sections of this thesis. Of course, the case for leave as the 'saviour' of the disqualification system should not be overstated. The many instances, for example, where disqualified individuals would not have gone on to cause, in whole or in part, loss to creditors must still be seen as examples of the failure of the disqualification regime to meet its policy objective. The resources spent on securing such disqualifications will still be wasted in so far as they do not protect the public from loss. All that leave applications have the potential to do is prevent *further* loss by creating the possibility that an individual will be allowed to participate in beneficial activity despite disqualification.

[437] See for example, Mithani, *Directors Disqualification*, part VI paras 3-8.
[438] For an example of a disqualification order being used in just such a way see *Re Gibson Davies Ltd* [1995] BCC 11, where an individual was granted leave but prevented from being involved in the financial side of company management by a number of conditions or 'safeguards' being set in the leave order.

Nonetheless it is clear that leave can, and does, have a role to play in reducing the further loss that could flow from stifling successful entrepreneurial activity by directors from whom the public does not need protecting[439], and indeed, potential loss from the absolute nature of the bar imposed by section 1(1)[440]. And the 'flexible' approach of the courts (who have held that the discretion to grant leave is "unfettered by any statutory condition or criteria"[441] and that it would be "wrong for the court to create such fetters or conditions"[442]), would appear to strengthen the case for the benefits of leave. However, the extent to which leave mitigates the loss that flows from this particular failing of disqualification can be doubted.

6.3.1 Costs, Evidence the Incidence of Leave.

A real drawback with leave of a disqualification order is that it can only be granted in relation to specific activities and specific companies. This is made clear in section 1(1) of the Act which states that an individual shall not act in any of the prohibited capacities "unless (*in each case*) he has the permission of the court [my emphasis]". 'Universal' leave to act in any of the capacities in section 1, in relation to any company, cannot therefore be granted. Indeed, if it were, it would rather make a mockery of the fact of disqualification. Disqualified individuals who wish to act in a prohibited capacity must therefore seek leave for each company in which they wish to

[439] See for example, *Re Furniture Integrated Telephony Plc* [2002] All ER (D) 106.
[440] *Re Gibson Davies Ltd, supra* note 438
[441] *Re Dawes and Henderson (Agencies) Ltd (No 2)* [1999] 2 BCLC 317.
[442] *Ibid.* The primary factor that the courts consider in leave cases is whether leave is compatible with the goal of public protection (*Re Dawes and Henderson*). See further note 446 below.

be involved and the cost and laboriousness of the leave application process must limit the extent which disqualified individuals are able to seek leave.

The Disqualification Act states that every application for leave of a disqualification order or undertaking must be made to a court, as (even in the case of undertakings) the Secretary of State has no power to grant leave himself[443]. Furthermore the Act obliges The Secretary of State to appear at each leave application "and call the attention of the court to any matters which seem to him to be relevant" to the application[444] . He may also call witnesses or himself give evidence[445]. Not only are applicants for leave therefore required to submit to the court details of the company in which they act, the role they wish to fill and demonstrate that they would not pose a danger to the public in such a role[446], but they may also incur the cost of responding to the Secretary of State, which, should he chose question the application, could be considerable. The potential time and expense involved in making an application for leave must therefore act as a strong disincentive for making leave applications. Indeed, the practical considerations of

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[443] Company Directors Disqualification Act 1986, section 17(3).
[444] *Ibid*, section 17(5).
[445] *Ibid.*
[446] The protection of the public interest is the overriding concern of the courts in leave cases, *Re Dawes & Henderson (Agencies) Ltd (No 2)* [1999] 2 BCLC 317, *Re Barings plc (No 4)* [1999] 1 BCLC 262. In order to obtain leave from a court the applicant therefore has to demonstrate to the court either that he poses no danger the public in the particular role he wishes to fulfil (e.g. *Re Dawes & Henderson, supra*), or that protection can be secured by means of imposing conditions on the activities of the director (see for example, *Secretary of State v Palfreman* [1995] 2 BCLC 673 or *Re Majestic Recording Studies Ltd* [1989] BCLC 1. In both cases leave was granted subject to the condition that a solicitor and an 'independent chartered accountant' were respectively appointed as directors to supervise the activities of the 'disqualified' director). It was thought that as well as satisfying the court that leave could be granted whilst satisfying the goal of public protection , applicants for leave also had to establish a 'need' from them to be granted leave. Following Re Dawes & Henderson and Re Barings it would now appear that 'protection' is the only condition that *must* be satisfied for leave to be granted.

applying for leave must undermine the notion that it is a remedy in all instances where disqualification stifles desirable entrepreneurial activity.

6.3.1.1 Williams' 2000 Survey.

Empirical evidence from a survey of the disqualified directors register carried out by Williams[447] provides persuasive support for this contention by demonstrating that leave is rarely granted. Williams studied the register of directors disqualified during 1999-2000 held by Companies House. The register contains an entry for every person subject to a disqualification order giving biographical details of the disqualified individual, the period of his disqualification and the details of leave orders applicable to him (if any)[448]. Williams' survey showed that out of 1,704 directors disqualified during the year only, 69 (representing only 4.05% of the total number of disqualified individuals) had been granted a significant period of leave within the period of 6-18 months after their disqualification.

Of the 69 individuals who obtained leave, 49 were given leave to act for the whole period of the remaining period of their disqualification at the time leave was granted. The remaining 20 were granted leave for a lesser period. Williams argues that a number of those who obtained 'partial' leave orders were likely to go on to obtain leave for the whole period of their disqualification due to the practice of granting an 'interim' leave order followed by a longer order after review by the court of the director's

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[447] R. Williams, *An Analysis of Empirical Research into Aspects of the Disqualification of Company Directors*, LL.M Thesis 2000. Cardiff University, chapter 5.
[448] The database is available on line at <www.companieshouse.gov.uk/ddir/>.

conduct[449]. However, other cases of short leave periods appeared to be examples of interim leave being granted to directors at the start of their disqualification to give them a period of grace in which to make alternative arrangements for the management of their companies[450]. In such cases leave was granted for a very short period, typically 6 weeks, and as such they cannot be regarded as meaningful instances of leave. Thus, in truth fewer than 69 individuals were granted a true exemption from their disqualification order. However Williams' 2000 survey does not include sufficient data to conclude the number of cases in which significant periods of leave were given. In order obtain more data in relation to this issue, and more generally to provide up-to-date information[451] on the frequency of leave, a survey similar to that undertaken by Williams was repeated for the purposes of this thesis.

6.3.1.2 The New Survey.

For the purposes of this thesis a random sample of 1,704 disqualification records were selected from the Companies House database[452]. Unlike Williams' original survey the records included for this

[449] This practice was referred to by Rattee J in *Secretary of State for Trade and Industry v Barnett* [1988] 2 BCLC 64. His Honour noted that if a court had reservations about granting leave it could set a probationary period of leave, then review the director's conduct, and if satisfied grant a more substantial period of leave (often for the remainder of the period of disqualification). Williams note that 14 of the cases where full leave had been granted at the time of the survey were examples of this procedure of, probationary, then 'full' leave, see Williams, *supra* note 447 chapter 5.

[450] See for example *Re Amaron* [1998] BCC 264.

[451] Williams original survey was undertaken before the introduction of disqualification undertakings by the Insolvency Act 2000, therefore I was thought important to undertake research into leave as it currently is use to determine if the introduction of disqualifications had lead to changes in the use of leave.

[452] The records were accessed via the Companies House online database (address *supra* note 448). The database is searchable by typing in the surname of disqualified individuals. If a single letter (e.g. 'A')is entered as search criteria the database returns records of all

thesis were not linked to any particular year, but all of the records included related to 'live' disqualification orders. The survey of the Companies House records carried out for this thesis produced remarkably similar results the those of Williams' 2000 survey, indicating no significant change in the use of leave.. Study of the selected records showed that a total of 71 (4.17%) of the 1,704 disqualified individuals had obtained leave of their disqualification order under section 17. Of those 71 directors who had obtained leave, 44 were granted leave by a single order that covered the whole outstanding period of disqualification from the date it was granted[453], 16 were granted leave for the reaming period of their disqualification but in the form of probationary and supplementary orders[454] and 11 had been granted an period of leave that did not cover the outstanding period of disqualification. Thus a total of 60 individuals were granted leave for the whole of their period of disqualification. Indeed, of those 60 individuals 55 were granted leave for the entire period of disqualification i.e. leave was granted at the same time as disqualification and ran for the whole period of disqualification[455].

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disqualified directors with surnames beginning with that letter. Therefore, the sample of records for the survey was taken by entering each letter of the alphabet into the database and randomly selection 60-65 records from each letter to be included until a total of 1,704 records were obtained. Each record was printed from the database and entries showing a leave order were collected and analysed. An example of a record showing a leave order is contained in appendix 1 to this thesis.

[453] Of which, 27 individuals were granted leave in relation 1 company and 17 granted leave to act in relation to 2 or more companies. Williams' 2000 survey revealed 35 of 69 leave orders were granted for the whole period of disqualification. 20 of the 35 individuals obtained leave in relation to 1 company and 15 for 2 or more companies.

[454] The number was 14 in Williams 2000 survey, see Williams, *supra* note 447.

[455] Section 1 of the Act provides for a 21 delay in the commencement of disqualification orders. As such any leave orders (or combination of probationary and subsequent orders) commencing with 21 days of the start of disqualification and continuing in force until the end of the period of disqualification were counted as running for the entire length of disqualification.

Of the 11 directors granted leave for a period that did not extend to the end of their disqualification, 4 were granted very short periods of leave (ranging from 1 week to 3 months), and would appear to be clear examples of interim leave of the sort illustrated in the case of *Re Amaron*[456]. In a further 3 cases directors had been granted longer, but expired, periods of leave. In one case leave had been granted for a period of 7 months, in another for a period of 1 year and in the final case for a period of 1.5 years. The periods in these cases would appear to be rather long to fit into the category of interim leave and the most likely explanation would be that probationary[457] periods of leave were granted, but not extended. In the remaining 4 cases directors had been granted leave for limited periods which had not expired at the time of the survey. In all of these cases the period of leave granted was significant (7, months 9 months, 13 months, 18 months) and they would appear to be current examples of probationary periods of leave. The number of leave orders that can discounted as examples of interim leave do not , therefore appear to be large[458].

Both the 2000 and the current surveys raise significant questions in themselves as to the effect of disqualification, aside from the issue of

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[456] *Supra*, note 450. In all of the 4 cases the period of leave had expired at the time of the survey.

[457] See note 449, *supra* and accompanying text.

[458] It is, however, likely that instances of 'interim' leave were higher at the time of Williams survey, since the original version of section provided that disqualification orders were to commence on the day which they were made. Section 5(2) of the Insolvency Act 2000 however, inserted a new section 1 providing for a 21 day delay in the commencement of a disqualification order or undertaking. The purpose of the amendment was the same as that of 'interim' leave, i.e. to allow directors a period of time in which to make alternative arrangements for the management of any companies the may direct at the time of disqualification and as such it is likely that the number of interim leave orders granted will have fallen since the amendment came into force in 2001.

whether leave is an effective remedy for secondary losses . The fact, for example, that a majority of directors who obtained leave in both the current and 2000 studies of leave were granted a single leave order covering the entire period of their disqualification suggests that in the majority of leave applications the 'protection of the public' is secured very easily without the need for a blanket ban on involvement in the management in companies. Indeed, one could go as far as to suggest that in such cases the public cannot need much, if any, protecting from disqualified individuals if the court is happy to grant leave for the entire period of disqualification without any element of review[459]. This argument is strengthened by the fact that the new survey revealed that 20 individuals obtained leave of the whole period of their disqualification in relation to 2 or more companies[460]and that two individuals obtained leave to act in relation to four companies, with no probationary period of leave. In these cases it is difficult to conceive the disqualified individuals posed much danger to the public. The fact that they were disqualified despite their evident ability to manage companies satisfactorily indicates that, as suggested above, individuals who pose no danger to the public are being disqualified. Leave cases therefore indicate the pitfalls of the 'tunnel vision' approach.. Similarly the fact that in 16 of the 18 cases where 'probationary leave' was granted directors were allowed leave for the remainder of their period of disqualification suggests that even

[459] According to the NAO's research no protection is necessary from 94% of those currently disqualified.
[460] Of which 17 obtained multiple leave orders covering the whole remainder of their disqualification, and which 3 obtained following a probationary periods of leave.

where there is some doubt about a director's fitness, many disqualified individuals are able to conduct themselves perfectly satisfactorily.

Nonetheless as well as confirming doubts about the effectiveness of disqualification, both studies also appear to demonstrate the positive attributes of leave, i.e. that it introduces a degree of flexibility into the disqualification system which can prevent the sanction from stifling successful entrepreneurial activity. The issue therefore must be whether the frequency with which leave is granted is sufficient to remedy the apparent loss caused by disqualification. In answer to this question perhaps the most significant finding of both surveys lie.

6.3.2 The Impact of Leave.

The obvious conclusion to be drawn from both studies is that leave is rarely granted and therefore that (in practical terms) it does not play a significant role in reducing the 'secondary'[461] loss caused by disqualification. The reason why leave is so rarely granted is, however, less easy to identify. The small number of leave cases is not explicable because of a restrictive approach by the courts when considering leave cases; the 'flexible' approach outlined above would seem to exclude this possibility[462]. Much more likely a cause is either ignorance of the possibility of obtaining leave on the part of directors, or a reluctance to make leave applications.

[461] By which I mean loss caused where disqualification prevents successful entrepreneurial activity, either because an individual would not have been involved in an insolvency during the period of his disqualification or because he could have usefully discharged a *limited* function in the management etc., of a company.

Ignorance of leave is however, an explanation that is difficult to sustain given that the guidance material on disqualification supplied to individuals subject to proceedings under the Act refer quite explicitly to the possibility of obtaining leave[463]. Much more likely a cause of the low instance of leave is a reluctance to apply for leave as the cost and evidential implications of making an application (as outlined above) simply cannot be ignored. Costs is an issue that is widely recognised as being a significant determinant of a director's response to an initial disqualification application[464] and must also be relevant to leave. Indeed if a director is unable to contest an original application be he cannot afford to do so, it seems unlikely that he will be able to make an application for leave either[465]. Of course it should be noted that leave applications can be made at any point during the currency of a disqualification, and as the financial circumstances of disqualified individuals improve leave applications may become more practical. However, the low incidence of leave appears to suggest that this does not have a significant impact and, indeed, it is hardly satisfactory that leave should only be available to the rich.

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[462] Analysis of the leave cases cited by Mithani in his encyclopaedic work "Directors Disqualification"(supra note) appears to confirm that the courts are sympathetic to leave applications; that in most cases leave was granted

[463] Copies of the materials supplied are available at: www.insolvency.gov.uk/directordisqualificationandrestrictions

[464] For example in *Re Barings Plc* [1998] 1 BCLC 18, Sir Richard Scott expressed 'concern' that directors were not contesting disqualification applications simply because they could not afford to do so. Hoffman J expressed similar concerns in *Re Swift 736* [1992] BCC 93, which were repeated (extra-judicially) by the then Lord Hoffman, see *The Fourth Annual Leonard Stainer Lecture* (1997) 18 Comp. Law. 194.

[465] See further Chapter 7, below which discusses the costs issue more full. The reasoning outlined relates to the ability of directors to contest applications but is also applicable to their ability to make a leave application.

Therefore whilst leave may have the potential to alleviate a limited amount of the potential loss caused by the disqualification regime its role is, for whatever reason, not significant. Thus leave is no way transforms the rather drastic failures of disqualification to deliver effective protection that the NAO suggests. It should not be forgotten that, according to NAO research, 94% of disqualifications bring no protective benefit, may stifle successful business activity, and are (in terms of protection) wasted. Leave, (in any case only capable of providing a remedy to stifled activity) is applicable to only 4% of directors and is unlikely to significantly reduce the costs of over-regulation. It cannot, therefore, significantly alter the disappointing picture painted by the NAO.

6.4 Long-term Protection.

All the available empirical data therefore indicates that disqualification fails to meet it goal of 'protecting' the public from unfit directors, and indeed is likely to inflict loss on them. However, before the analysis moves on to consider whether disqualification is more successful in meeting its other declared goal, i.e. deterring unfit conduct, it is worth noting one last protective failure of the section 6 regime.

In addition to its other deficiencies, disqualification under section 6 provides little in the way of long-term protection, even where it prevents secondary insolvencies. This is because those who have been subject to disqualification are not subject to any restrictions after the end of their disqualification. They are not, for example, required to undertake any training in good stewardship of companies nor prevented from becoming sole directors. Therefore, whatever 'protection' is afforded by disqualification is temporary. This is a particularly important aspect of disqualification given that the vast majority of section 6 disqualifications are for a period of less than 11 years[466], with about half being for less than a 5-year period[467]. It is of course true that the average length of a disqualification has risen in recent years[468], and this has had a positive effect on the level of protection, but 5 years is still a relatively short space of time.

The NAO, advocated longer periods of disqualification as a way to increase the protective effect of the sanction[469] and its justification for its view has an appealing logic, for it would appear that longer disqualifications mean a longer period during which the public will be 'protected' from a rogue director. Therefore it might be thought that more 'protection' (i.e. loss-reduction) can be secured from longer disqualifications. However, it would appear that longer disqualification only marginally increases the number insolvencies prevented by disqualification.

The NAO's research showed that the likelihood of a director being involved in a 2[nd] or 3[rd] insolvency is very low 7 or 8 years after the a first insolvency[470]. Therefore, longer disqualifications are not the best way of

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466 See: Insolvency Service Executive Agency, *General Annual Report for the Year 2002*, (London, DTI, 2003), table 5.

467 *Companies in 2002-2003, supra* note 427, table A3.

468 See the Insolvency Service's General Annual Reports published between 1998 and 2002, (London, The Stationary Office, 1998, 1999,2000, 2001 and 2002).

469 See also A. Hicks, *Director Disqualification: Can it Deliver* [2001] JBL 433, at page 446.

470 4.5% of directors are likely to be involved in a second insolvency within one year, 2.2% in the second year and 2% in the third but only 0.2 and 0.1% in the 7[th] and 8[th] years respectively; see National Audit Office, '*Follow Up Report'*, *supra* note 406.

improving the protective effect the sanction. An increase of two years on the average disqualification, for example, would prevent only an extra 0.2% of directors being involved in another failed business. Thus if the average length of disqualification in 2003-2004 had been 7.5 years instead of 5.5, only 3 extra insolvencies would have been prevented. Furthermore, there are limits to extent that disqualifications can be made longer without making disqualification periods disproportionate to the misconduct committed[471].

Unfortunately, the focus of disqualification is on short-term 'protection' with little attention paid to what happens once disqualification is over. At the present time, the long-term effectiveness of post-insolvency disqualification relies upon the hope that directors will have 'learned by their mistakes', which is hardly a guarantee of good conduct. Apart from this the only factor that may prevent a repeat of misconduct is caution exercised by creditors in dealing with ex-disqualified directors[472].

There is therefore little evidence to suggest that the benefits from disqualifying directors are in any sense 'significant'. The evidence from the NAO report indeed indicates quite the contrary, for it would appear that not only is the disqualification sanction often not applied to loss causing conduct, but that even when it is, it delivers few real benefits. There is also a

[471] In *Re Sevenoaks Stationers*. [1991] Ch. 164 the Court of Appeal provided guidelines to determine the length of a disqualification under section 6 of the Act according to the seriousness of the unfit conduct shown. In so doing the court also divided the mandatory 2-15 years period of disqualification into three brackets. The brackets were stated as follows:

- Eleven to fifteen years' disqualification should be reserved for a particularly serious case of unfit conduct. This might be in the case of a second disqualification or breach of an earlier order.
- Six to ten years for cases not involving conduct meriting the highest band.
- Two to five years for less serious cases.

significant risk of over-regulation causing loss. Leave may have the potential to alleviate some such loses but it is so rarely used (probably dues to cost considerations) that its impact is not significant. However, before reaching a final judgement about the worth of the current disqualification regime, it is necessary to consider whether the supposed 'deterrent' effect of disqualification under section 6 is likely to produce a more significant benefit.

6.5 Deterring the Unfit.

The deterrent effect of disqualification plays a significant part in the supposed facilitation of confidence the market that the sanction brings[473]. However, there are sound reasons for doubting that disqualification has a significant impact in deterring unfit conduct and therefore, reducing losses from unfit conduct.

6.5.1 Disqualification as a 'Personal' Sanction.

The use of disqualification as a means to deter unfit conduct is premised on the belief that 'personal' sanctions are an effective way of securing directors' compliance with proscribed standards of behaviour. However, recent evidence from a study by Robert Baldwin[474] casts doubt upon whether such personal sanctions effectively motivate directors to comply with regulatory requirements. As part of his inquiry into the

[472] However, it should be noted that directors who are disqualified for a second time face a longer period of disqualification, see *Re Sevenoakes*, *ibid*.
[473] The NAO stated that disqualification had a significant role in 'the fostering of improving standards of company stewardship, without inhibiting genuine enterprise and entrepreneurial management'. See NAO 'Follow Up Report', *supra*, note 406, para 1.5.

response of directors of FTSE companies to punitive regulation, Baldwin studied the main 'drivers' behind director's efforts to manage regulatory risks. His survey revealed that 'corporate' as opposed to 'personal' concerns were the most important factors motivating compliance with regulatory standards. For example, 90% of the directors questioned for Baldwin's survey cited 'concern for their company's reputation' as the most important driver of their conduct, compared to only 36% of directors who cited the fear of personal sanctions.[475].

Baldwin's research would suggest that the effectiveness of disqualification as a deterrent to unfit conduct is therefore based on a false assumption and is limited. However, it should be emphasised that Baldwin's research was limited to directors of FTSE companies. Disqualification, however, is a sanction largely applied to directors of small owner-managed companies whose attitudes are likely to be different from directors of public companies. It is possible that directors of owner-managed companies would have greater regard for personal sanctions, given that they are often the only actors behind the company and are more exposed to such sanctions than a director of a public company who shares responsibility with several fellow directors and managers. Nevertheless, Baldwin's research does challenge the assumption that directors behave in a rational and therefore compliant way when faced with personal sanctions.

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[474] Baldwin R., *The New Punitive Regulation*, (2004) 67 MLR 351.
[475] *Ibid.*

However, aside from the general question of whether personal sanctions encourage compliant behaviour, certain factors specific to the disqualification regime raise doubts about the efficiency of post-insolvency disqualification as a deterrent mechanism.

6.5.2 Knowledge of Disqualification.

At the time of their first report into disqualification under section 6, the NAO carried out a survey that tested, amongst other things, awareness of the disqualification legislation amongst directors. The results of the survey showed that awareness was relatively low, with 58% of directors questioned claiming to be unaware of the legislation[476]. The low level of awareness of the legislation found was explicable due to the low number of disqualifications that were made prior to 1993 and the scant publicity that the sanction attracted. However, a similar survey that was carried out for the NAO's follow up report in 1998, actually showed an ***increase*** in ignorance of the legislation; 66% of directors then claiming no knowledge of the sanction[477]. The apparent increase is surprising given that between the 1993 and 1999 the number of section 6 disqualifications had tripled, increasing from 399 in 1993-4 to 1,284 in 1998-99. If this research is accurate, grave doubt is cast on the on the policy of increasing the number of

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[476] National Audit Office, *Report by the Comptroller and Auditor General: The Insolvency Service Executive Agency, Company Director Disqualification* (House of Commons Papers, Session 1992-1993, 907), para 2.47.

[477] National Audit Office, Report by the Comptroller and Auditor General, *Insolvency Service Executive Agency, Company Director Disqualification – A Follow Up Report,* (House of Commons Papers, Session 1998-1999, 424), para 2.49. There was also an increase in the number of director who felt that disqualification was *unsuccessful* at deterring unfit conduct. See note 498, below.

disqualifications as a way to enhance the deterrent effect of disqualification. If anything, the figures suggest a negative correlation between the number of disqualifications and awareness of the legislation.

In the five years since the last NAO report the annual number of disqualifications has continued to rise[478], but it would seem unlikely that this has increased awareness of the legislation. However, the limited knowledge of the disqualification legislation shown in the second NAO survey would not appear to be unique. In Baldwin's survey [479], for example, only 38% of directors claimed that they were aware of 'company law' regulatory risks. Given that Baldwin's survey was concerned with knowledge of regulatory risks amongst the professional class of directors, there seems to be little indication that the findings of the NAO will have significantly changed.

In any case, the deterrent effect of disqualification rests upon more than mere knowledge of the sanction. In order for disqualification to effectively prevent loss-causing conduct it is not only necessary that directors are aware of the possibility of being disqualified, but also that they are aware of what conduct is 'unfit'. For, if directors do not know what unfit conduct is, how can they be deterred from carrying it out? Therefore, given the low awareness of the existence of disqualification, it is unlikely that more than a few directors have any knowledge of the elements of unfit conduct.

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[478] Between 1997-1998 and 2002-2003 the annual number of disqualification increased in 5 out of 6 years. The number of disqualifications is now approximately 22% higher than at the time of the last NAO report; see, *Companies In 2003-2004*, *supra* note 427.
[479] *Supra*, note 474.

In this respect one of the costs of settling upon a general standard as opposed to a set of rules in disqualification are apparent. The compliance costs associated with the 'unfitness' standard or the courts' formulation of 'a breach of commercial morality' or 'negligence to a marked degree'[480] are high, especially to a director who is unfamiliar with the law. Indeed, there are so many precedents and potentially unfit acts that it would be extremely time-consuming and costly to be aware of them all. The complexity of the precedents and the notorious insistence by the judges that unfitness is essentially a 'jury question' is a substantial impediment to reducing creditor loss through compliance or deterrence[481]. Furthermore, the remote possibility of becoming subject to disqualification proceedings is likely to persuade directors that the cost of complying with the standard (if it were possible) is greater than the likely benefit.

6.5.3 Post-Insolvency Deterrence.

The formal insolvency requirement for disqualification under section 6 does not help to increase its deterrent effect because only the relatively small number of directors whose companies are subject to formal insolvency proceedings fall within the purview of the system. For example, directors of solvent companies who commit misconduct, and those of companies that are simply dissolved and struck off the register, largely fall outside the

[480] For example as per Brown-Wilkinson v-c in *Re Lo-Line Electric Motors Ltd* [1988] 1 Ch 477 at 486. "Ordinary commercial misjudgement is in itself not sufficient to justify disqualification. In the normal case the conduct complained of must display a lack of commercial probity, although I have no doubt that in an extreme case of gross negligence or total incompetence disqualification could be appropriate"

disqualification system[482]. This makes disqualification a remote prospect for most directors.

In 2003-04, for example, 154,300 companies were struck off and dissolved whereas only 15,700 were subject to insolvency proceedings before being removed from the register[483]. Therefore, the chances of a director falling within a post-insolvency disqualification system are limited. As such, compliance with the disqualification standard is likely to be a marginal factor in the mind of a director immersed in day-to-day decision taking. For, whilst a company is in good financial health, post-insolvency measures aimed at deterring unfit conduct will not present the kind of immediate danger to a director that would deter him from carrying out 'unfit' acts. The cost of complying with the sanction is therefore likely to be much higher than the obvious benefit. It is only when the prospect of insolvency is a real and pressing possibility that compliance with the disqualification standard is likely to be a rational course of action, by which time unfit conduct may well have taken place.

However, even if a company enters formal insolvency proceedings, the likelihood of becoming subject to disqualification proceedings is low and, indeed, very arbitrary. Much rests on the Insolvency Practitioner (IP) or

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[481] See For example Dillion LJ in *Re Sevenoakes Stationers Ltd*, *supra* note 471, who condemned attempts to paraphrase the disqualification standard through judicial precedents.
[482] Hicks, *Directors' Disqualification*, *supra*, note 469. As Hicks notes, the Victoria Law Reform Committee, recommended reform of the Australian disqualification provisions to remedy exactly this weakness. See: Parliament of Victoria Law reform Committee, *Second Report of the Law relating to Directors and Managers of Insolvent Companies*, (Victoria, Parliamentary Papers, 1995), para 3.16.
[483] *Companies in 2003-2004*, *supra*, note 427, table C1.

Official Receiver (OR) who is appointed to the company[484]. This also weakens the deterrent impact of disqualification.

6.5.4 IP Discretion in the Reporting Process.

In a study carried out in 1992-93, Sally Wheeler[485] discovered significant variations in the nature and quality of IPs compliance with their reporting obligations under the Disqualification Act. Wheeler discovered that IPs were often unclear as to when their reporting obligations arose under the Act, that many undertook only a very cursory investigation into possible unfitness and that several filed inadequate reports to the Secretary of State[486]. The varying quality of reports was one factor that was thought to explain why at the time of the survey, 81% of unfit conduct reports received by the Insolvency Service were not pursued.

Since the first NAO report and Wheeler's study, the Insolvency Service, in conjunction with the Insolvency Practitioner Compliance Unit

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[484] IPs and Ors are placed under an obligation by Section 7(3) of the Disqualification Act to report unfit conduct to the Secretary of State if it appears to him that the conditions mentioned in section 6(1) are satisfied in respect of a person who is or has been a director of the company, the office holder is obliged to report the matter to the Secretary of State. In reliance upon this provision a two-stage reporting process has been established whereby the Secretary of State is notified of the potentially unfit conduct of directors.
In accordance with section 7(3) and rule 4 of the Insolvent Companies (Reports on Unfit Conduct of Directors) Rules 1996(SI 1996/1909), an office holder has to make an interim return under s7(3) within six months of him coming to office if he feels the matters in section 6(1) are satisfied. This initial report is to be made on a form set out in the schedule 1 of the 1996 statutory instrument and is called a D2 'Interim Return'. When an office holder submits an interim report he falls under an obligation to submit a final and full report on unfit conduct, called a 'D1' form. It has now become the practice of the Insolvency Practitioner Control Unit (I.P.C.U). to notify the office holder of the date by which he is expected to submit a final report. In general an office holder is expected to submit a final return within nine months of having filed an interim report.

[485] S. Wheeler, *Directors Disqualification: Insolvency Practitioners and the Decision Making Process*, [1995] Legal Studies 283.

[486] The same matter was highlighted by NAO's first report in to disqualification. It noted that in 34% of all reports submitted to the Insolvency Service were incomplete. See,

(IPCU), has made significant efforts to improve both the number and quality of reports submitted by IPs. These efforts have produced positive results. The NAO follow-up report noted a significant rise in the recording and reporting of unfit conduct by ORs between 1992 and 1998 and the same is likely to be true of IPs. IPs compliance with their statutory obligations is now subject to a sophisticated monitoring regime with each IP's reporting profile monitored by the IPCU[487]. IPs who routinely do not submit reports to the Insolvency Service where they should, or who submit late reports, can be subject to disciplinary proceedings[488]. The Insolvency Service has helped to improve IP's recording and reporting profile by producing guidance on statutory reporting obligations. The *Guidance Notes for the Completion of Statutory Reports and Returns*[489], for example, explains IPs reporting obligations under the Act, how to complete 'D1' and 'D2' reports and returns as giving guidance about various types of unfit conduct.

However, whilst significant advances have undoubtedly been made in improving the timeliness, nature and quality of IP reports, variations in the quality of the investigations carried out into unfit conduct continue to be a concern. The follow-up report noted that the variation in the number of D1 *reports* made by OR offices had narrowed to between 4% and 14% in 1998, compared with of 0.3% to 10% in 1992. Similarly the variation in recorded

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National Audit Office, *Report by the Comptroller and Auditor General, supra,* note 466, para 3.10.

487 See, Insolvency Service, *Dear Insolvency Practitioner Letter: Millennium Edition* (London, Insolvency Service, 1999), chapter 10. Available at *http://www.insolvency.gov.uk/information/dearip/dearipmill/chapter10.htm*

488 See: Insolvency Service, *Enforcement Concordat*, April 1999. Available at www.insolvency.gov.uk /information/iparea/ipguide.htm

unfit conduct (D2 forms) narrowed to a range of between 25% and 65% in 1998 compared with 2% to 56% in 1992[490]. However, whilst the improvement in consistency between official receivers is welcome, it is obvious that significant variations in levels of reporting between ORs offices exist. The recent case of *Official Receiver v Jones*[491] shows that defective investigations by ORs are far from being a thing of the past and it remains likely that some of the variations in recording and reporting between ORs can be put down to the type of differing investigation strategies that Wheeler[492] discovered in relation to IPs. Indeed, it is still the case that fewer than half of all reports made to the Insolvency Service are pursued, which suggests that reporting is still far from perfect[493].

However, perhaps more concerning is the difference between the number of recorded instances of unfit conduct and official reports received by the Secretary of State. In 2002, for example, reports of unfitness were only submitted in 36% of cases where it had been recorded (i.e. where *prima facie* evidence of unfitness was found)[494]. The 2002 figures show an improvement on 1998, when only 19% of D2 records reports lead to a D1 report, however the fact that almost two-thirds of recorded instances of unfit conduct do not proceed to the formal reporting stage raises the prospect that several cases of unfitness are falling through the disqualification net. Of

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489 (London, Insolvency Service, 2001).
490 NAO, *Follow Up Report, supra*, note 406, fig. 12.
491 [2004] EWHC 2096.
492 *Supra* note 485.
493 Insolvency Service. *Insolvency: General Annual Report for the Year 2002*, (London, The Stationary Office, 2003).
494 *Ibid.*

course, it is inevitable that in some cases where *prima facie* evidence of unfitness is found, sufficient evidence to file a full report will not be forthcoming, however, the variation between the recording and reporting of unfit conduct is large and not readily explicable.

The variation between D1 and D2 reports could be due to over-cautious recording of unusual conduct by directors because of the pressure on IPs and ORs to identify unfit conduct, or it is could be due to a reluctance to carryout a detailed investigation into suspected unfit conduct due to the costs and time involved, a particular concern in companies which have few assets. Whatever, the reason may be, the limited number of cases that proceed from the D2 to D1 stage hardly increases the deterrent effect of disqualification.

What is certain is that the reporting decision vests a lot of discretion in the hands of IPs and ORs which causes uncertainty as to whether unfit conduct, if discovered, will be reported. Put simply, the obligation to report unfit conduct arises when there is sufficient evidence that a director's conduct makes him or her unfit to be concerned in the management of a company[495]. This reporting test is simply a replication of the test that the court must apply when deciding whether to disqualify. It therefore requires IPs or ORs to exercise the same value judgement about a director's conduct as the courts. As such, it is little wonder that empirical evidence from Hicks' survey of IPs in 1997[496] suggests that IPs are confused as to when their

[495] As set out in the *Guidance Notes*, *supra* note 489, pages 3-4.
[496] A. Hicks, *Director Disqualification: Can it Deliver*? [2001] JBL 433, page 436.

reporting obligation arises. Each IP and ORs decision must depend ultimately on his or her knowledge and appreciation of the law and correct application of the test would require and encyclopaedic knowledge of disqualification precedents. Inconsistency in decision making is therefore hardly surprising.

However, the lack of certainty that surrounds the reporting of unfit conduct and its subsequent investigation does significant harm to the deterrent effect of disqualification. Taken together with the 'narrowing' effect of the insolvency requirement, the actual level of deterrence achieved by post-insolvency disqualification is likely to be low even for a director who believes his company will become insolvent.

Rational deterrence assumptions[497], dictate that a director will weigh the expected costs and benefits of non-compliance with a behavioural rule before deciding whether to comply. A rational director who undertook such an exercise when considering compliance with the disqualification standard may well conclude that non-compliance was the rational course of action given the slight chances of becoming subject to a post-insolvency disqualification regime and the limited chances of being disqualified if he did. Even when insolvency is a real prospect the odds are stacked against disqualification, and given that directors probably are not purely rational actors it is doubtful whether the current disqualification regime would have a positive effect even in these circumstances.

[497] Baldwin, *supra,* note 474.

Therefore, it is probably unrealistic to expect a post-insolvency disqualification to be an efficient means of deterring unfit conduct. Empirical evidence from surveys of directors and IPs seem to back up this conclusion. For example; 64 % of directors questioned for the NAO in 1998 felt that the disqualification regime was unsuccessful in deterring unfit conduct and 61% felt the disqualification regime was unsuccessful at 'disqualifying those who need to be disqualified'[498]. In a similar survey carried out by Andrew Hicks, two-thirds of IPs felt that disqualification did not influence directors' behaviour[499].

6.5.5 Other Relevant Factors.

Several other factors also limit the impact of disqualification. The lack-lustre enforcement of disqualification orders is a debilitating factor on the legislation as a whole. The annual number of convictions obtained for breaches of a disqualification is low, only 16 being obtained in 2002[500]. In order to be as effective as possible it is necessary for disqualifications to be properly enforced, otherwise any deterrent or protective effect that the sanction may produce will be undermined[501]. Indeed, a survey carried out

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[498] See NAO *Follow Up Report, supra*, note 406, fig 27. It is also interesting to note that the percentage of directors who felt that the disqualification legislation was *unsuccessful* in deterring unfit conduct had actually *increased* compared to the results of a similar survey carried out for the first NAO report in 1993.

[499] Hicks also questioned 20 disqualified directors as to whether their knowledge of the possibility of disqualification had influenced the way they had run their companies. None of the 20 said that it had. This finding is noted by the NAO; see *Follow Up Report, supra,* note 406 para 3.35.

[500] Insolvency Service, *Insolvency: General Annual Report for the Year 2002*, (London, The Stationary Office, 2003), table 4.

[501] See: Hicks, *Directors' Disqualification: Can it Deliver?,* supra note 469 and S. Griffin, *The Disqualification of Unfit Directors and the Protection of the Public Interest*, (2003) 53 NILQ 207.

for the NAO report showed that 72% of directors felt that the disqualification legislation was not enforced vigorously enough[502]. Recent initiatives such as the 'Disqualified Directors Hotline'[503] have been launched in attempt to increase the enforcement effort, or at least give the impression of an increased effort, but the results are disappointing.

However, the actual extent to which disqualification orders are breached is difficult to gauge. A small survey of 34 disqualified directors carried out by Andrew Hicks for the ACCA[504], showed evidence that 6 of the 34 were acting in breach of their disqualification orders. If this research were accurate and representative of all directors then breaches of disqualification orders would appear to be relatively common and the enforcement effort woefully inadequate.

6.5.6 The Current System.

Therefore all the available evidence suggests that the current disqualification system is manifestly inefficient. Most disqualifications provide no protection from loss-causing conduct and all empirical evidence indicates that the sanction has a low deterrent impact. However, there appears to be no sign of a change in the policy of using post-insolvency disqualification to 'protect' the commercial world. Indeed, ministers appear to believe, in spite of the evidence that clearly exists, that disqualification is working. The new system of undertakings and the 'record number' of

[502] NAO, *Follow Up Report*, *supra*, note 406, para

[503] The hotline was set up in 1998 for the public to report persons who they suspect of acting in breach of a disqualification order.

disqualifications it has brought are cited as evidence of the success of the policy[505]. Ironically, it is the NAO follow-up report which praised the 'effectiveness' of the higher-numbers-equals-success strategy, which is partly responsible for the continuation of the policy.

However, much of this inefficiency is specific to post-insolvency application of disqualification, for in such circumstances the success of disqualification is wholly reliant upon preventing a repeat of misconduct and the losses that may flow from it. Therefore, given the apparently low incidence of 're-offending' and the limited opportunity to tackle misconduct presented by a post-insolvency system, it should be unsurprising that disqualification struggles to produce clear benefits. However, a pre-insolvency disqualification regime would not suffer from such disabilities.

Therefore, in the following section I discuss whether a pre-insolvency disqualification regime would provide a more effective mechanism to protect the public from rogue directors. I also offer some observations as to why a post-insolvency regime was chosen over a pre-insolvency one. I do not seek to demonstrate that a pre-insolvency regime would be perfect or even that it is necessarily desirable; merely that it affords the opportunity to secure greater loss reduction than the current system.

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[504] See A. Hicks, *ACCA Research Report 59*, Director *Disqualification; No Hiding Place for the Unfit?*, (London, ACCA, 1998).
[505] For example, see the DTI press release *"Fast Track Disqualification Results in Record Bans"* 2nd January 2002. See also Griffin, *The Disqualification of Unfit Directors and the Protection of The Public Interest, supra,* note 501.

6.6 Pre-Insolvency Disqualification.

6.6.1 Advantages - Protection.

Pre-insolvency disqualification has the potential to overcome, or significantly reduce, many of the protective failures of post-insolvency disqualification. The most attractive feature of disqualification before insolvency is that it provides the possibility of preventing the losses from an initial insolvency that are untouched by a post-insolvency disqualification. Of course, the success of pre-insolvency regime in this respect would depend upon the regulator's ability to target disqualification at cases where unfitness was likely to lead to business failure, however, even partial success in this respect would be preferable to a situation where no attempt is made to prevent insolvencies before they occur. However, such a regime would most likely be more complex than the current.

6.6.2 A Pre-Insolvency Regime.

One of the major advantages that the post-insolvency disqualification regime may be thought to have over a pre-insolvency system is that insolvency proceedings provide a steady stream of information to the Secretary of State from IPs and ORs at no cost to the tax payer. There is no such obvious source of information on misconduct *before* insolvency that the Secretary of State could access. As such, a pre-insolvency regime would be likely to be reliant upon reports of misconduct from creditors and the public the public at large. This obviously creates a risk that many instances of unfit conduct would not be reported. Creditors, for example, may be reluctant to report suspected misconduct for fear of getting a 'bad name' in their trade and scaring off business partners. The time and expense of reporting may also discourage them. The general public may be less concerned about getting a 'bad reputation' from reporting, but may be put off by other factors, such time and expense. That said the experience of the Companies Investigation Branch of the DTI does not demonstrate undue reluctance on the part of the general public to report suspected corporate misconduct. In 2003-2004, for example over half of the requests received for investigations under Part XIV of the Companies Act were received from the public, or their representatives (e.g. MPs).[506] However, the pubic and creditors are not the only potential sources of information on apparent unfitness, as the example of investigations under part XIV shows. The DTI itself and other government departments already hold a substantial amount of information concerning some of the most common types of misconduct[507] that could be used to start investigations. Indeed in the case of part XIV the second major source (20%) of requests for investigations came from divisions and agencies within the DTI[508]. Other government agencies, such as the Director of Public Prosecutions' office, the Police, other departments of State, as well as bodies such as the Financial Services Authority were also

[506] Companies in 2003-2004 (London, The Stationary Office, 2004) page 18, table 3.
[507] For example, Companies House holds information concerning a failure to submit accounts and returns and information regarding a failure to pay crown debts should be held by the Inland Revenue and Customs and Excise. If this information was pooled it could be used to highlight cases of potential misconduct, if this is the sort of conduct the DTI wishes to target. However, this takes nothing away from my assertion that targeting such misconduct should be discontinued as an inefficient application of the disqualification standard. See Chapter 4 , *ibid.*
[508] Companies House was a significant source of requests for investigation, see Companies in 2003-2004, *supra* note 506 tables 3 and 4..

significant sources of information. Of course, such disparate sources of information may not provide as complete a picture of director's conduct as is available from a single IP or OR investigation and report but at the very least the experience of part XIV investigations shows that several sources of information on misconduct pre-insolvency exist, as the Insolvency Service itself has commented[509]. Thus, investment in co-ordinating information received from government agencies, combined with an investment in providing the opportunities for creditors and others to report suspected corporate misconduct, could provide sufficient sources of information for a pre-insolvency regime to function. However, a note of caution should be sounded. For whilst the experience of part XIV investigations by the DTI shows sources of information pre-insolvency exist, it must be noted that only a small proportion of the requests for investigation under that are received under that part proceed past the initial vetting stage of investigation.[510].In 2003-2004, for example the Secretary of State received 4,732 requests for the investigation of the affairs of a company, of which 2,644 were not accepted or referred elsewhere, 858 formally considered for further investigation, 200 actually investigated and 618 formally refused.[511] Therefore whilst there would seem to be no shortage of information, very

[509] See '*Guidance Notes*', *supra* note 489, page 13.
[510] The Secretary of State has discretion as to whether to pursue requests for investigation. All requests received are therefore vetted to see if grounds for suspicion of wrong doing can be established. Even then the Secretary of State has discretion whether to pursue the complaint, eliminate it or redirect it to another government agency. See *Companies in 2003-2004*, *supra* note 506, page 16.
[511] Companies in 2003-2004, *ibid*, page 17 table 1.

little of it would seem to be sufficiently strong to merit formal investigation[512].

In addition to problems concerning gathering of information, a system that relied upon pre-emptive investigation by the Secretary of State would inevitably involve greater costs than is the case under the current system, where the cost of the initial investigation of unfit conduct is borne by IP's and OR's and ultimately by creditors[513]. As such it is likely that fewer disqualifications would be made unless the resources that were devoted to disqualification were to be substantially increased. However, this is not necessarily a disadvantage because most post-insolvency disqualifications provide no protection, indeed the over-regulation of the current system is likely to lead to loss. Therefore, a smaller number of targeted pre-insolvency disqualifications could have no less a protective effect than the current number of post-insolvency disqualifications. Indeed, if they prevented an initial insolvency the protective effect could be greater. Therefore the impact on the cost-benefit of disqualification from pre-insolvency disqualification is likely to be at least neutral if not positive.

The protective benefits of pre-insolvency disqualification could therefore be much greater than post-insolvency disqualification, provided that directors who are an insolvency 'risk' were properly the target of disqualification applications. However, in addition to preventing loss

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[512] This could be a particular concern with information received from the public which may be incomplete, or simply wrong. Malicious reporting where there is no genuine evidence of wrongdoing could also be a problem that diverts resources from investigation of genuine reports of wrongdoing.
[513] See 5.5, *supra*.

caused by insolvency where a director's conduct has been unfit, a pre-insolvency regime could also provide more effective future protection. For, one of the major criticisms that can be levelled against post-insolvency disqualification is that it fails to provide protection from unfit directors during the period in which they are most likely to be involved in a second corporate failure, i.e. the first two years after an initial insolvency[514]. Pre-insolvency disqualification, on the other hand, could easily neutralise this high-risk period by removing the unfit *before the first insolvency* and preventing them from being involved in a second for a number of years. Thus, the potential protective effects of a disqualification can be greatly enhanced.

The potential benefits of pre-insolvency disqualification can be demonstrated in a hypothetical example that combines NAO calculations with some conservative assumptions about a pre-insolvency regime.

A pre-insolvency regime that succeeded in disqualifying just 300 individuals whose unfitness would have lead to insolvency would bring substantial cost savings to creditors. Because, assuming that the average loss to creditors from the insolvencies prevented would have been the same as in the NAO model (£170,000)[515] the net benefit to creditors of 300 pre-insolvency disqualifications would be some £51 million[516]. If this small number of disqualifications could be achieved with the current Disqualification Unit budget of around £25 million, the cost-benefit analysis

[514] See, National Audit Office, *Follow-Up Report*, *supra* note 406, fig. 31.
[515] Adjusted for inflation using the headline retail price index figures from 1999-2004. See Office for National Statistics, *Consumer Prices from 1750 – 2003*, (London, ONS, 2003)

of disqualification is dramatically turned around. Indeed the Disqualification Unit would only need to prevent 150 insolvencies through pre-insolvency disqualification to produce a cost efficient disqualification regime.

The benefits of pre-insolvency over post-insolvency disqualification increase still further if the likely benefits in terms of prevented second insolvencies are considered. To estimate the likely benefit here the average length of a pre-insolvency disqualification was assumed to be the same as a post insolvency disqualification, i.e. 5.5 years. The NAO's research on the likelihood of director's being involved in a second insolvency were also used as the basis for the calculations. If it were assumed that in an ideal pre-insolvency disqualification system a director would be disqualified 1.5 years before insolvency would have occurred[517], disqualification would prevent further insolvencies that would have occurred within 4 years of an initial insolvency. The NAO research estimated that 10%[518] of directors would be involved in a further corporate failure during this period. Therefore, again assuming 300 insolvencies were prevented by disqualifying 300 directors, 30 of those directors would have gone on to be involved in a further corporate failure during their period of disqualification. Assuming average debts of £170,000, pre-insolvency disqualification would add a further £5.1 million of creditor savings to the £51 million already secured. *Thus, the total*

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[516] 170,000 x 300 = 51,000,000.

[517] 1.5 years was thought to be a reasonable figure for an effective pre-insolvency regime as it would provide ample time for a business to be turned around before insolvency became inevitable.

[518] The NAO's research suggested that 6.7% of directors would be involved in another insolvency with a year of first , 3.6%% in the second, 2.6% in the third and 1.3% in the fourth. See the *'Follow Up Report'*, *supra*, note 406, fig 31.

creditor saving from just 300 pre-insolvency disqualifications could be as much as £56.1 million. This compares with the £18.5 million saving from 1,367 post-insolvency disqualifications. Indeed just 150 pre-insolvency disqualifications could achieve a benefit of over £28 million.

Therefore, in terms of cost-benefit efficiency, a pre-insolvency disqualification system is *potentially* more efficient than the post-insolvency disqualification. For, even a substantial increase in the Disqualification Unit's budget to achieve 300 pre-insolvency disqualifications could be absorbed. However, the existing Disqualification Unit budget of £25 million to achieve just 300 disqualifications would seem a generous allocation as over 5 times the resources could be put into each disqualification compared to the current system.

6.6.3 Remaining Problems.

Nevertheless, many of the difficulties with post-insolvency regime would also be applicable to pre-insolvency disqualification, and as was stated at the outset, most of the benefits that could flow from such a system rest upon it being efficiently and properly administered. Therefore it is far from guaranteed to be efficient. However, even if we assume that the system was operated in an effective way, the long-term effectiveness of even a pre-insolvency disqualification can be doubted if directors are still permitted to re-enter the world of limited liability without any safeguards after their disqualification has ended. As with the post-insolvency model, a pre-insolvency disqualification system is also likely to disqualify individuals who may have gone on to run a successful second business even if their first had failed (up to 90% of directors may not 're-offend' according to NAO statistics). Therefore, some of the cost benefit is likely to be lost through over-regulation. However, the benefit of preventing the initial insolvency goes some way to mitigating such disadvantages, and certainly represents an improvement on the current post-insolvency system where the loss of the initial insolvency is neither prevented nor recovered. Indeed on an efficiency measure, the worst-case scenario pre-insolvency disqualification system could not be more inefficient than the current post-insolvency regime.

However, a further practical problem that would undoubtedly be thrown up by a pre-insolvency regime would be what to do with companies which were left with no effective management due to disqualifications (i.e. where all the active directors were disqualified). In this situation the choice must be between allowing such companies to continue in existence with the same management as an unincorporated entity without limited liability, ordering the compulsory winding up the company, or allowing it to continue with new management. It would be difficult to chose a universal rule from these options that would provide a satisfactory outcome in all cases. Rather it would be best for the disqualifying authority to have regard to the rights of all those affected by the disqualification (e.g. the company's employees, creditors and the disqualified director) and direct an outcome that balances those rights effectively. In some cases it may be better for the company to continue trading because of the interests of employees. In others there may be few or no employees and winding up may be the best outcome for the principle interest group, i.e. the creditors. Thus, the most satisfactory solution to this problem would for a flexible approach to be adopted, thereby limiting the 'losses' that could flow is companies left without directors were simply wound up.

6.6.4 Deterring the Unfit.

A pre-insolvency disqualification system could have a greater deterrent effect than the post-insolvency system because of the removal of the insolvency precondition for disqualification. Pre-insolvency disqualification would not be limited to a narrow class of unfit conduct i.e. that associated with business failure, and is a sanction that could be applied soon after unfitness occurs.

Directors also stand to suffer greater personal loss from disqualification during solvency than they do from disqualification after insolvency. Pre-insolvency disqualification would deprive a director of his current earnings as well as future opportunity. Post-insolvency disqualification, on the other hand, is only guaranteed to deprive a director of future opportunity, given that he will have lost his current earnings at the time of insolvency. This greater personal loss is likely to give pre-insolvency a prominence in the minds of directors that post-insolvency lacks and consequently increase its deterrent effect[519].

However, pre-insolvency disqualification would not, for instance, provide a guarantee that unfit conduct would lead to disqualification. The

[519] Although doubt would be cast on this by Baldwin's study. See Baldwin, *The New Punitive Regulation*, *supra* note 474.

chances of being disqualified would still depend upon many variables, such as government agencies passing on information on suspected rogues, creditors or customers reporting corporate misconduct etc, in the same way as the current system rests on IP and OR discretion. Thus, there are still likely to be gaps in the system that let much unfit conduct go unchallenged. However, in the context of an existing approach to the regulation of directors that suffers endemic flaws, pre-insolvency disqualification has arguably fewer flaws than post-insolvency disqualification. On rational deterrence assumptions therefore, pre-insolvency disqualification is likely to be more effective than post-insolvency disqualification. The removal of the insolvency precondition would make the likelihood of being subject to disqualification greater and the risk of losing a current salary increase the costs associated with the sanction. Consequently the benefit of complying with the standard is increased. However, whether the increased benefit would be sufficient to out-weigh the cost of compliance would remain open to question given the complexity of the unfitness standard.

Nonetheless reform may be desirable because of a very simple point, namely, that the current system constrains the Secretary of State to *re-act* to the aftermath of supposed corporate misconduct and it limits her to responding to 'unfitness' only in the small number of companies who enter formal insolvency proceedings. Pre-insolvency disqualification would at least afford the Secretary of State the opportunity to act *pro-actively*, tackling misconduct before it leads to insolvency and wherever it was evident.

6.6.5 The Use of Pre-insolvency Disqualification.

Given that pre-insolvency disqualification could be a more effective response to supposed misconduct than the current system, it is surprising that greater use of the pre-insolvency disqualification provisions already in the Disqualification Act has not been strongly advocated.

The Disqualification Act actually provides several opportunities for directors to be disqualified for unfitness before insolvency. Sections 3 and 5 of the Act, for example allow for pre-insolvency for persistent breaches of the companies legislation and upon summary conviction respectively. Disqualification for general unfitness is not limited to post-insolvency situations either. Section 8 of the Act allows disqualification for unfitness *without* the need for insolvency following an investigation ordered under the Companies Act 1985 or the Financial and Services Market Authority Act 2000[520]. However, a clear preference for section 6 has consistently been shown. Over the period 1998 –2003 disqualifications under section 6 accounted for between 86% and 91% of all the disqualifications made under the Act in each year, whereas section 8 only accounted for between 0.008% and 0.02% of the total number[521] of disqualifications. Other provisions of

[520]Disqualification under section 8 of the Act, like section 6, is premised on a director's unfitness to be concerned in the management of companies. It occurs as a result of an application to court by the Secretary of State (or his accepting an undertaking) following a DTI investigation of the company of which the person against whom the disqualification is sought is a director. A DTI investigation under section 8 is any report made under section 437 of the Companies Act 1985 (or section 94 or 177 of the Financial Services and Market Authority Act 2000) or information or documentation obtained under section 447 or 448[520] of the same Act.

[521] See, *Companies in 2002-2003*, *supra*, note 427.

the Act allowing pre-insolvency disqualification on grounds other than general unfitness are also rarely used[522].

The number of disqualifications made under section 8 of the Act is remarkably low when the potential pool of cases is considered. In the year 2002-2003 for example, section 359 investigations were completed under section 447[523] of the CA 1985 alone[524], yet only 17 disqualifications were made under section 8[525]. Given that a section 447 investigation is only one of several sources that can lead to a section 8 disqualification; the figure of 17 disqualifications looks very low indeed[526]. However, the excessive secrecy that surrounds section 447 investigations makes it difficult to judge whether a sufficient number of disqualification cases are being brought on the evidence uncovered[527], but a reluctance to bring section 8 cases, and

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522 Disqualifications under section 3, 4, 5 and 10 can be made pre insolvency however the account for fewer than 1% of all disqualifications made. See, *Companies in 2002-2003, ibid.*

523 Sections 447 and 448 of the Companies Act 1985 allow the Secretary of State to direct a company to produce to herself, or an officer appointed by her, any such documents as may be specified (section 447(3)), with a view to investigation the affairs of the company. The Secretary of State is empowered to issue such directions 'whenever she thinks there is good reason to do so'. Judicial review of the Secretary of State's power is difficult, as it has been held that a section 447 investigation is an administrative act to which the rules of natural justice do not apply: *Norwest Holst Ltd v Secretary of State* [1978] Ch. 201. 'Fairness' must however be observed: *R v Secretary of State for Trade and Industr,y ex Parte Perestrello* [1981] 1 Q. B. 19.

524 *Companies in 2002-2003* (London, DTI, 2003), table 2, page 19.

525 *Ibid*, table D1.

526 The number of investigations actually started by the DTI is also low when compared to the number of requests received. For example in 2002-2003 5,256 requests for investigations were received by the DTI of which only 419 were accepted. Given that 66% of the requests were received from agency who can assume would not make frivolous or unfounded requests , such as other parts of the DTI itself, the Police, the Director of Public Prosecutions, the Financial Services Authority, the Bank of England, the London Stock Exchange and other government departments, it would appear it is the policy of the DTI that limits the potential of section 8 by pursuing so few investigations.

527 It is the Secretary of State's practice not to publicise s 447 investigations. The reason for this is that "to do so would undermine the effectiveness of the inquires and could damage the business of the company concerned without any evidence of wrong doing" (*Companies in 2002-2003* (London, The Stationary Office, 2003), para 10). Similarly the conclusions and reports under s447 are not routinely published.

indeed initiate section 447 investigations, does appear to be evident from the statistics.

Following the coming into force of the Financial Services and Markets Act 2000 the Financial Services Authority has taken on the role of primary enforcer of those parts of the new legislation applicable to section 8 applications and it is foreseen by the DTI that the Secretary of State's powers to order company investigations under sections 431, 432 and 442 will only be exercised where it is inappropriate for the FSA to do so[528]. Thus, it remains to be seen whether the FSA will be more prolific in turning up potential unfitness than the DTI has been. Whatever evidence is laid before the DTI, however, the decision to initiate section 8 proceedings will still lie with the Secretary of State and there are no signs of a policy shift in favour of greater use of pre-insolvency disqualification.

6.6.6 The Implications of a Pre-Insolvency Regime.

A shift towards a predominantly pre-insolvency disqualification regime would certainly require a more interventionist policy towards the regulation of companies and their directors than is currently evident. Contemporary policy is apparently directed towards fostering an 'enterprise culture'[529] which encourages greater entrepreneurship, particularly in the small business sector. Free access to limited liability is an integral part of this policy. Within this general policy approach, the preservation of the

[528] *Companies in 2002-2003*, *supra*, note 524 pages 21-22.
[529] See for example, DTI press release *"New Drive to Encourage Tomorrows' Entrepreneurs Today"*, 17th December 2002.

current corporate governance rules seems secure[530]. Despite bold claims from ministers such as, 'there is no hiding place for those who abuse the privilege of limited liability'[531] the disqualification system is a not highly interventionist form of regulation. For, whilst disqualification is novel in that it seeks to address the risks that creditors face from the 'abuse' of limited liability, it avoids direct interference in the management of companies by applying *ex-post facto* standards in a very limited spectrum of cases. Greater use of pre-insolvency disqualification would be out of step with this policy approach. A pre-insolvency system would put the DTI's reputation as an effective regulator at greater risk than is the case under the current post-insolvency regime, because if instances of gross misconduct were not picked up before leading to insolvency then the DTI would be likely to be severely criticise. Whether such considerations have an impact on policy, however, can only be a matter of speculation.

Application of the 'morality' standard in disqualification cases is often justified by reference to a director 'showing' himself to be unfit by being involved in an insolvency and concession-type theory is used to

[530]A change to the general shareholder-orientation of corporate governance rules was considered and rejected by the Company Law Review Steering Group. See: Company Law Steering Group, *Modern Company Law for a Competitive Economy. Completing the Structure*, (London, Department of Trade and Industry, 2000), chap 3.

[531] DTI ministers of the of both the present and previous government have been fond of talking up disqualification as the weapon that is used to purge the commercial world of the unfit director. The Conservative minister John Taylor was quoted in *The Times* (22nd August 1996) as saying that 'There will be no hiding place for those who abrogate or neglect their responsibilities'
More recently and, somewhat more provocatively, the former Labour minister Nigel Griffiths, declared in a DTI press release *"Griffiths goes Gunning after Cowboy Directors"* 5th June 1997, "Let there be no doubt – war has been declared on the cowboy director".

justify withdrawing the 'privilege'. Without insolvency the foundation upon which the regulation appears to be built disappears. Nevertheless whilst it may be more interventionist regulation it is more likely to be effective regulation.

6.7 Concluding Remarks.

The post-insolvency regime that the State has developed to protect creditors from abuse of limited liability is most unlikely produce a benefit greater than its cost, according the research carried out by the NAO. The fact that disqualification is not a restitutionary remedy places a significant limitation on its success, which makes it all the more important that those benefits which it is capable of delivering are maximised. Unfortunately, the post-insolvency regime does not go anywhere near achieving this. One of its greatest limitations is that it precludes any preventative use of disqualification, at least in terms of preventing an initial insolvency. This leaves only future protection and general deterrence to deliver a benefit and the NAO's research indicates that it delivers very little of either. Indeed, the 'direct' benefits from protection are actually less than the amount spent by the Insolvency Service on disqualification each year. Similarly the number of future insolvencies it prevents is derisory. There is also little evidence to suggest that disqualification has a significant deterrent effect, Awareness of the legislation is low and the chances of being subject to the post-insolvency regime are slight. However, perhaps more damning for disqualification is the fact that it is likely to have 'chilling effect' on desirable business activity that imposes costs on the 'commercial world'. Thus, the focus on the number and length of disqualifications by the government and others is entirely wrong, for more disqualifications may actually *reduce* the benefit of disqualification if care is not taken to avoid erroneous disqualifications. However, in this instance the courts must bear some of the responsibility for the inefficiency of disqualification because the 'tunnel vision' approach that looks to past conduct not future risk, is bound to lead to a significant number of disqualifications that do not protect the public from abuse of limited liability. The state has not helped reduce the chilling effect of erroneous disqualification though by its ready acceptance that more disqualifications equal a more successful sanction.

Some of the low benefit and high cost of the post-insolvency regime may apply to a pre-insolvency disqualification regime of the sort in section 8 of the Act. Therefore, a move to pre-insolvency regime could increase the efficiency of disqualification. The main benefits of such a system could be prevention of initial insolvencies and greater deterrence. However, its success would rely entirely upon it being correctly targeted at cases of misconduct that were likely to lead to insolvency and therefore it is far from guaranteed to be successful, indeed in the best case scenario a pre-insolvency system may only be *less inefficient* than the post insolvency regime, rather than 'efficient'.

Therefore, all of the available evidence suggests that disqualification manifestly fails to meet its objectives. Indeed, the benefits of disqualification are so obviously low that this raises questions about whether the true intent behind disqualification is punitive. However, disqualification continues to be defended as a measure to 'protect the public' and not to 'punish directors' and given that there is a definite need to protect the public, disqualification ought to be judged against its stated goal, which, in short it fails to meet.

However, it should be noted that disqualification has undergone a significant reform since the publication of the NAO report which I have used in this chapter as the basis for much of my analysis. This reform was the introduction of disqualification undertakings, which was canvassed as a means to secure cheaper and speedier disqualifications, which it was presumably thought would increase the effectiveness of the regime. My analysis has hopefully demonstrated that this is a flawed logic as the deficiencies of post-insolvency disqualification are more fundamental questions of speed and administrative cost. However, the 'undertakings' reform is unlikely to have increased the benefits from disqualification because it has made the disqualification system significantly more unjust than was the case at the time of the NAO report. Therefore, it is to an analysis of the new system that the next chapter turns.

Chapter 7: Disqualification Undertakings.

"We see no good reason why the Secretary of State should not be able to accept a disqualification undertaking from a director...if he considers it expedient in the public interest that the director should be disqualified..."

Dr Kim Howells MP, Competition and Consumer Affairs Minister, 7th November 2000[532].

7.1 Introduction.

The new regime of disqualification undertakings came into effect in April 2001 and has since become the usual procedure by which a disqualification is obtained under section 6. In 2003-2004, for example, some 80% of disqualifications obtained by the Secretary of State were made in the form of undertakings.[533] The essence of the undertaking procedure is disqualification by administrative action rather than court order. Before the introduction of undertakings, the power to disqualify a person for unfitness lay exclusively with the court and the Secretary of State was obliged to proceed to a evidential hearing of each case whether the respondent to the application intended to defend the case against him or not. This aspect of disqualification was, rightly or wrongly, blamed for much of the delay in obtaining disqualifications singled out for criticism by the NAO and the

[532] Evidence to standing Committee B, when considering clause 6 of the Insolvency Bill 2000 that proposed the introduction of disqualification undertakings. Hansard [HC], Standing Committee B, 7th November 2000, col 119.

[533] *Companies In 2003-2004*, (London, The Stationary Office, 2004), table D1.

Committee on Public Accounts. Indeed, significant moves away from the 'judicial model' of disqualification had already been made by the time undertakings were introduced. Nonetheless, the reform represents a much more radical shift in the nature of disqualification than that which had hitherto been seen.

During the passage of the undertaking reforms through Parliament, the minister responsible for the Bill that proposed the necessary amendments to the Disqualification Act[534] identified two benefits that the introduction of undertakings would bring. First, he claimed that the introduction of an undertakings procedure would lead to a reduction in the time taken to disqualify an 'unfit' person, thereby increasing the protective benefit of disqualification and, second, he claimed that the procedure would reduce the cost of disqualification[535].

The argument that a reduction in the time taken to obtain a disqualification has been borne out to the extent that the reduced time lag between insolvency and disqualification has lead to an increase in the relative protective effect of each disqualification in recent years. However, that rise has been slight. In respect of the second proposed benefit of the reform, a reduction in the cost of disqualification would be a desirable goal given the quantitative analysis of section 6 above. However, it is unlikely that any cost savings from the introduction of an undertakings procedure

[534] Insolvency Bill [Lords] (Session 1999-2000).

[535] See evidence to Standing Committee B (Commons) by Dr Kim Howells, Minister for Competition and Consumer Affairs during the Committee's consideration of clauses 6 and 7 of the Insolvency Bill. See; Hansard [HC], Standing Committee B, 7th November 2000, col 118.

would be sufficient to overcome the imbalance between the direct costs of section 6 and its direct benefits, to say nothing of the cost of the many other flaws on disqualification, such as the cost of erroneous disqualifications. Thus, it is likely that the undertakings procedure, could only marginally improve the effectiveness of section 6, or perhaps it is more accurate to say that an undertaking procedure is only likely to make section 6 marginally *less inefficient.* However, it is unlikely that the undertakings system brings even this marginal 'benefit', because there are significant costs associated with its operation that are likely to *reduce* and not increase, the effectiveness of disqualification.

Therefore in this chapter analyses the likely effect of the new procedure on the efficiency of disqualification. It begins with an outline of the gradual move away from a 'judicial' disqualification system to the 'administrative' system now in place before discussing the specific problems with the undertaking procedure.

7.2 Moving to Administrative Disqualification – The *Carecraft* Procedure.

The mandatory nature of disqualification for unfitness under section 6 of the Act has always marked the provision out from other forms of disqualification. However, whilst disqualification is mandatory where unfitness has been found, the section obviously gives discretion over the factual finding of unfitness. Under the original Act this discretion lay with an impartial court, which held the power to disqualify. During the time that there were relatively few disqualification cases brought by the Secretary of State, this procedure was relatively uncontroversial. However, following the rapid rise in the number of disqualification cases after the NAO and Public Accounts Committee reports the requirement that each disqualification case had to be brought before a judge for a full hearing came to be seen as a barrier to the creation of an effective disqualification system For, the more time each disqualification took and the more money it cost, the fewer disqualifications were likely to made. Therefore, as the number of disqualifications obtained by the Secretary of State was seen as a key measure of the sanction's success, 'judicial' disqualification came to be seen as something of a problem[536].

Ever willing to help a regulator with a problem, the courts appeared sympathetic to the argument that the requirement for each disqualification application to proceed to a full hearing was inhibiting the Secretary of State's efforts to make disqualification a more effective solution. Thus, in the case of *Re Carecraft Construction Co Ltd*[537] a new procedure for dealing with 'uncontested' disqualifications was outlined to speed up the disposal of uncontested applications under section 6. The use of the *Carecraft* procedure, as it came to be known, was confirmed in the subsequent *Practice Direction No. 2 of 1995*[538]. Under *Carecraft*, a disqualification

[536] See for example comments made by Sir Richard Scott in *Practice Direction No. 2 of 1995* [1996] 1 All ER 442, see further below. See also the NAO follow report which noted that when parliamentary time allowed it was the government's intention to legislate for an undertaking proceed and commented that: "This arrangement would save court time ...", See NAO, *Follow up Report, supra* note 406, para. 2.34.
[537] [1994] 1 WLR 172.
[538] *Ibid.*

could be made without a full hearing of evidence if the respondent to a disqualification application so agreed. Where a disqualification was dealt with under the *Carecraft* procedure, the Secretary of State or Official Receiver, was required simply to submit a written statement to the court containing the material facts of the 'unfit conduct' that was agreed, or at least 'not disputed', by the respondent director. The statement was required to specify a 'bracket' period of disqualification into which the parties had agreed the case fell. The court was then 'invited' to make a disqualification within that bracket[539]. The usual practice was for a limited form of plea-bargaining to take place between the Secretary of State and director. Usually the Secretary of State would suggest a 1-year discount on the period of disqualification in *Carecraft* cases as an incentive for directors to agree to dispose of their case under the procedure.[540]

The effect of the *Carecraft* procedure was therefore to transfer effective control over the decision to disqualify from the court to the parties. For even though it was the court that had to nominally exercise the power to disqualify, the courts rarely departed from the agreement reached by the parties.

The significant transfer of power in *Carecraft* cases from the court was justified by the claim that *Carecraft* could only be used where a respondent to a disqualification application consented to its use. Thus, if a person did not consent to be disqualified or could not reach agreement with

[539] See *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch. 164.

the Secretary of State, it was argued that his right to have his case determined by a judge was absolute. Consequently, the risk of inaccurate or disproportionate disqualifications being forced from directors by the Secretary of State was not seen by the sate as a hazard under *Carecraft*. However, whilst consent was the justification for *Carecraft*, precisely what is meant by 'consent' was unclear. The fact that the statements of unfit conduct annexed to *Carecraft* applications were described as something which directors 'did not dispute' implies that varying degrees of consent were in play[541]. The nature of consent under *Carecraft* was, however, important because if consent was less than freely given then the use of *Carecraft* could have significant implications for fairness and efficiency of the disqualification system.

However, despite some concerns about the nature of consent[542] the *Carecraft* procedure was perceived to have successfully eliminated many of the delays and wasteful practices associated with the original disqualification process. The courts' time was saved, as were some of the Secretary of State's resources and it was even argued that the procedure also had advantages for the directors because it enabled them to curtail

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[540] A policy that has been applied to disqualification undertakings. See the response of a Chief Examiner in the Disqualification Unit of the Insolvency Service to question number 3 of the 'research questions' put to the service in appendix 3 below.

[541] Again the practice of describing schedules of unfit conduct in cases disposed of 'consensually' has been extended to the new undertakings procedure, See response 'research question 5', appendix 3 below.

[542] For example in *Re Barings Plc* [1998] 1 BCLC 18, Sir Richard Scott noted that directors who whished to contest a disqualification faced potentially ruinous costs and may have little option other than to 'give in' to disposal of their case under *Carecraft*. See also *Re Swift 736* [1992] BCC 93, where Hoffman J (as he then was) expressed similar concerns.

potentially expensive and stressful legal proceedings.[543] It came to be widely used in the years before the introduction of disqualification undertakings, when it accounted for approximately one-third of all disqualifications[544]. However, from the Secretary of State's point of view, *Carecraft* was evidently not as successful a measure at reducing perceived wasteful practices as it might have been because one of the arguments made for further reform of the system was that even with *Carecraft,* over half of all section 6 disqualification cases were simply uncontested[545], i.e. the director neither agreed to *Carecraft* nor offered any evidence in court[546]. In such cases the Secretary of State was obliged to proceed to a full evidential hearing of the case, despite the fact that the respondent offered no evidence in response to the Secretary of States case. Only some 10% of all cases were actually contested[547].

The perceived failure of *Carecraft* to remove all wasteful practices seems to have increased desire for a more radical procedure that completely abrogated court involvement in the disqualification process. Such a desire appears to have been shared by at least some members of the judiciary, such as Sir Richard Scott, who called for the institution of a practice whereby agreed disqualifications could be disposed of between the Secretary of State

[543] It was the Secretary of State's practice to pursue costs against directors who contested disqualification proceedings and lost.
[544] This data was presented to Standing Committee B (Commons) by Dr Kim Howells, Minister for Competition and Consumer Affairs during the Committee's consideration of the reforms proposed to the Act in the Insolvency Bill. See; Hansard [HC], Standing Committee B, 7th November 2000, col 118.
[545] *ibid.*
[546] *ibid.*
[547] *ibid.*

and the director without any court involvement at all[548]. Sir Richard considered that the *Carecraft* procedure was nothing more than a judicial rubber-stamping exercise, where even the limited discretion left to the judge in fixing the period of disqualification was rarely exercised. Much better, he argued, not to waste the court's time by requiring it to approve a 'done deal' but to let the parties determine the period of disqualification in 'agreed' cases and give legal effect to that agreement.

The argument for reform beyond *Carecraft* was accepted with the introduction of disqualification undertakings by the Insolvency Act 2000. The new undertakings procedure came into force on the 3rd April 2001 and has largely replaced the old *Carecraft* procedure as far as section 6 disqualifications are concerned. Like *Carecraft*, the undertakings system is described as a procedure for dealing with non-contested cases that saves time, money and stress for all parties in a disqualification application.

7.3 Shifting Control – Undertakings and the new 'Administrative System'.

7.3.1 Disqualification undertakings – Section 1A.

The Insolvency Act 2000 inserted a new Section 1A into the Disqualification Act, providing that, in the circumstances set out in amended sections 7 and 8, the Secretary of State may accept from an individual an

[548] Comments made as part of *Practice Direction No 2 of 1995* [1996] 1 All ER 446. However, Sir Richard did appear to temper his enthusiasm in later years, see *Re Bearings*

undertaking that he will not act in any of the capacities set out in section 1(1)[549]. There is no court involvement in the undertaking procedure and disqualification occurs when the Secretary of State accepts an undertaking from a person subject to disqualification proceedings.

There are essentially three stages in the undertaking process. The first stage is the same as that under the 'judicial' procedure, i.e. for the Secretary of State to form the opinion that it is expedient in the public interest that an individual be disqualified following the investigation of a report of unfit conduct.[550] The second stage occurs when the Secretary of State informs the individual that she intends to seek a disqualification order, at which point the individual must decide whether he wishes to offer an undertaking to the Secretary of State that he will not act as a director or whether he wishes to contest the application. A draft undertaking including the period of disqualification that the Secretary of State feels is appropriate to the case is included with the 'section 16' letter notifying an individual that the Secretary of State intends to apply for a disqualification order against him[551]. If a director decides to offer an undertaking, the third and final stage of the procedure is reached where the Secretary of State is

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Plc, *supra*, note 542.

549 Which are repeated in s1A(1)(a). On the undertaking procedure, see generally A. Walters, *Bare Undertakings in Directors Disqualification Proceedings: The Insolvency Act 2000, Blackspur and Beyond* (2001) 22 Co. Law. 290.

550 Section 7(1).

551 When the Secretary of State has decided that it is expedient to seek a disqualification order against an individual he writes to the said individual informing of this. As part of the notification the Secretary of State has developed the practice of informing the director that he can give a disqualification undertaking and avoid court proceedings. The Secretary of State also notifies the individual of the period for which he feels it would be 'appropriate' for the director to offer the undertaking. An example of a "Notification of the Secretary of State's Intention to Seek a Disqualification Order" letter is contained in appendix 2.

required to evaluate whether, in his opinion, the conditions mentioned in section 6(1) of the Act are met and that it is expedient in the public interest that she accepts the undertaking[552]. Thus, in the undertaking process it is the Secretary of State who must determine unfitness and all judicial discretion over the decision to disqualify passes to him.

Once the Secretary of State has accepted a disqualification undertaking it can only be varied or set aside by a court, as the Secretary of State has no power to do either of these things himself. Consequently, the Act provides that if a person subject to an undertaking wishes to have it set aside or seeks a reduction in the period for which the undertaking is enforced, that person must apply to court[553]. If such an application is made the Secretary of State must appear and call the court's attention to any matters that she feels are relevant to the application[554].

The widespread use of the undertaking procedure has therefore caused a significant change in the nature of section 6 disqualification. This is because it is now the Secretary of State who effectively controls the power to disqualify and, as such, it is she who determines what constitutes unfit conduct.

Thus, there is a likelihood that the new procedure will lead to the creation of a parallel administrative jurisprudence over the nature of unfit conduct and the possible 'misinterpretation' of the disqualification standard. As such the new power must create a danger that the Secretary of State will

[552] Section 7(2A).
[553] Section 8A.
[554] Section 8A(2).

seek to obtain disqualifications in circumstances where they would not be ordered by an impartial court.

However, the Secretary of State contends that the consensual nature of the undertaking procedure is a sufficient safeguard against such concerns because directors will offer an undertaking only when they believe that a court would find them unfit[555]. Thus, as was the case with the *Carecraft* procedure the need for a director to consent to the disqualification by undertaking is seen as a potent safeguard against 'abuse' of the system by the Secretary of State. In essence consent is seen to legitimise and justify the transfer of power from the court to the Secretary of State by the new procedure.

However, the, notion that undertakings can only be obtained consensually is even more problematic in undertaking cases than it was under *Carecraft,* for the simple reason that the bargaining strength of the Secretary of State and most of those subject to disqualification applications is very unequal. And any legal process that relies on the idea of a consent for its legitimacy can be questioned in a situation where the parties to that process are not of equal bargaining power. This was true with *Carecraft* and is true of the undertaking process because the practical effect of transferring the power to disqualify to 'the parties' in undertakings has been to empower the stronger party (the Secretary of State in most cases) at the expense of the

[555] See the Secretary of States response to the Trade and Industry Committee's comments on the proposed introduction of disqualification undertakings, Trade and Industry Select Committee, 4th Special Report, *Government Observations on the First and second Reports from the Trade and Industry Committee,* (House of Commons Papers, Session 1999-2000, 237), paras 17 and 18, discussed at 7.4 below.

weaker (usually the director). This is because the bargaining power of the Secretary of State, or the Insolvency Service who act on his behalf, cannot be compared to that of the average ex-director of a small private company who is the subject of disqualification proceedings. The Insolvency Service has a multi-million pound budget, expertise in disqualification proceedings built up over 20 years, high staffing levels and easy access to IPs and their reports. It is unrealistic to suppose an individual with limited resources and no experience of disqualification can in any way 'bargain' on equal terms with such an organisation. The likely outcome of any 'bargain' is for terms to be proposed to a director that he has little option other than to accept. This is a particular risk if the individual does not have sufficient resources to contest the case against him. However, the potential for oppression in undertaking cases is more acute than that which flows from a simple inequality of bargaining power because the Secretary of State manipulates the very practical concerns of people subject to disqualification proceedings in order to extract the offer of an undertaking from them.

7.4 Consent and Disqualification Undertakings.

7.4.1 Costs

The potential for oppression in disqualification because of cost considerations has been recognised on several occasions[556]. The root of the

[556]See, *Re Bearings Plc*, *supra* note 542. See also *Address to the Chancery Bar Association by Sir Richard Scott*, (2000) 21 Comp. Law. 91, *The Fourth Annual Leonard Stainer Lecture*, given by Lord Hoffman, (1997) 18 Comp. Law. 194. However, in *Re Pamstock Ltd* [1996] BCC 341, the Court of Appeal rejected the argument that special cost rules should apply to disqualifications proceedings.

problem lies in the application of the traditional civil cost rules to disqualification applications[557]. The result of the rule is that a person who wishes to contest a disqualification application runs the risk of incurring potentially ruinous liability should his defence not succeed..

This danger is particularly acute as persons subject to disqualification applications will usually have been involved in a corporate insolvency that may have resulted in personal financial loss. As such, the threat of heavy costs is likely to be a major factor in a person's response to a disqualification application and often be an incentive for a director to 'agree' to dispose of a disqualification application by offering an undertaking, even if he feels the allegations made against him are unfounded

The response of directors to disqualification applications before the introduction of undertakings certainly suggests that many felt unable to resist the Secretary of State's case. The fact that only 33% of persons agreed 'not to dispute' the case against them under *Carecraft* suggests that a majority of directors *did* dispute the case and were not prepared to agree to be disqualified even when a discounted period of disqualification was offered. Indeed, the fact that over half of directors did nothing in response to an application suggests an inability to defend cases may have been a significant factor in determining a person's response to an application under section 6.

[557] In accordance with section 51 of the Supreme Court Act 1981, the court in a disqualification case has discretion over the award of costs. Thus the award of costs depends upon the circumstances of each case – either party could bear full or partial responsibility for the others costs.

The Secretary of State is obviously conscious of the impact that costs have on a director's response to a disqualification application and has used it to his advantage in the new undertakings process. For, as an incentive to secure the offer of a large number of undertakings, the Secretary of State has adopted a policy of offering to waive all costs against a person subject to an application if he offers an undertaking within a set period of time. The offer is made in the letter notifying directors that the Secretary of State intends to apply for a disqualification order against them[558]. However, the letter also states that if an undertaking is not offered before the specified date, but at some later time, the Secretary of State will seek to recover her costs up to the date that the undertaking was offered. Should a director decide to contest the Secretary of State's application, the letter informs them that the Secretary of State will seek to recover all of her costs if her application is successful. The letter further states the costs that the Secretary of State has incurred in dealing with the case to the date of the letter.

From the Secretary of State's point of view this policy appears to have been successful, as the 80% of all disqualifications that are made as undertakings represent a significant improvement on the take up of the *Carecraft* procedure. The policy of offering to waive costs if an undertaking is offered promptly is justified by the Secretary of State on the ground that the offer encourages quick settlement of cases and secures the protective 'benefits' of disqualification earlier than may otherwise be the case[559]. The

[558] See appendix 2.
[559] See response to question 3, appendix 3 below.

idea that prompt settlement increases the benefit of disqualification has some justification[560]. However, it is not a *sufficient* justification for the policy because in truth it is simply a device to pressure directors into offering undertakings. For, the threat to pursue costs if an undertaking is not offered and the curious statement of the costs that have been incurred in dealing with case to the date of the letter ,can only be serve to increase a person's perception of the risk associated with contesting an application, and therefore increase his incentive to 'settle'. In short, the policy is an overt attempt use pre-existing problems with cost to the Secretary of State's advantage.

However, the possibility that the Secretary of State would use the costs issue in this way to extract the offer of an undertaking from directors was entirely foreseeable, and indeed was entirely foreseen. Sir Richard Scott, for example, seemed to temper his enthusiasm for an undertakings procedure because of the potential for the costs issue to lead to oppression disqualification proceedings when he noted 'concern' that some directors appeared to be accepting disqualification under *Carecraft* simply because they could not afford to contest an application.[561] He suggested that to avoid this possibility the criminal rules for applying costs should be used in disqualification cases. The Trade and Industry Select Committee noted the same concerns in its report into the proposed amendments to the

[560] The NAO's research suggests that directors are most likely to be involved in an second insolvency in the two years following in an initial insolvency. Therefore, a reduction in the time taken to secure a disqualification ought to increase its relative protected effect. However, that increase is limited, see chapter 6, *supra* .
[561] *Re Bearings Plc, supra* note 542.

Disqualification Act[562]. As such, the committee suggested that procedures should be put in place to "avoid any suspicion of the DTI either doing directors a favour" by agreeing to waive costs if an undertaking was offered or "bearing down on individuals unduly harshly, using the threat of expensive legal proceedings to force a director to give an undertaking"[563]. The Secretary of State rejected the committee's concerns, merely citing the consensual nature of the undertaking process[564] as a safeguard against such fears. However, the consent argument of the Secretary of State is surely irrelevant to the committee's concerns because the committee expressed anxiety that 'consent' may not be freely given in undertaking cases. The Secretary of State's response to these concerns appears to be that there is no danger of 'consent' being obtained by coercion because consent can only be obtained by...consent. The argument is circular and absurd for if consent is extracted by coercion, the fact of 'consent' cannot be safeguard against coercion, for the apparent consent is not truly consent at all.

In the event, the committee's concerns have been borne out by the practices of the Secretary of State. Because the unavoidable message conveyed by the Secretary of State's use of the costs issue is precisely that she is 'doing directors a favour' by offering to waive costs if an undertaking is offered within the set period of time. This message is re-enforced by stating the costs already incurred, thereby giving the impression that the

[562] Trade and Industry Select Committee, 2nd Report. *Draft Insolvency Bill.* (House of Commons Papers, Session 1998-1999, 112), para 42.
[563] *Ibid.*

Secretary of State is prepared to 'let the mater go' if an undertaking is quickly offered. However, with the apparent carrot comes the stick: the treat of expensive proceedings if an undertaking is not offered within the defined period.

It is therefore regrettable that the concerns of the select committee were not pursued during the passage of the Insolvency Bill through Parliament[565]. The fact that they were not can only have indicated to the Secretary of State that the requirement for consent justified the sort of practice criticised by the committee. However, is not only unfair and an arguable abuse of power for Secretary of State to use the cost issue to encourage settlement of applications, but it is also misguided if it is an attempt to increase the effectiveness of disqualification. For, if directors are left with no alternative other than to give an undertaking it is likely that the 'chilling' effect of inaccurate or disproportionate disqualifications will be increased. This would render disqualification less efficient at protecting the public, not more, because allowing directors a reasonable opportunity to challenge a disqualification application ultimately leads to a more efficient system because any disqualification that comes about from it is more likely to reflect the misconduct committed.

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564 Trade and Industry Select Committee, 4th Special Report, *Government Observations on the First and second Reports from the Trade and Industry Committee*, (House of Commons Papers, Session 1999-2000, 237), paras 17 and 18.

565 During it passage thorough Parliament it was suggested that the Insolvency Bill be amended such that that the Secretary of State be required to publish guidelines as to the circumstances in which she would accept an undertaking and, further, that she only be allowed to accept an undertaking for four years of less. These amendments did not directly address the issues raised by the Select Committee, but may have made the undertakings process a little fairer and more transparent. In the event none of the amendments were

The impact of the costs issue is therefore highly significant. It has an unarguably (negative) effect on a director's ability to resist a disqualification application, which has knock-on effects for the efficiency of disqualification. However, the costs incentive to submit to the undertaking procedure is re-enforced by the evidential barriers which directors face if they wish to contest an application.

7.4.2 Evidence.

Allegations made in disqualification applications tend to be complicated and relate to events that occurred several years before a disqualification application is made. This puts directors at a significant disadvantage because unless they possess very detailed records of board meetings etc., it may be very difficult for them to mount a defence to the allegations made by the Secretary of State. This compounds the pre-existing advantage that the Secretary of State has over directors (in terms of her expertise an resources) and must further increases her ability to force the offer of a disqualification undertaking. The Secretary of State has the greatest advantage in terms of gathering evidence in respect of many of the most common allegations made in section 6 cases, such as a failure to pay crown debts or to comply with accounting and disclosure requirements[566]. For example, the Secretary of State has ready access to records from the Inland Revenue or HM Customs and Excise that can be used as evidence of

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accepted. See, Hansard [HC], Standing Committee Debates, Insolvency Bill [Lords], 7th November 2000, coll 115-120.

566 See chapter 4, table 1.

non-payment of tax, which a director, deprived of detailed records, may find difficult to rebut. Similarly, records from Companies House that show that returns and accounts were not filed can be used as evidence of misconduct. Again, it would often be difficult for a director to show that he took all reasonable steps to comply with the requirements of the Companies Act in the absence of detailed records. In short, without such records it would be difficult to demonstrate that a director's actions were reasonable in the context within which they were taken. Indeed, this is not only true of allegations linked to government departments. It is, for example, relatively easy for the Secretary of State to show that debts to creditors were not paid, yet it is more difficult for a director to explain why non-payment was reasonable. Of course, the burden of proof rests on the Secretary of State to show his case on the balance of probabilities, but this is often of little significance because if a director can offer no firm evidence to challenge the Secretary of State's case the burden is more easily discharged and, in any case, the nature of the burden of proof in most disqualification cases is of largely academic concern because most section 6 applications never reach court.

Of course, the impact of evidential difficulties will vary from case to case. In larger companies they are likely to be less significant. However, as the majority of disqualifications concern small companies where detailed record keeping is not the norm, evidential considerations are likely to have a significant impact on a director's response to a disqualification application and most likely, increase the incentive to settle by offering an undertaking.

Evidential considerations also feed into the costs issue for a lack of evidence will increase the cost of mounting a defence. Which, in turn, increases the temptation for a director to 'cut his loses' and accept the Secretary of State's offer of a cost free undertaking.

Therefore, the argument that undertakings are given consensually, and that this prevents possible abuse of the system by the Secretary of State is unconvincing as very practical considerations are likely to leave directors with little option other than to offer an undertaking, whether they agree to the terms of the undertaking proposed by the Secretary of State or not. Furthermore, the oppressive conduct of the Secretary of State means that consent in many cases is likely to be far from free.

Such concerns are significant in themselves and increase the likelihood of erroneous disqualifications being obtained. This is especially so as there is a distinct lack of procedural safeguards in the disqualification system to protect the rights of persons who offer an undertaking. If undertakings were consensual this may not be a significant concern, however, if they are less than consensual, this is likely to increase the cost of disqualification.

7.5 The Undertakings Process and Rules of Natural Justice.

7.5.1 The Two Decisions in the Undertaking Process.

Under the original system, a section 6 disqualification could only be made after the Secretary of State had taken the decision that it was 'expedient in the public interest' that a disqualification order be made against a person *and* the court decided that the that person was unfit to be a director. The latter decision was obviously a judicial decision. The new procedure retains this basic structure, i.e. a disqualification can only come about after the same two decisions have been taken. The difference is that where an undertaking is offered it is the Secretary of State who takes *both* decisions. The decisions, however, remain distinct and in the words of the Court of Appeal, "have not been elided into a single condition in the case of a disqualification undertaking"[567]. The judicial decision to disqualify for unfitness is transferred to the Secretary of State by section 7(2A) of the Act, which states that the Secretary of State must be satisfied that the conditions mentioned in section 6(1) are met before she can accept an undertaking. The effect of section 7 (2A), again in the words of the Court of Appeal is that "where a disqualification undertaking is offered the arbiter of unfitness is the Secretary of State rather than the court"[568]. The implications for the fairness and efficiency of disqualification of this change are far reaching because it transfers the decision to disqualify from an *impartial tribunal* to a person who is closely involved in the *investigation and 'prosecution'* of disqualification cases. Obvious concerns regarding the compatibility of the new procedure with principles of natural justice can therefore be raised. Two matters are of particular importance. First, the new procedure does not give directors an obvious opportunity to make representations to the Secretary of State before she exercises his judicial power to accept an undertaking

[567] Per Chadwick LJ in *Secretary of State for Trade and Industry v Eastaway* [2001] EWCA Civ 1595 at para 19, [2002] 2 BCLC 236.
[568] *Ibid.*

(which can be contrasted with the original procedure where such a right was always available). And second, there is obvious scope for bias on the part of the Secretary of State when taking his judicial decision under section 7 (2A). These concerns are significant in themselves, however given the scope for oppression in undertaking cases they are particularly troubling.

7.5.2 The Right to a Fair Hearing.

The wide-ranging principle that those who are entrusted with a legal power cannot validly exercise it without first hearing the party who will suffer from its exercise is well established in the common law[569]. The common law protection is now supplemented by article 6 (1) of the European Convention on Human Rights. At common law the right has been jealously protected and has often been implied to exist in many cases where statute has not specifically provided it. Thus, it was stated in *Cooper Wandsworth v Board of Works*[570] that:

> "...a long course of decisions...establish that although there are no positive words in a statute, requiring that a party shall be heard, yet the justice of the common law shall supply the omission of the legislature".

The leading case on the right to a fair hearing is *Ridge v Baldwin*[571]. In subsequent cases it has been held that there is a presumption that an administrative decision maker must act fairly to those whom his decisions

[569] *Bagg's Case* (1615) 11 Co. Rep 93b, *R v University of Cambridge* (1723) 1 Str 557.
[570] (1863) 14 CB (NS).
[571] [1964] AC 40.

effect[572] and the principle has been applied to instances of 'judicial', 'quasi-judicial' and 'administrative' decisions[573]. The courts have, however, adopted a flexible approach to the rules of natural justice in administrative cases, holding that its requirements should depend upon the circumstances of each case and take into account factors such as the nature of the power exercised and the subject matter to be dealt with[574]. However, that the 'right to be heard' should apply to the Secretary of State's decision to accept a disqualification undertaking is clear.

The Court of Appeal has recognised that where a disqualification undertaking is offered, the Secretary of State is the "arbiter of unfitness"[575] and therefore the judicial nature of his decision is clear. Indeed, all the undertaking process does is to substitute the Secretary of State for the court; the nature of the decision to be taken remains the same. Therefore there can be little argument against the proposition that the Secretary of State acts judicially when determining whether to accept an undertaking. The Act reinforces this by specifically stating that the Secretary of State can only accept an undertaking when she is satisfied that the conditions in section 6(1) are satisfied, which is the same test applied to the court. That ministers need to afford an affected party the right to be heard in such cases is clear. The Privy Council, for example, has stated:

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[572] *R v Commission for Racial Equality, ex parte Hillingdon LBC* [1982] AC 779.
[573] See generally; W. Wade and C. Forsythe, *Administrative Law* 9th ed (2004, O.U.P. Oxford,), pages 480-494.
[574] *R v Gaming Board for Great Britain ex parte Benaim and Khaida* [1970] 2 QB 47, *Re Pergamon Press Ltd* [1971] Ch 388.
[575] *Secretary of State for Trade and Industry v Eastaway, supra* note 567.

"...the Minister was a person having legal authority to determine a question affecting the rights of individuals. This being so it is a necessary implication that he is required to observe the principles of natural justice when exercising that authority."[576]

However, despite the clear analogy with the Secretary of State's power to accept an undertaking, the amended Disqualification Act does not require the Secretary of State to give affected persons the opportunity to make representations to her before she exercises her judicial power under section 7(2A). Neither is she under an obligation to consider any representations that may be made. However, it should be noted that the Secretary of State has followed her previous practice of informing directors that they may make representations to her legal team[577], however, this offer is entirely voluntary and she is under no duty to consider any representations made. Thus, this practice cannot be regarded as a sufficient opportunity for directors to make representations in the undertaking process. This is especially so given that the practice is not specific to the undertaking process but is routine part of all section 16 notices. It is, in short, an offer made by the Secretary of State in her role as the 'claimant in civil proceedings' and not as the 'arbiter of unfitness'.

Thus the absence of an appropriate opportunity for persons who offer an undertaking to make representations to the Secretary of State would appear to be a clear breach of established principles of natural justice.

[576] *A-G v Ryan* [1908] AC 718.
[577] Section 16 letter, appendix 2.

However, the breach has been accepted because the undertaking process is apparently consensual and not coercive, as can be seen in the Secretary of State's argument that any deficiencies in the undertaking process are remedied by consent[578]. However, the significant scope for oppression in undertaking cases must undermine this justification.

Nonetheless, the common law, has been willing to accept that in some circumstances 'consent' can remedy instances where the normal rules of natural justice are not observed. Consent, however cannot give a public authority more power than it lawfully possess[579] and a distinction has been drawn between jurisdictional and procedural matters; the general rule being that a person may waive procedural rights at common law but not jurisdictional rights[580]. However, there are some exceptions. So for example, it has been held that if a biased person takes part in an adjudication, but the bias is known to the affected party and he raises no objection at the outset of the case, he is taken to have waived his right to object to the tribunals finding. This example suggests that the Secretary of State's universal argument that deficiencies in the undertaking process are remedied by consent may have some sound basis in law. However, on closer examination the basis for the consent argument at common law falls away because within the undertaking process itself persons are not given the *option* of waiving procedural or jurisdictional rights, because they are actually accorded none. For, 'consent' is only a relevant consideration at the stage where a director

[578] Response to the Trade and Industry Select Committee's second report, *supra* note 564.
[579] *Essex Congregational Church v Essex County Council* [1963] AC 808.
[580] *Wade and Forsyth, supra* note 573.

decides to given an undertaking. This consent then seems to be taken as an ongoing waiver of procedural rights throughout the subsequent process. This may be acceptable where a director's consent is freely given, however, to assume that this will be the case in all instances is highly unrealistic and unsatisfactory as 'consent' is likely to be less than free in many cases. A 'pause for thought' provision whereby the Secretary of State was required to re-evaluate the case against a director and consider any representations he may wish to make in mitigation would substantially increase fairness within the system. Because, despite the fact that a director offers an undertaking on specific terms (i.e. to be disqualified for X years because of A,B,C acts) this does not mean that that those terms are appropriate to the case. It is likely that many directors will offer an undertaking where they do indeed dispute the case against them but lack the resources to do so in court. In such circumstances a director may possess evidence indicating that the period of disqualification in the draft undertaking is not appropriate to his conduct and the Secretary of State should be required to review that evidence. Of course the Secretary of State *may* voluntarily consider any representations but the point is that under the current process she is not *required* to do so.

Of course, it should be noted that even where the Secretary of State considered evidence from a director, that director may still agree to offer an undertaking for a period of time he feels is in appropriate, or indeed offer an undertaking where he does not agree that his conduct makes him unfit. This could obviously happen if the director was unable to persuade the Secretary of State of case but lacked the resources to contest the application or period of disqualification in court. Nonetheless, the situation for directors where the Secretary of State refuses to consider any evidence (which she is perfectly entitled to do) would be unusual and unfair, especially where they are effectively forced to give undertakings. However, even in cases where undertakings are not given because of coercion, surely 'consent' should no more deprive a person of a right to make representations in mitigation than a guilty plea does in criminal cases.

However, not only is it true that directors should be given an opportunity to be heard to ensure fairness in undertaking cases, but it is also because it is necessary to ensue that disqualification holds on to whatever vestiges of efficiency that it has. A disqualification period that is too long, for example, could have a chilling effect on desirable business activity, increasing collateral losses from disqualification. A disqualification undertaking that is too short, on the other hand, provides sub-optimal protection from unfit conduct and a disqualification that should not have been made provides no benefit at all to the public, only losses.

The point is therefore that disqualifications that are made after representations from a director are considered are likely to better protect the public interest from unfit persons. That is not to say that all representations should be taken at face value, for some are likely to be false or of insufficient strength to answer the Secretary of State's case. I merely suggest that a disqualification that comes about through some real element of 'bargain' between the Secretary of State and a director is likely to be more accurate and therefore more efficient than one which comes about through the imposition of terms on a weaker party by a stronger party.

However, it is doubtful that any efficiency gain could be made in the undertaking process if directors were merely given the right to make representations to the Secretary of State without it being combined with further reform of the undertaking system. This is because the success of the right, both in terms of fairness and efficiency gain, depends upon any representations being considered impartially. However, such a fair hearing is almost impossible in the undertakings process because of the presence of obvious bias on the part of the Secretary of State.

7.5.3 The Rule Against Bias.

Concern over bias in the undertaking system arises from dual role of the Secretary of State in undertaking cases, in that she acts as prosecutor when she takes the decision under section 7(1) that it is 'expedient in the public interest' that a disqualification order be sought against a person and as judge when she decides whether to accept an undertaking under section 7(2A). The clear danger is that the judicial decision under section 7(2A) is determined by the decision already taken under section 7 (1). Indeed, the Secretary of State is most unlikely to decide not to accept an undertaking under section 7 (2A), when she has already decided that a disqualification order should be made. For, there can be little question that when the Secretary of State comes to determine whether she feels the conditions mentioned in s 6(1) have been satisfied she will be influenced by the decision she already taken under section 7(1) that it is 'expedient in the public interest' that a person be disqualified. The result of the second decision must be rendered a forgone conclusion by the first.

Concern over this aspect of the proposed undertakings system was again expressed by the Trade and Industry Select Committee when it noted that the Secretary of State would be granted unchecked powers to act as investigator, prosecutor and judge in undertaking cases[581]. Its concerns, however, received a curt response from the DTI and were not successfully pursued during the Insolvency Bill's passage through Parliament. The DTI's response to the committee merely stated that "the new provisions...will not be mandatory. They will not deprive directors of the right to a fair trial. It will remain a matter for the director to decide if he wishes to contest a disqualification application."[582] However, this response is simply not satisfactory given the scope for oppression in many undertaking cases. The committee was fully justified in raising concerns about the conflicting roles of the Secretary of State in the undertaking process for it increases the likelihood of unfair and inefficient disqualifications and runs counter to well established legal principles. For example, if, in the case of a motorist convicted for dangerous driving, the decision of a panel of magistrates can be invalidated for bias because the magistrate's clerk was a an employee of a firm involved in civil proceeding related to case[583], it hardly needs to be said that the Secretary of State would be regarded as a biased judge at

[581] Trade and Industry Select Committee, Second report, *supra* note 562, para 42.
[582] Trade and Industry Select Committee, Fourth Special Report, *supra* note 564.
[583] *R v Sussex Justices Ex parte Mc Carthy* [1924] 1 KB 256.

common law. The motorist's case is clearly a case of judicial bias, not administrative bias and given that the Secretary of State acts judicially when deciding to accept and undertaking[584] the judicial analogy is the correct one. Nonetheless, it is well established that the same rules apply to administrative decisions[585] and, given the strong possibility of actual bias in a case where a prosecutor also acts as judge, it would hardly matter how the section 7(2A) decision is classified.

Nonetheless, the Secretary of State's case that consent is a justification for the *prima facie* deficiencies in the disqualification system would appear to have some basis in common law.[586] For the argument is essentially that a director is aware of the Secretary of State's bias when he offers an undertaking. Indeed, it could conceivably be argued that it is the director who effectively 'disqualifies himself' by offering an undertaking to the Secretary of State, in which case the issue of a biased judgement would not arise. This argument has an appealing logic, but does not sit easily with the Disqualification Act, for if Parliament intended directors to disqualify themselves by offering an undertaking, it would not have required the Secretary of State to consider whether the conditions mentioned in section 6 (1) were met before she could accept an undertaking. The fact that Parliament requires the Secretary of State to take a separate decision under section 7(2A) shows that disqualification moves from her and not the

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[584] *Official Receiver v Jones*, *supra* note 568, *Secretary of State for Trade and Industry v Eastaway*, *supra* note 567.
[585] See for example, *R v Secretary of State for the Environment, ex parte Kirstall Valley Campaign Ltd* [1996] 1 All ER 304.
[586] *Moore v Gamgee* (1890) 25 QBD 244.

director. Similarly the fact that the decision to disqualify under section 7(2A) is separate from that under section 7(1), indicates that Parliament intended the Secretary of State to consider the case afresh before accepting an undertaking. Indeed, the structure of the Act adds weight to the argument that the Secretary of State should be required to consider representations from a director before accepting an undertaking. However, it does seem that Parliament was rather confused as to exactly what was required of the Secretary of State. For whilst the Act clearly suggests she must review a case before accepting an undertaking the fact of obvious bias on the part of the Secretary of State, renders such an exercise rather pointless. A matter that cannot have escaped anything other than the most inept scrutiny of the reforms.

Therefore, a challenge to the undertaking system, citing its practical incompatibility with long established principles to combat bias would be highly desirable. And given the post-human Rights Act legal culture we might expect any change to the legitimacy of the undertaking procedure to be brought primarily in relation to the convention. Thus, consideration of the compatibility of the undertaking process procedure with article 6(1) of the European Convention on Human Rights is useful.

7.5.3.1 The European Convention on Human Rights.

Article 6(1) of the convention guarantees citizens of contracting states the right to have their civil obligations determined by an independent and impartial tribunal. It has been established that disqualification is a procedure that determines civil obligation under article 6[587] and so the 'civil' protection of the convention applies to the undertakings system. The convention tests bias both objectively and subjectively in a manner akin to the common law rule that justice 'must not only be done but must be seen to be done'. And as with the common law, the undertaking procedure appears to be a clear breach of the convention's test of subjective bias.[588] However, the DTI's argument that directors retain the right to have their case determined by the court may be persuasive in the context of the convention.

For, in order to accommodate administrative decision making, the European Court of Human Rights has held that prima facie non-compliance with convention can be cured by 'access to a court of full jurisdiction[589]'. Following this principle, a recent case in the House of Lords upheld the decision of a local authority housing officer (acting in a appellate role) despite the fact that she was not 'independent' within the meaning of article 6 (1)[590]. It was held that the *prima facie* breach of art, 6 was cured because a right of appeal existed from the decision to a fully independent court, even though an appeal could only be made on a point of law[591]. Therefore, it would seem likely that the Secretary of State's argument that directors have the 'right' to have their case determined by court would be accepted as a cure to the actual (or subjective) bias of the Secretary of State in undertaking

587 *EDC vUnited Kingdom* [1998] BCC 370, affirmed in *DC, HS and AD v United Kingdom* [2000] BCC 710 and most recently in *Eastaway v United Kingdom*, application 74976/01, 20th July 2004.
588 The conventions subjective test is a test of actual bias. See *Wade and Forsyth, supra* note 573, page 453.
589 *Wade and Forsyth, ibid*, page 448.
590 *Runa Begum v Tower Hamlets L.B.C.* [2003] UKHL 5, [2003] 1 All ER 731.

cases. The Secretary of State's case may be further strengthened by the fact that a director is free to seek the variation or revocation of an undertaking after it has been accepted[592].

However, in practice the fictional nature of consent in many undertaking cases undermines the notion that the breach of art. 6 can be cured. The right to seek the variation or removal of an order, which is akin to a right of appeal, is also an unsatisfactory cure. For, if cost and evidential considerations preclude a person from challenging the original application it is likely that they will also preclude an appeal. Of course, as the matter has not been litigated it is possible that a UK or European court may recognise the reality of the undertaking process and declare it incompatible with article 6, or indeed common law rules. Any such decision would be very welcome, however given the English court's readiness to accept that incompatibility with the convention can be cured rights of appeal, it does not seem likely.

7.5 The Impact of the Undertakings System on Disqualification.

One positive consequence of the lack of procedural fairness in the undertakings system is that it certainly ought to reduce the cost to the Secretary of State of obtaining a disqualification,[593] however is likely that this reduction in the cost of disqualification is more than offset by an

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[591] *Runa Begum, ibid.* See also *R v Secretary of State for the Environment, Transport and the Regions* [2001] 2 All ER 929.
[592] Section
[593] Seethe response to question 3, appendix 3 below where a chief examiner in the Disqualification unit if directors offer an undertaking promptly it *"prevents the need for protracted discussions (including meetings and correspondence over many weeks) the public are protected earlier at a reduced cost to the public purse."*

increase in the costs of erroneous disqualifications. For, the combination of obvious bias on the part of the Secretary of State, the lack of opportunity for directors to make representations to him and, most importantly, the scope for oppression in the system, increases the likelihood of disqualifications being obtained where they are not merited and for periods that do not accurately reflect the need to protect the public.

The incentive for directors to settle for a slightly shorter disqualification rather than contest the case against them is especially likely to increase the costs of erroneous disqualifications. Of course, this danger is not unique to the undertakings system because it existed under the old *Carecraft* procedure; however, it is certainly exacerbated by the undertakings system. For under *Carecraft* there was some independent review of the case by a judge when the agreed statement was laid before a court, which at least reduced the likelihood of erroneous disqualification, even if the possibility of a judge rejecting an agreed statement was remote. Furthermore, judicial discretion over fixing the period of disqualification in *Carecraft* cases must have at least reduced the likelihood inaccurate period of disqualification being handed down. To a limited extent these arguments could also be made as far as instances where directors did not agree to the *Carecraft* procedure but offered no defence to an application by the Secretary of State are concerned, for again, there was at least some impartial review of the Secretary of State's case even if the court did not benefit from full adversarial proceedings. This should have at least partially reduced the likelihood of erroneous disqualification, even if that likelihood remained high.

However, the undertakings system removes any possibility of independent review of both the decision to disqualify and the fixing of the period of disqualification and must be more likely to lead to erroneous disqualification than either *Carecraft* or uncontested cases. Consequently, the likelihood of an increase in erroneous disqualifications being brought about by the undertakings system further reduces the already low protective benefits of disqualification and, indeed, increase its costs. For, the more inaccurate disqualifications that are made, the lower the number of future insolvencies prevented by disqualification will be. Consequently, the public and commercial world will be protected from even less loss than was the case at the time of the NAO follow up report. Also the reduction in desirable business activity brought about by erroneous disqualification will be increased and thus collateral losses caused by section 6 will rise. Disqualification can ill afford such a reduction in its efficiency, or more accurately, an increase in its inefficiency.

In addition to concerns about the accuracy of disqualifications obtained under the new procedure, the undertaking process increases the likelihood of misinterpretation (if not misuse) of the section 6 standard. For, in giving the Secretary of State control over the decision whether a director's conduct amounts to unfitness under section 6, the undertaking process presents him with the opportunity to sanction conduct that is of particular concern to government, but which inflicts little harm on creditors.

The non-payment of tax is a perfect example. The courts as, discussed in chapter 5, have made efforts to confine the instances in which non-payment of tax can be cited as evidence of unfitness to cases where it has some bearing on a director's honesty or competence. However, there is no guarantee that Secretary of State will follow the courts line, and despite declarations to the contrary[594], she certainly has an incentive not to. Further, it is the Secretary of State who will now decide the fitness of novel forms of delinquency and there is every reason to suppose that as time passes she will develop a parallel jurisprudence of unfitness that may diverge from that in the courts. As the courts appear to have been attentive to the economic goal of disqualification, the reduction in their involvement in the process must increase the likelihood that it the practical application of the sanction will diverge from its economic goals. Any such divergence would further weaken the benefits of disqualification in terms of both protection and deterrence.

Thus, it is highly likely that the introduction of disqualification undertakings has made for a less effective system than that which operated at the time of the NAO follow up report. However, that is not to say that similar concerns could not be expressed about the *Carecraft* system then in operation. For if the myth of consent in undertaking and *Carecraft* cases is exploded, the whole case for them collapses. This is particularly true in the case of undertakings where court involvement in the disqualification process

[594].The Secretray of State does not publish the criteria by which she decides whether to accept an undertaking. She merely cites the test in Section 7(2A), see response to questions 3 and 4, appendix 3 below.

is completely abrogated. Thus whilst the widespread use of the undertakings procedure may lead to slightly quicker disqualifications and reduce the costs of the Secretary of State, the courts and even directors (in that they can escape liability for the cost of proceedings), the costs associated with the increase in erroneous disqualifications it is likely to bring are most probably far greater.

Chapter 8: Punishment and Reform.

8.1 The Inefficiency of Section 6

Section 6 disqualification is not a successful form of regulation in the sense that it brings about a net increase in the welfare of 'the public and commercial world', on the contrary it is likely to reduce it. The high compliance and litigation costs that the sanction brings are compounded by costs from erroneous disqualifications. These costs can be contrasted with the low benefit of the section in terms of its derisory direct savings to creditors and weak deterrent effect.

Much of this inefficiency has been apparent since the NAO published its follow-up report in 1998[595], yet the state has continued to put its faith in disqualification as a desirable method of 'protecting' the public interest from abuse of limited liability, as the introduction of disqualification undertakings shows. Therefore the fact that the state has continued to pursue a policy of disqualification in light of clear evidence that section 6 is unlikely to deliver any real benefit raises questions about the true motivation of the state in seeking to disqualify directors. For, whilst the stated aim of disqualification is to protect the fact that the section actually provides little

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[595] National Audit Office, Report by the Comptroller and Auditor General, *Insolvency Service Executive Agency, Company Director Disqualification – A Follow Up Report,*

protection leaves nothing but punishment as the outcome of the state's policy. For where a director who will not repeat his misconduct is disqualified the only effect that disqualification can have is to punish wrongdoing by withdrawing the privilege to be involved in the management of limited liability companies. The question then is whether this outcome is accidental or deliberate.

8.2 Punishment Effect.

Several authors and judges[596] have favoured the view that disqualification involves a strong penal element. As such there has been some debate in the academic literature as to whether the courts follow purely protective principles in their decisions under section 6. In terms of the judicial approach to the section it is clear that some judges treat disqualification as a punitive sanction,[597] that some treat is as a protective civil sanction[598] and that others sit on the fence[599]. The punitive approach can be seen in particular in the line of authority which holds that directors must be disqualified when conduct has *fallen* short of the standard laid down

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(House of Commons Papers, session 1998-1999, 424) (London, The Stationary Office, 1998).

[596] See for example Balcombe LJ in *Secretary of State for Trade and Industry v Langridge* [1991] Ch 402, who noted at page 412 that a disqualification could be restrictive of a person's liberty..

[597] See for example Hoffman J (as he then was) in *Re Swift 736 Ltd* [1993] BCLC 1 who at page 3 described a section 6 application as "penal Proceedings".

[598] See for example Morritt LJ in *R v Secretary of State for Trade and Industry ex parte McCormick* [1998] BCC 329.

[599] Browne- Wilkinson v-c, for example, commented in *Re LoLine Electric Motors* [1988] 1 Ch 477 (at page 486) that "The power [to disqualify] is not fundamentally penal. But if the power to disqualify is exercised, disqualification does involve substantial interference with the freedom of the individual".

by Parliament, i.e. those who adopt the tunnel vision approach in *Re Pamstock Ltd*[600].

Some judges have followed the logical conclusion of the punitive approach and appear to regard disqualification as a quasi-criminal if not criminal sanction. This approach manifests itself in a number of ways, from the emphasis placed on blameworthiness by judges who adopt Finch's rights approach[601] to judges who use the language of the criminal courts in disqualification cases[602]. Those who treat it as akin to a criminal sanction appear to do so because of the 'substantial interference with the right of the individual' that disqualification entails. However, to be contrasted with judges who view disqualification as a punitive sanction are the many cases where the protective objectives of section 6 have been stressed, such as in the case of *R v Secretary of State for Trade and Industry, ex parte McCormick*[603]. Janet Dine[604] has discussed these conflicting approaches and argues that disqualification contains many elements of a 'criminal provision'. Dine therefore argues that confusion as to the classification of disqualification under section 6 ought to be resolved to "prevent an erosion of the rights of those accused of misbehaviour"[605]. Vanessa Finch[606] has also considered the civil-criminal dichotomy that section 6 gives rise to and

[600] [1994] 1 BCLC 716. See 6.2.1 *supra*.
[601] See, V. Finch, *Disqualifying Directors: Issues of Rights, Privileges and Employment* (1993) 22 Industrial Law Journal 35 and chapter 4, *supra*.
[602] See for example the case of *Official Receiver v Jones* [2004] EWCA 2096 where Weeks J consistently referred to allegations of unfit conduct as "charges".
[603] [1998] BCC 379.
[604] Dine, J *Punishing Directors* [1994] JBL 325.
[605] Dine, *ibid* at page 337.
[606] V. Finch, *Disqualification of Directors: A Plea for Competence* (1990) 53 MLR 385.

appears to favour the view that disqualification is operated along punitive lines in many instances.

However, the issue that must be addressed is whether instances where section 6 is used punitively means that that section itself can be characterised as punitive. It is certainly true, as Dine argues[607], that a disqualification contains many of the elements of a punitive sanction. However it does not follow that section 6 *is* punitive, because notwithstanding its punitive characteristics a disqualification is capable of being protective if it is applied with intention to protect and its scope does not exceed that necessary to secure protection. As such it is submitted that the classification of a particular disqualification can only be determined by an assessment of the desire that motivates its imposition. Thus, if a disqualification is imposed with the *intention* of punishing, then its 'interference with the freedom of the individual' can quite properly be regarded as a punishment. However, if a disqualification is imposed with the intention of providing protection it will not be punishment even if certain characteristics of the sanction may look punitive *provided that the scope of the disqualification does not stray beyond that needed to 'protect'*. Therefore, the fact that disqualification may demonstrate certain features of a punitive provision does not mean that it constitutes a punishment if it can be justified according to protective principles. Thus, whilst the practice of handing down longer disqualification periods to dishonest directors[608] could

[607] Dine, *supra* note 604.
[608] *Re Sevenoaks Stationers Ltd* [1991] Ch. 164.

be viewed as involving a penal element (i.e. the desire to punish a culpable wrongdoer), it can just as easily be justified by protective goals in that dishonest directors pose more of a risk to the public, which needs the maximum possible protection. Therefore, provided that such a disqualification is motivated by a desire to protect then it will not be punitive. However, if a disqualification were to go beyond protective aims in that a period of disqualification ordered was over and above that needed to protect, then that disqualification would become partially punitive. This situation has undoubtedly arisen many times. Finch gives the example of *Re Cladrose Ltd*[609] where a chartered accountant was disqualified for a longer period than an 'ordinary' director even though both were found to be unfit because of a failure to file returns and produce audited accounts. In this case the 'extra' period of disqualification was handed down to the chartered accountant director because the court regarded his failure as more culpable that that of the other director. Such a disqualification can properly be regarded as punitive because it went beyond the period of disqualification (if any) necessary to protect the public interest because of a desire to 'punish' a culpable wrongdoer.

However, whilst the intention to punish is evident in many reported cases it must be emphasised that the *objective of section 6 is to protect* and not to punish. Therefore any disqualification or disqualification period that is motivated by as desire to punish ought to be condemned as an inefficient use of disqualification. As such, instances where the courts have used

[609] [1990] BCC 11.

disqualification to punish and not to protect ought not to be cited as evidence that section 6 is a punitive sanction. On the contrary, they should simply be condemned as instances of judicial error. Similarly, the 'tunnel vision' approach, which looks exclusively to past conduct in the disqualification process, is also out of step with the stated purpose of the section. For, whilst there are many reported cases under section 6 that involve punitive considerations, there is ample authority for the protective approach to the section, not least from the Court of Appeal in *R v Secretary of State for Trade and Industry, ex parte McCormick*[610]. As such it is relatively easy to condemn individual cases where a court is shown to have disqualified out of a desire to punish (such as Finch argues was the case in *Re Cladrose*).

However, the total failure of section 6 to fulfil its protective aim raises questions not about the role of the courts in section 6 cases but rather about the state's motivation in continuing to pursue a policy of disqualification. For, if the state were aware that disqualification provided no real protective benefit (as the NAO follow-up report clearly showed) then logic would dictate that the desire to protect cannot be the only motivation behind the state's continued use of the sanction.

8.3 A Desire to Punish?

When assessed against the objective of protection, the state's approach to section 6 is puzzling, if not bizarre. To take the recent

[610] *Supra*, note 603.

introduction of disqualification undertakings as an example, any reasoned analysis of the reform must conclude that the lack of procedural safeguards built into the undertaking system are highly likely to increase error in the disqualification process and make the disqualification system less efficient. In terms of the conduct cited in section 6 cases, the state's conduct also appears to be at odds with the objective of protection in certain respects, such as its preference for citing the failure to fulfil accounting and disclosure obligations as evidence of unfitness. Just as puzzling was the continued drive to increase the number of disqualifications post-1998, when the NAO follow-up report had showed that only 15% of disqualified directors were likely to be involved in further business failure[611]. Surely, if the state's desire were really to protect the 'public and commercial world' this finding ought to have generated a policy focused on the *quality* and not quantity of disqualification?

However, whilst the state's approach often makes little sense in terms of a desire to protect it makes somewhat more sense in light of a desire to *punish*. For, in terms of punishment, none of the criticisms of advanced above would reduce the success of disqualification. Thus, the fact that only 15% of disqualifications result in protection is irrelevant of the state really intends to use section 6 to punish undesirable conduct. Because every disqualification punishes a perceived wrongdoer. Similarly, the frequent citing of accounting and disclosure misconduct would be a perfectly rational way of punishing those who digress from rules set down

[611] See 6.2.2 *supra*.

by the state. And the state's cavalier attitude to procedural safeguards in the undertaking process is at least understandable, if not legitimate, within the context of a punitive sanction. Indeed, the previous cost benefit analysis of section 6 would not apply if its benefits were intended to include punishment. On the quantitative level the £11 million deficit found by the NAO is based on an analysis of disqualification as a protective measure. However, if its objectives included punishment the cost-benefit deficit would likely be reduced if not extinguished by the benefit of punishing those who abuse limited liability, whatever that benefit may be.

Therefore, in terms of a desire to *punish* errant conduct much of the state's approach to disqualification is a good deal more logical than it is in relation to a desire to 'protect the public and commercial world from abuse of limited liability'. And it should be noted that a desire to punish undesirable conduct does not necessarily conflict with apparent purpose of section 6, which as I have argued in previous chapters is to support 'confidence in the market'[612] (i.e. free access to limited liability) by sanctioning those who are seen to 'abuse the system'. The state can promote such confidence by punishing errant directors just as easily as it can by seeking to protect creditors from them, even if (as is argued below) punishment is ultimately of less value to creditors.

[612] National Audit Office, Report by the Comptroller and Auditor General, *Insolvency Service Executive Agency, Company Director Disqualification – A Follow Up Report*, , (House of Commons Papers, session 1998-1999, 424) (London, The Stationary Office, 1998), which stated at page 1 that "[t]he disqualification arrangements are intended to promote confidence and risk-taking in the market, by assuring those who do business with limited liability companies that directors who are unfit will be disqualified". See chapter 3, *supra.*

Nonetheless, whilst the state's conduct makes more sense in terms if a desire to punish, it cannot be emphasised strongly enough that *punishment is not the stated objective of section 6.* Its stated objective is to protect, and is an objective that has been repeated many times by the state itself[613], the courts[614] and bodies such as the NAO[615]. Therefore any punitive use of section 6 by the state must be condemned as strongly as any punitive approach by the courts. However, that is not to say that a desire to punish directors for errant conduct is undesirable *per se*, but rather that it is undesirable within the context of a measure which aims to protect and which accordingly makes use of the rules of civil procedure.

Nonetheless, despite the logic of the state's approach to section 6 in terms of a desire to punish, there is no direct evidence that a desire to punish motivates the state. All that can be stated is that a desire to punish is a logical inference that can be drawn from the state's continued use of the section. However, given its frequent reiteration of the protective aims of section 6[616], it would appear that either the state is acting in a highly duplicitous fashion in its use of section 6 or that it misguidedly believes that section 6 does afford effective protection. In which case the actual punitive

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613 See: Hansard [HC], (Session 1999-2000), Standing Committee B, 7th November 2000, col 119.

614 See Dillon LJ in *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch 164, who stated at page 176 that "It is beyond doubt that the purpose of section 6 is to protect the public, and in particular potential creditors of companies, from loosing money through companies becoming insolvent when the directors of those companies are unfit to be concerned in the management of companies"

615 See, National Audit Office, Report by the Comptroller and Auditor General, *Insolvency Service Executive Agency, Company Director Disqualification – A Follow Up Report, supra* note 612, which stated at page 1 that disqualification existed to "protect the public and commercial world from those who abuse limited liability status"

616 See note 613 and generally chapter 1, *supra.*

effect of the many disqualifications that provide no protection would be unintended. However, if the state were acting duplicitously, it would equate to a gross abuse of power, with the state deliberately deceiving in order to take advantage of the more relaxed civil procedure rules to enforce a 'criminal' sanction.

8.3.1 Protection is the Most Desirable Goal.

Whatever the true motivation of the state may be, 'protection' is the most desirable goal for section 6 to follow. The sort of activities that the state seeks to sanction through its use of section 6 are, as has been discussed in earlier chapters, activities that inflict economic harm on the public and commercial world and a protective sanction is most likely to bring about a net reduction in economic harm and therefore provide the greatest 'benefit' to the public. This is because protective measures are necessarily intended to reduce the number of instances where harm (be it economic or otherwise) is inflicted upon a certain class of persons. As such, reducing effective 'harm' is the core objective of a protective measure. Measures that are intended to punish do not have such a reduction in harm as their primary aim, because punishment primarily involves satisfying a desire for retribution. That is not to say that bringing about a reduction in harmful conduct is irrelevant to punishment, for punitive sanctions often seek to reduce harm through a deterrent effect as well as to satisfy a desire for retribution. Thus, the mandatory life sentence for murder, for example, is justified by both retributive and protective principles. The severity of the sanction imposed is said to reflect society's abhorrence for murder and therefore satisfy its desire to seek retribution against those who commit murder, but also to act as a deterrent to murder and therefore to protect society from harmful conduct. However, the protection afforded by punitive sanctions is not always 'optimal', to use the economic jargon. This is because the retributive element in punitive sanctions can limit or reduce the benefit that can be derived from protection by extending the sanction for undesirable conduct beyond that necessary to achieve protection. In which case some, if not all, of the benefit of protection will be lost. Thus, in the context of section 6 disqualification some of the protective benefit of disqualification will be lost where disqualification is used to punish undesirable conduct.

Let us take for example the hypothetical case of a professional director disqualified for 10 years, where the judge estimates that a 5 year disqualification would satisfy protective goals but nonetheless hands down a 10 year disqualification to satisfy the goal of punishing culpable conduct. On a superficial level this disqualification brings both retribution and protection, in that the public interest in punishing culpable conduct is satisfied and the public is protected from a repeat of the misconduct by both the lengthy disqualification and deterrent effect it may have on misconduct by other directors. However, the actual protective benefit from such a disqualification will be reduced to the extent that that the 10 year disqualification 'over-protects' and prevents the individual from being involved in desirable business activity during the 6th to 10th years of his disqualification, which according to protective principles are unnecessary years of disqualification. The same basic outcome results from the more extreme case where a disqualification is made for punitive motives where no need to protect exists, for in such a case disqualification will prevent potentially desirable business activity.

As such, punitive disqualification tends towards 'over-protection', which inflicts its own type of harm on the public and commercial world. Therefore it is likely to bring less of a 'benefit' in terms of reducing harm than purely protective disqualification. Consequently, purely protective goals are by far the most desirable in terms of regulation that is aimed at economic harm resulting from 'abuse of limited liability'.

Therefore, whatever may motivate the state, and indeed the courts, in their approach to section 6, the stated protective aim is the correct one given its context. Unfortunately, however, the condemnation of any punitive uses of section 6 that this necessitates leads to the condemnation of the whole of the section 6 regime. Because, be it by accident or design, the actual effect of most section 6 disqualifications is only to punish and in so doing it actually inflicts *a cost* on the groups it is intended to protect from loss. Therefore, given sections 6's clear failure to bring about a net reduction in economic harm to creditors, reform of the states approach to 'abuse of limited liability' is highly desirable if effective protection is to be secured.

8.4 Personal Liability.

A potentially more effective way for the state to protect the public and commercial world from unfit conduct would be to replace *disqualification* with *personal liability* as a sanction for unfit conduct, the benefits of which have been discussed in an earlier part of this thesis[617]. Such a personal liability provision could take the form of either a new provision rendering unfit directors liable for debts related to their unfit acts, or a provision allowing civil recovery to be made under existing provisions where unfitness has been found.

The protective benefits of either form of personal liability over disqualification rely essentially on the greater protective effect of personal liability for the victims of errant conduct and upon it having a greater deterrent effect. To elaborate a little further, personal liability could provide much greater protection from unfit conduct because it would insulate victims of unfit conduct from suffering loss, at least in so far as it increased the likelihood that they would be paid sums owed to them because of unfit conduct. As such, it would afford victims of 'abuse of limited liability' much greater protection from its harmful effects than is the case with the current remedy of disqualification, which can only provide future protection for an unknown class of potential creditors.

The more certain benefit of a personal liability remedy would also be advantageous because it is unlikely to give rise to a large number of wasted instances of regulatory intervention as occur under the current disqualification system. For, each instance of civil recovery ought to provide at least some direct and quantifiable protective benefit to victims of unfit conduct. As such the situation where up to 85% of regulatory interventions

[617] See 5.3, *supra.*

provide no direct protection should to be avoided. This feature of personal liability is consequently likely to lead to fewer interventions with only a punitive *effect*, even if the motivation behind the intervention were protective. However, that is not to say that personal liability provisions cannot be used to fulfil punitive goals, because they most certainly can. Dine[618], for example, cites the case of *Re a Company (1988)*[619] to illustrate the punitive use of a personal liability provision. In that case a director was ordered to pay £131,420 by way of compensation for fraudulent trading under section 213 of the Insolvency Act 1986 along with £25,000 by way of punishment for the same conduct. However, what does seem likely is that so long as the principle of protection is adhered to, personal liability would lead to fewer wasted interventions producing only punitive effects. Which (as has been argued above) are likely to produce costs and therefore not secure the maximum possible benefit for the 'public and commercial world'.

A further benefit of a personal liability remedy could be an increased deterrent effect from the sanctioning of unfit conduct, relative to that secured by disqualification. Such an increase could flow from the incentive to avoid unfit conduct created when directors are required to pay its cost, which has an arguably greater impact on the director than disqualification[620]. For whilst disqualification can have a financial impact upon a wrongdoer by depriving him of his living, the financial consequences of disqualification

[618] Dine, *supra* note 604 at page 325.
[619] [1991] BCLC 197.
[620] Essentially, personal liability provisions restore directors to a position of unlimited liability if the commit prohibited acts. Therefore, provided directors know which acts are prohibited, the treat of personal financial loss ought to be an effective deterrent.

can be mitigated by entering a partnership or conducting a business as a sole trader. With personal liability, however, the financial impact of unfit conduct could not so reduced as once a liability order had been made an unfit director would be obliged to satisfy it, unless discharged after bankruptcy. As such the incentive to avoid potentially ruinous liability would be high with a personal liability sanction. Consequently, awareness of potential liability for the harm inflicted by unfit conduct is likely to weigh much more heavily on the mind of a director contemplating unfit acts than the prospect of a disqualification.

8.4.2 Limits of Personal Liability: Asset, Sanction and Enforcement Insufficiency.

However, despite its *potential* advantages over disqualification as a remedy for unfit conduct, personal liability provisions are fraught with difficulties[621]. For one thing a personal liability sanction for unfit conduct is likely to suffer from similar difficulties to those that it has been argued limit the effectiveness of enterprise liability provisions (i.e. where corporations not individuals are held liable for wrongdoing). Thus, asset insufficiency[622] where directors lack assets to satisfy a liability order is an important factor restricting the success of personal liability sanction because where a director's personal assets were less than their liability, the remedy would fail

[621] For a discussion of the benefit that the main civil recovery provisions can deliver to creditors see S. Wheeler, *Swelling the Assets for Distribution in Corporate Insolvency* [1993] JBL 256.
[622] V. Finch, *Personal Accountability and Corporate Control: The Role of Directors and Officers Liability Insurance* (1994) 57 MLR 880. See also R. Kraakman, *Corporate Liability Strategies and the Cost of Legal Controls*, (1984) 93 Yale LJ 857.

to protect creditors from the full harm of unfit conduct. Asset insufficiency would be a particular problem for a personal liability provision that could only be applied post-insolvency because directors may already have had their assets depleted, especially in the case of entrepreneurs who have personally guaranteed some corporate debt. Sanction inefficiency[623], whereby judges were unwilling to impose ruinous liability on directors whose conduct was not culpable, is another potential drawback to both the protective and deterrent effect of personal liability. For any reluctance by the courts to impose full liability on a negligent director, for example, because of concerns that the financial impact on the director would be disproportionate to his 'blameworthiness' would prevent creditors from being fully protected from unfit conduct. Sanction insufficiency could also have an adverse impact on the deterrent effect of personal liability if judges were either reluctant to order liability for directors who were not blameworthy or if they limited any liability order they did make. However, at the other end of the spectrum, deterrence could also suffer if directors *were* made liable for the full cost of unfit conduct on purely protective principles because under such an approach dishonest and fraudulent directors would not suffer greater penalties for their extra culpability than negligent or incompetent directors, in which case it could be argued that dishonest and fraudulent conduct may become more likely.

[623] Finch, *ibid.* See generally J. Coffee, *No Soul to Damn: No Body to Kick: An Unscandalized Inquiry into the Problem of Corporate Punishment*, (1981) 79 Mich. LR 386.

A further drawback with personal liability is enforcement insufficiency[624], which occurs when an insufficient number of 'offences' are detected and prosecuted for a rule to achieve its goals. The experience of the pilot civil recovery scheme between 2001-2003 certainly indicates that enforcement insufficiency could be a concern with a personal liability provision, for that 2 year scheme resulted in only 18 actions for personal liability[625]. However, enforcement insufficiency would not only harm the actual protection delivered by a personal liability sanction but could also reduce its deterrent effect. However, it should be noted that if the resources currently put into disqualification were diverted to civil recovery, the number of recovery actions would be likely to rise significantly. Indeed, caution should be exercised in drawing conclusions from the lack of success of the pilot recovery scheme because that scheme was conducted on a conditional fee basis and relies on the participation of private practitioners who may well have been reluctant to take up risky cases[626].

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[624] Finch, *ibid.*

[625] See 5.3, *supra.*

[626] The 'Dear IP' letter requesting expression of interest from practitioner to participate in a national civil recovery scheme suggests that a reluctance to take up risky cases without charging a fixed fee had been encountered during the pilot scheme. The letter stated that "Whilst it is accepted that civil recovery trustees/liquidators would charge a premium on normal fees from recoveries, to cover its risks of funding cases, it would not be acceptable for recoveries to be swallowed up to a large extent by fees and disbursements". See the '*Dear Insolvency Practitioner*' letter, Issue Number 14, September 2003, chapter 3, page 3.9. Available at *http://www.insolvency.gov.uk/information/dearip/dearipmill/ fullissue14.doc.*

8.4.3 The Limits of Personal Liability: Future Protection and Deterrence.

A further significant limitation of the effectiveness of personal liability is the fact that it provides no future protection from unfit conduct by directors. This could be a particular drawback in light of asset and enforcement insufficiency because in cases where the protective impact of personal liability was limited by these factors, the total benefit of a personal liability sanction could be low. Of course, personal liability also brings the benefit of deterrence as well as protection but its effectiveness in this respect has also been doubted. Finch[627] notes evidence from North America that the deterrent effect of personal liability may be 'scant' and that judging the deterrent effect of personal liability is difficult in any case[628]. The UK experience with personal liability provisions certainly does not support the view that the deterrent effect of personal liability is strong. The personal liability sanction for wrongful trading under section 214 of the Insolvency Act 1986, for example, certainly does not seem eradicated insolvent trading if the disqualification cases are anything to go by[629]. However, whether this is due to problems with section 214 itself[630], problems with its enforcement or a lack of deterrence from the sanction is unclear.

[627] Finch, *supra* note 622 page 885.
[628] See Dewees and Trebilcock, *The Efficacy of the Tort System and its Alternatives: A review of Empirical Evidence*, (1992) 30 Osgoode Hall LJ 57, cited in Finch, *ibid*, note 24.
[629] 'Trading whilst insolvent' was a matter of unfitness found in almost 43% of the disqualification cases included in the empirical research carried out for this thesis. See *supra* 4,7.1, table 1.
[630] See generally F. Oditah , *Wrongful Trading* [1990] LMCLQ 205. Oditah notes the benefits that section 214 is capable of providing but also discusses problems with the way

It is however clear that a personal liability sanction for unfitness would suffer from many of the same drawbacks as disqualification. Evidence from Baldwin's study of directors that personal sanctions are not the most effective 'drivers' of compliance with a regulatory standard would apply as equally to personal liability as it does to disqualification[631]. Post-insolvency sanctioning of unfit conduct would also limit the deterrent effect of personal liability if it were to simply replace disqualification without more fundamental reform of section 6. That said, the deterrent impact of personal liability would depend upon the number of liability orders made and the extent of the liability imposed. If liability were seen by directors to be frequently imposed then the risk of personal financial harm may well come to exercise significant influence over the minds of directors. Indeed, for this reason it has been argued that personal liability provisions can actually lead to 'over-deterrence' whereby people are deterred from becoming directors because of the risk of personal liability[632]. This concern is often expressed in relation to large companies where the financial risk of personal liability is greatest[633], but could also apply to the owner-manager directors against whom disqualification is most often applied. As such, personal liability provisions run the risk of imposing a cost in terms of desirable business activity prevented by the rule. In terms of those people who are prepared to act as directors it is further contended that personal

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the section is drafted and uncertainty over who will benefit from it. See also Wheeler *supra* note 621.

[631] Baldwin R., *The New Punitive Regulation*, (2004) 67 MLR 351, see further 6.3.1 *supra.*

[632] Finch, supra note 622

[633] Finch, *ibid.*

liability may make them excessively risk-averse[634]. Directors' liability insurance has been offered as a solution to such concerns, but its operation is not without problems[635].

8.5 Conclusion.

Therefore, whilst personal liability may bring the advantage of protecting some victims of unfit conduct from harm, it is far from being a guaranteed way to fulfil the desirable goal of '*protecting* the public and commercial world from abuse of limited liability'. As such, it is not possible to say that would be a more effective sanction for unfit conduct than disqualification, even though disqualification under 6 is clearly ineffective. A similar conclusion, it will be recalled, was reached earlier in this thesis in respect of a pre-insolvency disqualification regime[636]. Consequently there would seem no obvious way in which effective protection from unfit conduct by directors can be secured. However, the failure of section 6 and the other methods of regulation considered should be taken as leading to this conclusion. For, in truth the alternative regulatory strategies that have been discussed are all set within the broad approach to regulating unfit conduct laid down by section 6, i.e. regulation that attempts to provide protection from unfit conduct *after it has occurred.* This *ex post* strategy is obvious in section 6, in personal liability provisions and indeed in pre-insolvency disqualification, for even in that instance disqualification

[634] Finch, *ibid.* See also M. Jensen, & W. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, (1976) J. Financial Econ. 305.
[635] See Finch, *ibid.*
[636] See 6.4, *supra.*

would occur after unfit conduct has been committed (although before insolvency).

The emphasis on *ex post* strategies in current regulation in born of a desire to maintain free access to limited liability for entrepreneurs yet at the same time provide effective protection from its abuse. What the inefficiency of section 6 shows is that the current attempt to do so is a failure. However, the question marks over alternative regulatory strategies seem to point to inherent limitations in the ability of *ex post* strategies to deliver effective protection. Therefore, if the state wishes to provide effective protection from unfit 'abuse of limited liability' *ex ante* strategies which prevented the unfit from being in a position to commit acts of abuse would be far more desirable.

Chapter 9: Limiting Limited Liability.

"*We are not aware of any evidence suggesting that the ease of incorporation [in the UK] (which is cheaper and quicker than almost anywhere else in Europe) has lead to unusually high levels of failure or abuse by the standard of international comparison*"

> Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework*, (London DTI, 1999) at para. 5.2.12.

9.1 Introduction.

The State acknowledges that free access to statutory limited liability creates a need for regulation to control undesirable conduct by directors. This is obvious from the fact that section 6 is applied only against unfit persons who 'benefit from limited liability'. In the early part of this thesis it was shown that regulation is necessary because in the real market place statutory limited liability leads to 'loading' of risk on to some creditors who are unable to protect themselves from the effects of the rule. It was argued that this created a 'need' for regulation that is most acute in relation to owner-managed companies because risk-loading creates a particular moral hazard (i.e. incentive to engage in undesirable acts) in these companies, which disqualification is intended to control. Disqualification is intended to do this in order to preserve the benefit of increased entrepreneurial activity that state sees free access to limited liability as bringing. As such, the policy of allowing free access to limited liability and disqualification go hand in hand. It is not an exaggeration to say that disqualification is necessary to legitimise this policy. It exists to re-assure creditors that undesirable individuals will not be allowed to transfer excessive risks, and more importantly, to prevent the 'benefits' of limited liability being wiped out by the 'costs' of undesirable activity.

However, the net *reduction* in wealth that section 6 actually brings means that it is an inefficient method of controlling undesirable activity that ought to be scrapped. The question then would seem to be what alternative form of regulation should be put in its place to ensure that the benefits of limited liability are not lost through undesirable conduct. However, it is this thesis' argument that the most desirable response to undesirable use of limited liability is *not* to install an alternative form of regulation to replace section 6 but rather to address the root cause of the need to regulate directors i.e. free access to limited liability itself. For, the failure of section 6 makes it doubtful whether allowing *free* access to limited liability brings any benefit. Therefore, little would be lost by restricting access to limited liability in a way which removed the 'problem' of undesirable conduct by incorporated individuals and hence the 'need' for regulation.

9.2 The Choice Presented by the Failure of Disqualification.

Andrew Hicks' survey of disqualified directors in his ACCA report[637] provided empirical support for a matter obvious to anyone acquainted with section 6 disqualification, i.e. that the vast majority of disqualified individuals were owner-managers. This focus on incorporated entrepreneurs cannot be ignored when discussing alternative strategies to resolve the regulatory problem to which section 6 disqualification is addressed. For, section 6's focus on this issue can only really be taken as a comment upon limited liability in such companies.

The State promotes a policy of free access to limited liability because it perceives it to bring the benefit of increased entrepreneurial activity and therefore an increase in the country's wealth. However, as was discussed in chapter 3, creditors' demands for compensation will limit the actual increase in entrepreneurial activity (and hence wealth) brought by the rule. As such, entrepreneurship will only increase where uncompensated transfers of risk can be made. However, this apparently beneficial risk transferring comes at a cost; that cost being losses resulting from the moral hazard that uncompensated risk transferring brings.

To deliver a real benefit therefore limited liability would have to bring about an increase in wealth through more entrepreneurial activity that exceeded losses from the undesirable activity that the rule creates. However, in so far as disqualification under section 6 is a failed attempt by the State to

[637] A. Hicks, *Disqualification of Directors: No Hiding Place for the Unit?* (London, Certified Accountants Educational Trust, 1998), see chapter 1, *supra*.

control losses from 'moral hazard', it can be doubted how far the policy of allowing individuals access to limited liability brings any benefit, regardless of the costs imposed by section 6. The fact that the State feels the need to regulate in order to reduce losses caused by unfit conduct indicates that the costs of allowing free access to limited liability are at unacceptable levels. If the benefits of the policy were seen to be greater than its costs the regulation to reduce cost would be unnecessary if not irrational. Thus, it can be assumed that either those costs exceed the benefit brought by limited liability or at the very least that an unacceptable portion of those benefits is cancelled out by losses such that the benefits of the rule are slight. As such, this thesis contends that the 'problem' of undesirable conduct by directors presents the State with a simple choice.

It is submitted that the State should determine whether its bare policy of allowing free access to limited liability is desirable or not according to the costs and benefits of the policy. If the State concludes that that policy is desirable because it brings benefits greater than its costs[638], then the State should simply accept the cost of undesirable conduct as an unwelcome but inevitable consequence of a desirable policy and disqualification ought to be scrapped. However, if the State decides that costs are greater than benefits, then the policy itself should be reformed as the most desirable way to control undesirable activities by unfit individuals. Disqualification is an attempt to avoid this choice by controlling cost through regulation. However its existence indicates that the cost of the policy is greater than its benefits, in which case methods of preventing risky individuals from obtaining limited liability should be considered.

9.3 The Case for Reducing Access to Limited Liability.

The argument for removing limited liability as the most desirable response to the 'problem' disqualification fails to solve is strong. For not only does the existence of disqualification suggest that granting entrepreneurs limited liability bring no increase in wealth, but it is also true that granting owner-managers statutory limited liability brings none of the other benefits which have been claimed for the rule.

Such benefits have become prominent in the literature favouring limited liability because of the problems presented for the 'increased risk-taking' argument by Posner's 'compensation model'. For, as was made clear earlier in this thesis, if creditors were able to demand compensation in the manner claimed by Posner, limited liability would not result in increased risk-taking. Posner's thesis has presented adherents to the contractual analysis of the company with a problem, for their instinct to favour the entrepreneur over other groups makes then pre-disposed to favour a rule which benefits him. As such, they have been forced to develop alternative arguments in favour of allowing shareholders to oust normal market rules and invoke statutory asset partitioning.

Easterbrook and Fischel, for example, concede that a rule of limited liability is unlikely to lead to more or less risk taking than a rule of limited

[638] 'Cost' in this instance could include economic and/or social costs.

liability[639]. They make this concession when seeking to rebuff the argument that limited liability leads to 'socially excessive risk-taking' and are quite correct to make this point, as under Posner's model 'moral hazard' ought to be the same under both limited and unlimited liability[640]. Nonetheless, they assert six 'rationales' for limited liability, and assert rather weakly, that "[i] f limited liability were not the starting point in corporate law, firms would create it by contract"[641]. Their assertion is, however, unsupported by empirical evidence and impossible to sustain. Firms may *want* to create limited liability through contract, but it is far from certain that they *would* be able to create it, because to do so they need the agreement of creditors. And it is fanciful to state without any supporting evidence that creditors would always agree to create limited liability. Rather, under a statutory position of unlimited liability, limited liability would only be created to the extent that creditors were induced to create it. And creditors' willingness to create limited liability through contract would depend upon a number of variable factors, such as the creditworthiness of a firm and the compensation offered.

However, despite their obvious enthusiasm for the rule Easterbrook and Fischer accept that none of the six 'rationales' for limited liability apply to owner-managed companies[642] and that it brings an incentive to engage in overly risky activity. They do not however, go so far as to advocate the

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[639] Easterbrook and Fischel *The Economic Structure of Corporate Law* (Cambridge, Mass, Harvard University Press, 1991), page 52.
[640] See 3.3 *supra*.
[641] Easterbrook and Fischel, *supra* note 639, page 41.
[642] See also, P. Halpern, M. Trebilcock, and S. Turnbull, *Limited Liability and the Corporation*, (1980) 30 U. Toronto. L. J. 117 who concludes that unlimited liability is likely to be a more efficient rule for owner-managed firms.

removal of limited liability from owner-managed firms. Rather, they only note that piercing the veil reduces the extent to which creditors bear the costs of undesirable conduct[643]. However, given the restrictive approach to the courts of to piercing the veil[644] this is hardly a satisfactory response to the problem that entrepreneurs with limited liability present. Others appear less ready to concede the point[645].

Easterbrook and Fischel are quite correct to conclude that limited liability brings few benefits. For example, the assertion that limited liability decreases monitoring costs because it reduces shareholders incentive to monitor directors[646] and fellow shareholders is clearly inapplicable to entities where there is complete unity of ownership and control. Monitoring is not only unnecessary, but also impossible in such circumstances. The argument that limited liability reduces the monitoring costs of creditors is similarly inapplicable to owner-managed companies.

In larger companies with many shareholders, a rule of unlimited liability could increase overall monitoring costs by creating an incentive for creditors to monitor the wealth of a large and fluctuating body of

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643 Easterbrook and Fischel, *supra* note 639, chapter 2.

644 In *Adams v Cape Industries* [1990] Ch. 433 the Court of Appeal comprehensively rejected attempts to establish a broad doctrine allowing the courts the freedom to disregard the corporate veil where the merely felt that it would be just to do so, such as that favoured by Lord Denning in *DHN Food Distributors Ltd. v Tower Hamlets LBC.* [1976] 1 WLR 852. Rather, the court favoured a narrow definition of the circumstances in which the veil could be lifted. See chapter 2, *supra.*

645 For example, Hansmann and Kraakman claim that statutory limited liability "can play a valuable contracting role even in situations where a corporation has a single shareholder who does not require the corporate form to raise equity capital…" See: Kraakman, Davies, Hansamnn, Hertig, Hopt, Kanda and Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, (Oxford, Oxford University Press, 2004), chapter 1. See also R. Posner, The *Rights of Creditors of Affiliated Corporations*, (1967) 43 U. Chi. L.R. 499.

646 Easterbrook and Fischel, *supra* note 639, page 41-42.

shareholders[647]. This, however, is not the case with limited liability where creditors only need to monitor the assets of the corporation and, as such, less monitoring will take place. However, with owner-managed companies the difference in monitoring costs under both limited and unlimited liability would not be great, as in both situations creditors only need to monitor a fixed pool of assets. Thus, unlimited liability may be just as efficient as limited liability[648] for small owner-managed companies. It is even conceivable that unlimited liability in owner-managed firms may decrease monitoring costs because the greater security of creditors may reduce their incentive to monitor. Conversely, the response of risk-minimising creditors to statutory limited liability may well be to increase monitoring of an entrepreneur if they have been unable to secure compensation for increased risk because of the skewing effect of the statutory rule. In such a situation general monitoring is the only weapon a creditor has to protect his position, even if monitoring alone would not be a particularly effective weapon[649].

Furthermore, the argument that limited liability promotes the free transfer of shares which in turn increases managers' incentive to act efficiently[650] is also inapplicable to owner-managed companies because shares in such companies are not freely transferable. Thus, there will be no market for shares to reflect the value of the firm and the threat of take-over

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[647] Easterbrook and Fischel, *supra* note 639, Halpern, Trebilcock and Turnbull, *supra*, note 642.

[648] Halpern, Trebilcock and Turnbull, *ibid.*

[649] Aside from exerting moral pressure on the entrepreneur, there would be little that an unsecured creditor could do to prevent harmful conduct even if he became aware of it. In order to prevent wrongful trading a creditor could partition the court to wind up a company

for inefficient management will not arise. Manne's assertion that limited liability permits efficient diversification[651] in investment portfolios is also inapplicable to owner-managed companies, for they are not primarily vehicles for investment. Thus, they do nothing to allow investors to spread risk by investing in a range of different companies.

The argument that statutory limited liability for entrepreneurs reduces the transaction costs associated with bargaining between owners and their creditors has some mileage in it. However, it is not a strong argument because the supposed reduction in transaction costs assumes that individuals who currently benefit from the rule would create limited liability through contract if the rule were abolished. However, this is not necessarily so as they would only create it to the extent that creditors consented to its creation. In any case, it is unclear whether a rule of limited liability would reduce transaction costs as compared to a rule of unlimited liability. For, a rule of statutory limited liability brings its own transaction costs because where creditors seek to contract around imposed limited liability; transaction costs will be incurred in negotiating *away* from limited liability, the same as they would be in negotiating away from unlimited liability under the alternative rule. The particular legal rule used (limited or unlimited liability) is irrelevant to transaction costs unless parties never seek to depart from the

under section 122 of the Insolvency Act. However, such action would be unlikely to help unsecured creditors.

[650]Easterbrook and Fischel, *supra* note 639, page 42

[651] See Manne H, *Our Two Corporation Systems: Law and Economics*, (1967) 53 Va. L. R. 259. See also B. Cheffins, *Company Law: Theory, Structure and Practice* (Oxford, Claredon Press, 1997), page 499 and L. Ribstein, *Limited Liability and Theories of the Corporation* (1991) MLR 80, page 99-102.

rule, and some parties are likely to seek to transact away from either rule. Therefore, the 'saving' of statutory limited liability is more imagined than real and, what is more, comes at significant cost to creditors.

9.3.2 The Abolition of Limited Liability.

Thus, there would seem no reason why limited liability for undercapitalised, owner-managed companies should not be abolished as the most preferable method of preventing directors from 'abusing the privilege of limited liability'. For, preventing such persons from obtaining limited liability in the first place would remove at a stroke most of the problem that necessitates regulation. It is not therefore submitted that reducing access to limited liability for entrepreneurs would eradicate all loss from undesirable use of limited liability, merely, that it would reduce the greater portion of the loss that the State sees as necessitating regulation. Thus, this argument only seeks to demonstrate that restricting access to limited liability would be an effective method of addressing the regulatory problem that disqualification is aimed at. It is not claimed that limited liability for firms that are not owner-managed is a necessarily desirable rule. There may be arguments for further restriction of that rule to address other regulatory problems, as will be made clear at the conclusion of this chapter. However, the case for the abolition of statutory limited liability is strongest in relation to owner-managed companies.

9.4 Methods of Restricting Limited Liability.

9.4.1 A Minimum Shareholder Requirement

The goal of restricting access to limited liability as the most desirable method of preventing unfit conduct by directors is easier to state than to achieve in practice.

An obvious method of attempting to prevent high-risk individuals from incorporating could be by means of a rule that required companies to have minimum number of shareholders, say for example 10 shareholders. Such a rule could prevent individuals from incorporating and where incorporation was possible, allow some scope for shareholder monitoring of directors to control undesirable activity (assuming at least some shareholders would not also be directors).

Such a reform is most unlikely to be successful however. History teaches us that such a rule could be easily circumvented, as the example of the Joint Stock Companies Act 1856 and the facts of *Salomon v Salomon*[652] shows. And indeed it unlikely that 'nominee' shareholders would be effective monitors due to family ties and general passivity[653].

A rule denying limited liability to *de facto* owner-managed firms could be one way around the use of nominee shareholders. However, such a rule could run into definitional problems and prove difficult and expensive to enforce, which is likely to restrict its effectiveness. For example, such a rule would be likely to lead to disputes as to the true role of non-

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652 [1897] A.C. 22

management shareholders with 'entrepreneurs' seeking to show that some shareholders were 'independent'. Furthermore, there is no guarantee that greater diversity in the ownership of firms would prevent excessive risk shifting, moral hazard and unfit conduct. Part-managers and 'independent' shareholders may be just as likely effect excessive risk transfers as single entrepreneurs.

9.4.2 A Minimum Capital Requirement.

The imposition of a minimum capital requirement for private limited companies is a potentially more attractive reform to reduce 'abuse' of limited liability. Minimum capital requirements are commonplace in continental jurisdictions where they are seen as an important method of protecting creditors from abuse of limited liability[654]. They have not, however, proved popular in the Anglo-American legal tradition[655], and the rules relating to minimum capitalisation in the UK apply only to public companies. The combined effect of section 11 and 118 of the Companies Act 1985 is that a public company cannot commence trading unless it has allocated at least £50,000 of capital, although only one-quarter of that

[653] See chapter 2, *supra*.
[654] See J. Freedman, *Limited Liability: Large Company Theory and Small Firms* (2000) 63 MLR 317. Freedman notes at pages 335-336 that there has been some relaxation of capital requirements and they are not universally accepted as a successful method of creditor protection.
[655] The extent to which free access to limited liability has welded itself to notions of free enterprise is evident in the 7th edition of *Gower and Davies' Principle of Modern Company Law* which states that one risk associated with introducing a minimum capital requirement into UK would be that it was set at too high a level, which would "simply reduce competition (by discouraging new entrants into the field [of limited liability]". P Davies, *Gower and Davies' Principles of Modern Company Law*, 7th Edn, (London, Sweet & Maxwell, 2003), page 229.

amount need be paid-up[656]. In addition to the requirement that public companies have minimum capitalisation, the Act proscribes that if a company's net assets fall below one-half of its capital, the company must convene a shareholders meeting to consider whether any steps should be taken[657]. Private companies however, are not subject to this provision.

The issue of extending the minimum capitalisation requirement to private companies was discussed by the Company Law Review Steering Group as part of its recent review of UK company law. The Steering Group rationalised rules regulating share capital as mechanisms of creditor protection[658]. However the group's work focused on how current rules regulating the raising and maintenance of capital[659] could be reformed to meet this objective and it did not encourage consultees to advocate the introduction of any restrictions on access to limited liability[660]. The notion of extending minimum capitalization requirements was, unsurprisingly, reject by the group but was favoured by a number of respondents to the Review Group's consultation exercise[661].

In the academic literature the notion of minimum capital requirements as an effective method of creditor protection has been widely

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656 Section 101(1) Companies Act 1985. On the Companies Act requirements, see generally E. Ferran, *Creditors Interests and 'Core' Company Law* (1999) 20 Co Law 314.
657 *Ibid* section 142.
658 Company Law Review Steering Group, *The Strategic Framework,* (London, DTI 1999) page 81.
659 *The Strategic Framework, ibid,* chapter 5.4. For the groups final recommendations on regform of the capital maintenance regime see. Company Law Review Steering Group, *Completing the Structure*, (London, DTI, 2000, chapter 7.
660 Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework* (London, DTI, 1999). The group posed the question to consultees 'is it agreed that it is not desirable to restrict access to limited liability? If not, then what constraints should be considered?

criticised[662]. Instead the rule is discussed simply as a mechanism for restricting access to limited liability, as, indeed, it was by the Company Law Review Group[663].

The argument that minimum capital requirements are, in themselves, effective mechanisms to protect creditors from loss must always have been more illusory than real because to be effective a capital requirement would have to vary according to the riskiness of the business[664], equal the company's highest expected level of debts[665] and would have to accompanied by rules preventing the loss of capital through trading. As Cheffins comments, the mere fact that a company's memorandum states that it has a certain level of capital is no guarantee that the stated sum will be available if the company is in financial distress[666].Thus it is easy to see why a simple capital requirement is viewed as an unattractive form of regulation if the objective of policy is to protect creditor's interests.

It is for this reason that rationalisation of minimum capital requirements tends towards their benefits as methods of restricting access to limited liability. This benefit is particularly useful to questions presented in

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[661]See Freedman, *supra* note 654, page 336.

[662] See for example, Freedman, *supra* note 654, Easterbrook and Fishcel, *The Economic Structure of Corporate Law*, (Cambridge, Mass, 1991) Chapter 2, H. Hansmann and R. Kraakman , *Towards Unlimited Shareholder Liability for Corporate Torts*, (1991) 100 Yale LJ 1879, B.Ceffins, *Company Law: Theory Structure and Operation* (Oxford, Claredon Press, 1997) and J. Armour, *Share Capital and Creditor Protection: Efficient Rules for Modern Company Law* (2000) 63 MLR 355..

[663] *The Strategic Framework, supra* note **Error! Bookmark not defined.**, chapters 5.1 – 5.6.

[664] P. Davies, *Gower and Davies' Principles of Modern Company Law*, 17th Edition, (London, Sweet and Maxwell 2003) page 229.

[665] Easterbrook and Fischel, *ibid*, page 60

[666] B. Cheffins, *Company Law: Theory Structure and Operation* (Oxford, Claredon Press, 1997, page 531. See also Gower and Davies, *supra* note 664, pages 229-230, Freedman, *supra* note , page 337

response to the failure of disqualification. However, before this aspect of a minimum capital requirement is considered, it is intuitive to consider other benefits that such a rule could bring..

9.4.2.1 Corporate Prospects and Moral Hazard.

The undercapitalisation of private companies has been an area of concern noted by several inquires into UK company law[667]. The danger posed by such undercapitaliastion is essentially twofold, depending upon the precise definition of 'undercapitalisation' adopted. In the first instance 'undercapitalisation' can refer to a company in which insufficient capital is injected to give the business a realistic chance of success . 'Capital' in this sense would include, share capital, loan capital and any other source of finance put into the business as it's inception. In essence, therefore such a company can be described as having *insufficient* capital. Lending to a company with *insufficient* capital will be significantly riskier than lending to companies with adequate capitalisation,. In the second incidence undercapitalisation can refer to a company which has a *small amount of share capital.* These two aspects of undercapitalisation are in no way exclusive, indeed they will often go hand in hand. A company, for example, which has insufficient capital for its business needs will often have very little share capital and in all cases will have *insufficient* share capital. That said, it is possible for a company to have very little share capital, yet not be

[667] See, for example, *Report of the Review Committee on Insolvency Law and Practice*, (Chairman Sir Kenneth Cork), Cmnd 8558, (London, HMSO, 1982), which proposed reforms to designed to penalise those who abuse the privilege of limited liability by operating behind one-man, insufficiently capitalised companies", (ibid, para 1815). See

undercapitalised in so far as it has adequate capital fro other sources to meet its business needs.

Nonetheless, both aspects of undercapitalisation pose a danger to creditors, in the case if *insufficient capital* through increased risk of failure, and in the case of *small share capital* from acute 'moral hazard'[668]. The moral hazard problem where shareholders limit their liability to a nominal investment is, as has been noted in previous chapters, a particular concern in the UK where the overwhelming majority of companies having £100 or less of capital[669].In terms of whether this statistic demonstrates a large number of companies with *insufficient* capital, however, we must be cautious not to conclude that *all* such companies have insufficient capital. It is likely that in many small companies share capital is seen primarily as a device to limit liability and bares little relation to the money actually injected in the business[670]. As such many, apparently undercapitalised companies will actually have received a significantly higher injection of cash in the form of loan capital[671]. Nonetheless even if such companies are

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also, *Company Law Committee Report* (Chairman Lord Jenkins) Cmnd. 1749 (London, HMSO, 1967),

668 Halpern, Trebilcock and Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, (1980) 30 U. Toronto L.J. 117. On moral hazard generally, see T. Baker, *On the Genology of Moral Hazard*, (1996) 75 Texas LR 237; E. Bele Posner and Moral Hazard, (2000) 7 Conn. Ins. LJ 81; S. Chandler, *Visualising Moral Hazard*, (1995) 1 Conn, Ins. LJ 97; G. Goble, *The Moral Hazard Clause of the Standard Fire Insurance Policy*, (1937) 37 Columbia L. Rev 410. For a slightly different view of moral hazard see D. Stone, *Beyond Moral Hazard: Insurance as a Moral Opportunity* (1991) 77 Cornell Law Rev. 1099.

669 *Companies in 2003-2004*, (London, DTI, 2004), table A7, chapter 2, *supra*.

670 J. Freedman and M.Godwin, *Incorporating the Micro-Business: Perception and Misperceptions*, in A.Hughes and D. Story, Finance and the Small Firm, (London, Routledge, 1994).

671 Freedman and.Godwin's survey of incorporated and unincorporated businesses, (*ibid).* found that borrowing from banks and trade creditors were the largest sources of finance for incorporated businesses and that capital 'invested by the owner' was cited as the 'most

not at the increased risk of insolvency associated with *insufficient* capital, the moral hazard associated will small share capital is certainly an acute danger.

The Jenkins Committee felt that the introduction of a minimum capital requirement for private companies would help ensure that companies had some 'financial substance' to be of benefit to creditors. However, whilst the committee's report 'reluctantly' declined to recommend the institution of a minimum capital requirement because of the ease with which it could be evaded, the idea was taken up by the 1973 White Paper of company law reform[672].

Minimum capitalization certainly has the potential to address both the problems of insufficient capital being contributed to companies and that of 'moral hazard' in companies with particularly small amounts of share capital, and in so far as disqualification is intended to tackle both problems (especially moral hazard) its institution *could* be an attractive form of substitute regulation. A rule ensuring that companies were sufficiently capitalized before they began trading, for example, ought to reduce chances of business failure and in so doing benefit creditors, as well as addressing the 'moral hazard' problem by preventing incorporators from shifting the risk of their businesses activities to their creditors to the extent that they are currently able do. In short increased investment should increase the

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important source of finance' in substantially fewer incorporated companies than was the case in unincorporated firms (21.6% citing self-finance as 'most important' in companies compared to 70.5% in unincorporated firms), *ibid*, page 259.

[672] Department of Trade and Industry, *Company Law Reform White Paper*, Cmnd 5391 (London, HMSO, 1962), para 27. The reforms, were however, never implemented.

incentive for owner-managers to behave responsibly and, therefore, reduce moral hazard[673].

However, to be effective in reducing both problems it would be necessary that the any capital requirement was related to the riskiness of each individual business. In terms of the problems of insufficient capital, they can, rather obviously, only be eradicated by ensuring that companies have an amount of capital that is suited to the particular needs of their trade or business. In order to be regarded as adequately capitalised, some businesses, such as those with high start-up costs, would require relatively high levels of capital. Some businesses on the other hand, such as a company incorporated to obtain tax advantages for it incorporator and which has no plans to grow, would need relatively little capital. In short, what constitutes 'sufficient' capital is an entirely subjective matter, and the more risk that is associated with a particular business the more capital it would need. Therefore a uniform minimum capital requirement (such as that applied to public companies) is most unlikely to resolve problems associated with insufficient capitalisation. Under such a rule some companies would certainly remain insufficiently capitalised (although perhaps to a lesser degree than they would be without a minimum capital rule) and other companies would be required to invest too much capital.[674] Much the same problem arises with a minimum capital requirement as a solution to the problem of 'moral hazard', although perhaps to a lesser degree.

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[673] A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, (1992) 102 Yale LJ 387 at page 421.
[674] Grundfest, *ibid*, and Easterbrook and Fischel *supra* note 664, Freedman, *supra* note 654.

The 'moral hazard' that exists where entrepreneurs invest a minimal amount of capital in a company is determined by the entrepreneur's incentive to maximise his own welfare at the expense of others. The extent of that incentive (and hence the 'moral hazard') will itself be determined by the characteristics of each entrepreneur. The economic definition of 'moral hazard' has tended to eschew the 'moral' element of the incentive to engage in risky conduct, at least in so far as criteria such as honesty are trustworthiness are relevant[675]. Instead economists focus exclusively on the 'rational' economic incentive maximise welfare. Nonetheless, the economic 'moral hazard' recognises variation in incentives between different individuals[676]. Thus, whether it be because of greater honesty of varying incentives to maximise welfare, the 'moral hazard' accompanying limited liability will vary in each individual case. Therefore, if a minimum capital requirement, were to effectively tackle 'moral hazard' it too would have to vary according such characteristics. Thus, the more likely an individual was to exploit moral hazard, the higher his required investment should be in order to of-set this temptation.

However, whilst variable capital requirements would be necessary to effectively address the problems of moral hazard and business failure, they are likely to be highly impractical, if not impossible, rules put into law. Such rules would be complex to formulate, apply and administer; requiring exhaustive inquiry into hundreds of business sectors and modes of

[675] See generally T. Baker, *On the Genealogy of Moral Hazard*, (1996) 75 Texas LR 237
[676] Baker *ibid.*. See also K. Arrow, *The Economics of Moral Hazard: Further Comment*, (1968) 58 American Economic Review 537.

entrepreneurial conduct in order to formulate appropriate benchmarks to be applied to each business and individual. In addition, a complicated statutory formulation of different capital requirements would be needed. Lastly, and perhaps most importantly, a burdensome administrative procedure would be necessary if the law where to be effective, whereby each company and entrepreneur was assessed by the registrar to ensure that an appropriate capital requirement was set and complied with. Furthermore, if such rules were to provide meaningful protection to creditors in the long-term, capitalisation would have to be kept under review as companies grew and their business diversified.

The practical hurdles to an effective (variable) capital requirement are therefore significant and likely to defy attempts to easily overcome them. A capital requirement that varied simply with a company's turnover, for example, would be relatively crude and ineffective as turnover is not a reliable indicator of the risk of the business or indeed the entrepreneurs dispensation to exploit moral hazard. Indeed, turnover is a difficult criterion to use as minimum capital would have to be set at incorporation when turnover could only be *projected*. Actual turnover may prove to be very different from that envisaged before trading. The necessity for variability in minimum capital requirement for them to be effective, but the problems inherent in such a regime, therefore make the rule an unattractive method of creditor protection.

9.4.2.2 A Minimum Capital Requirement and the Diversification of Shareholding.

An appropriately high minimum capital requirement could also reduce the likelihood of undesirable conduct by reducing the number of owner-managed companies, thereby making the model of shareholder monitoring a more realist strategy to control directors' conduct. To achieve this goal the capital requirement would have to be set at a level that made it unlikely that individuals would be able to incorporate alone and therefore made it necessary to attract outside investment. The consequential increase in diversification of ownership that this would cause would increase the prospects of monitoring by risk-minimising investors[677] and therefore decrease the risk of 'abuse of limited liability'. However, as I have previously stated, diversified shareholding is only likely to reduce unfit conduct to the extent that shareholders are willing and able to monitor managers. It should also be recognised that a capital requirement is not certain to increase diversification in ownership of all companies. For, whatever the level at which the requirement was set, some individuals would still be able to incorporate. However, even with these drawbacks the capital requirement would still have the advantage of forcing those individuals who

[677]Some authors have claimed that increased monitoring would lead to wasteful transaction costs, see, Halpern, Trebilcock and Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, *supra* note 642, and Jensen and Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, (1976) 3 Journal of Financial Economics 305. The claim has been made in response to the proposed upsurge in monitoring that unlimited liability would bring about, but would be equally applicable any to increase in monitoring brought about by a diversification in the ownership of firms. In either context the claim that increased monitoring leads to increased transaction costs can hardly be a disadvantage if it reduces mismanagement and moral hazard.

incorporated to bear more risk and increase their incentive for responsible management.

9.4.2.3 Restricting Access to Limited Liability.

As a vehicle to prevent the regulatory problem that disqualification fails to resolve, perhaps the main advantage of a minimum capital requirement is simply that it would form a barrier to incorporation preventing the riskiest of entrepreneurs from obtaining limited liability[678]. For, assuming that risky individuals would find it hard to attract outside investment and be reluctant to invest significant sums of their own money in the company, unfit individuals would be less likely to incorporate. Of course this depends on Banks and other potential suppliers of capital being able to identify 'rogues'. Indeed, it was for this reason that the Jenkins Committee originally proposed the introduction of a minimum capital requirement in the UK[679]. Freedman also claims that a minimum capital requirement would prevent 'frivolous' incorporations[680]. However, it is submitted that to be successful in significantly reducing use of limited liability by 'unfit' individuals and by definition reducing the 'abuse' of limited liability at which disqualification is targeted, a minimum capital requirement would essentially have to mimic the idealised perfect market with unlimited

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[678] See Kahn-Freud who argued that minimum capital requirement would make incorporation more difficult and expensive thereby restoring limited liability companies to their 'original function', O. Kahn-Freund, *Some Reflections on Company Law Reform* (1944) MLR 54.
[679] Company Law Committee Report (Chairman Lord Jenkins) Cmnd 1749 (1962). The white paper following the report proposed a £1000 capital requirement as a method of reducing 'frivolous' incorporations (see Company Law Reform white Paper, Cmnd 5391 (1973). The proposal however was not pursued following the general elections of 1974.
[680] Freedman, *supra*, note 654.

liability, i.e. prevent individuals who could not obtain limited liability in the market from incorporating.

A consequence of the introduction of a successful minimum capital requirement would therefore be a decrease in the number of firms with limited liability. For, entrepreneurs who could not attract sufficient capital would not gain limited liability and be subject to the full force of the market in their dealings with creditors. Any notion that this decrease in limited liability would be undesirable because it reduced 'competition'[681] and by implication, wealth creation, would be misconceived. Generally, businessmen with unlimited liability are more likely to strike welfare-maximising bargains with their creditors. Unlimited liability for the individual is, indeed, preferable to a situation of statutory limited liability where the entrepreneur is able to oust the market from his dealings with the creditor with the harmful consequences that disqualification tries (and fails) to resolve through regulation. Further, individuals denied statutory limited liability are also likely to be more efficient risk takers because as Eucken notes[682], unlimited liability creates incentives for the unincorporated entrepreneur to take more care of his business by bearing the risk of his activities and to learn about responsible management through his bargaining with creditors.

[681] Davies, *supra* note 664.
[682]W. Eucken, The *Foundations of Economics* (Berlin, Springer-Verlag, 1992), cited in D. Campbell and S. Griffin, ENRON and the End of Corporate Governance, in S. MacLeod and J. Parkinson, (eds), *Global Governance and the Quest for Justice*, vol 2, (Oxford, Hart Publishing, 2004). See also Kahn-Freund, *supra* note 678.

Of those entrepreneurs who could not initially obtain statutory limited liability, only those whose businesses grew successfully under conditions of unlimited liability, or who were able to meet the capital requirement by way of a loan, would be able to avail themselves of limited liability once they had amassed sufficient capital to incorporate. Consequently, the likelihood of abuse of limited liability by those who obtained it would be much reduced compared to the current situation where an entrepreneur is able to avail himself of limited liability *ab initio* and shift risk even if he has no experience of managing a business.

A potential problem with a minimum capital requirement however is that its ability to prevent undesirable individuals from obtaining limited liability depends upon it being set at an appropriate level. The difficulty in finding such a level is a common ground for criticism of minimum capital requirements[683] and have been noted in an earlier part of this discussion. However, where a capital requirement was used simply restrict access to limited liability, (as opposed to solving the problem of insufficient capital or 'moral hazard'), it could be argued that there is a less pressing need to ensure that capital varies according to risk of the venture or the characteristics of the individual entrepreneur. All that would appear to be required is that the capital rule was set at such a level as to prevent incorporation by risky individuals. In essence the function of the minimum capital requirement would be to restore market transactions to the

[683] Easter brook and Fischel, *supra* note 664, H. Hansmann and R. Kraakman, *Towards Unlimited Shareholder Liability for Corporate Torts* (1991) 100 Yale LJ 1879.

acquisition of limited liability, i.e. limited liability could only be obtained through transacting with creditors. The major difference, however, is that under a default rule of unlimited liability multiple transactions specifically creating limited liability are needed, whereas with a capital requirement only a single (or small series of) credit transactions are needed. Therefore an advantage of a minimum capitalization requirement would be that it restored some market control over the acquisition of limited liability, whilst saving the transaction costs associated with multiple bargaining.

However, as the acquisition of limited liability under a regime with minimum capital requirements would rely upon the actions of creditors, the same criticisms discussed in earlier parts of this thesis apply, namely that transaction costs and information deficits will in many cases prevent the market from excluding rogues. However, in so far as entrepreneurs would need to produce minimum capital at the point of incorporation, a major source of credit to meet a minimum capital requirement is likely to be Banks and similar suppliers of credit[684]. In so far as Banks are more successful at accurately adjusting their terms of credit to characteristics of entrepreneurs and their businesses[685], a minimum capital requirement could be an effective at preventing 'unfit' directors from obtaining limited liability. On the other hand, the Banks still suffer from some information asymmetry and transaction costs when making decisions and some unsuitable individuals may obtain limited liability whilst others, who are 'suitable' would not. And

[684] Trade creditors, for example would not be a viable source of finance as they tend not to loan 'cash' that could be used to meet capital rules.
[685] See 3.3 above.

it hardly need be said that some 'unfit' individuals would always be able to satisfy a minimum capital requirement without the need for credit.

A more fundamental criticism of the notion that Banks would be effective gatekeepers for limited liability is that their bargaining with entrepreneurs will be self-interested, and as such, be of little benefit to other creditors. Where an entrepreneur sought a loan from a Bank to meet a minimum capital requirement, the Bank's objective would be to protect itself by taking security over corporate and personal assets[686] as well as adjusting interest payments to risk[687]. The Bank would not be concerned with ensuring that limited liability was only obtained by 'responsible' individuals. Where the Banks' welfare goals could be satisfied they would be likely to advance credit, thereby allowing the acquisition of limited liability and there is no guarantee that the self-interested bargain of the bank would exclude unfit individuals and therefore protect creditors. Indeed, very risky individuals may find it easy to obtain the necessary credit to incorporate if, in return, they are prepared to give a charge over their personal property that guarantees that the Bank will be able to recoup its credit (e.g. a mortgage on property of a value greater than that of the loan). In such a scenario the Bank will be happy but other creditors left in exactly the same situation as exists under the current law, i.e. contracting with a risky individual who has unilaterally invoked limited liability. Therefore, the notion that Banks and similar creditors will be effective 'gatekeepers' of

[686] Freedman and Godwin, *supra* note 670.
[687] R. Posner, *The Rights of Creditors of Affiliated Corporations*, (1967) 43 U. Chi. L.R. 499.

limited liability under a minimum capital regime is rather simplistic. In some cases the need to attract capital before investment *may* exclude the 'unfit', but it is by no means guaranteed to do so and Banks as will, quite naturally be self-interested in their bargaining.

Indeed, the self-interested nature of bargaining in credit transitions makes it quite likely that a minimum capital rule could be counter-productive for creditors. If a minimum capital requirement led to an increase in borrowing in the manner described above i.e. borrowing secured by charges on corporate and personal assets[688], then creditors who cannot or have not obtained similar security would be severely disadvantaged in insolvency proceedings. The increased ability of Banks to protect themselves with sophisticated security devices means that the sort of creditor who are likely to suffer from the rule would be exactly those whom it was designed to protect (e.g. trade creditors). Of course, the extent to which lending increased because of a capital requirement would depend upon the level at which the capital requirement was set. If the level were relatively low then there is unlikely to be a significant increase, at least in so far as the level is lower than the level of credit that entrepreneurs would have sought to finance the business in any case. However, in this scenario the capital requirement would not fulfil its purpose of deterring incorporation (at least in cases where Banks were indifferent to risk because of security devices). Rather, if it is to be effective in deterring incorporation,

[688] E.g Banks, which tend to take security for their debt, see Freedman and Godwin, *supra* note 670 .

the requirement would have to be set at a level that forced entrepreneurs to seek more credit than they otherwise would (i.e. to a point where risk was a controlling factor because security devices no longer provide a guarantee of repayment). Thus, to be effective at 'protecting' creditors from unfit directors with limited liability the requirement would have to increase the necessity to borrow, however, the more borrowing that were required the more disadvantaged unsecured creditors would become.

The introduction of a minimum capital requirement is not therefore, an attractive strategy by which to limit access to limited liability. In short it is plagued by significant practical barriers, doubts over the ability of creditors to exclude rogues from incorporating, problems of evasion and even the potential to harm certain groups of creditors.

Another strategy to reduce the moral hazard associated with statutory limited liability is liability insurance. Insurance has sometimes been discussed as an alternative measure to a minimum capital requirement or other devices for restricting access to limited liability. However, there is no reason why liability insurance should be an alternative to such a system, for a precondition of liability insurance would be some legal rule to modify access to limited liability. In so far as one option is to abolish limited liability completely it can be viewed as an alternative to a capital requirement, which would merely restrict access to limited liability. However, my discussion is focused on the problem of limited liability in owner-managed companies and as such is not concerned with whether limited liability should be abolished for all companies; rather it is concerned with preventing the excessive moral hazard that accompanies undercapitalised incorporated individual. In this context insurance is not an alternative to a minimum capital requirement. A minimum capital requirement could be used as a mechanism to deny individuals access to statutory limited liability but insurance could have a role in providing limited liability for individuals according to market principles.

9.4.4 The Role of Liability Insurance.

The compensation model of statutory limited liability implies that far from allowing entrepreneurs to transfer risk to creditors, the rule actually obliges them to purchase a form of insurance from creditors. This 'insurance' is purchased in the form of the higher price for credit that must be paid for the benefits of limited liability[689]. However, the phenomenon is perhaps more accurately described not as debtors purchasing insurance but as creditors 'self-insuring', for creditors are forced into a position of risk by the statutory rule from which compensation is their only escape. However, it is clear that higher charges for credit will not always protect creditors from the effects of statutory limited liability. An alternative approach that could afford greater protection to creditors would be to replace statutory limited liability with a compulsory insurance requirement for entrepreneurs who wished to incorporate, thus leave the liability status of entrepreneurs to be determined by an insurance market. In such system only those who were

[689] One author attributes the existence of statutory limited liability to the failure of insurance markets. See Arrow, *Essays in the Theory of Risk Bearing*, (1971), cited in Halpern, Trebilcock and Turnbull, *supra* note 668, page 128.

able to obtain liability insurance would benefit from limited liability and be able to incorporate their business. Those who could not obtain liability insurance would not be able to incorporate and only benefit from limited liability to the extent that they were able to create it through bargaining with their creditors. Liability insurance could help prevent unfit persons from obtaining limited liability status because the market for insurance ought to exclude high-risk individuals.

In a properly functioning insurance market the conditions upon which an insurer were prepared to supply insurance to an entrepreneur would depend upon the insurer's assessment of the risk that the entrepreneur would default on his obligations. In assessing this risk the insurer will consider the same factors that creditors should consider when deciding on their terms of credit, such as the experience of the entrepreneur; i.e. the likely success of the business venture and the likely conduct of the entrepreneur. The insurance premium offered to the entrepreneur (if any) would reflect the insurer's assessment of these factors. Entrepreneurs who pose the greatest risk of default would therefore pay high premiums for liability insurance or may not be able to obtain insurance at all if the insurer's assessment of the risk of default is so high that he is unwilling to assume responsibility for the entrepreneur's actions. As such, it is likely that certain individuals who are currently able to obtain limited liability would not be able to do so under an insurance regime.

A regime of liability insurance could therefore have certain advantages for creditors as compared to a regime of statutory limited liability. However, so would the simple abolition of limited liability. For, under both rules risky individuals would be prevented from obtaining limited liability without paying appropriate compensation for the transfer of risk it would cause. The question then is whether a regime of compulsory liability insurance would have any advantage for creditors over the simple abolition of statutory limited liability.

9.4.4.1 Transaction Costs.

If limited liability were simply abolished, entrepreneurs who were able to benefit from it could only do so by negotiating with each of their creditors to limit their liability. However, creating limited liability through multiple negotiations with creditors has transaction cost implications[690], even if it ultimately leads to a more desirable outcome from creditors than statutory limited liability. A regime of liability insurance, on the other hand, has the potential to reduce these costs by replacing multiple liability transactions with a single transaction, whilst still subjecting the determination of limited liability to market forces. As such it could lead to greater efficiency.. In the context of liability insurance this argument is persuasive because the saving would not come, as is the case with statutory limited liability, at the price of ousting market transactions[691]. For, the entrepreneur's ability to obtain liability insurance would depend upon a bargain with insurers and therefore would be subject to the market.

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[690] Reducing such transaction costs have been one reason cited in support of statutory limited liability. See for example Easterbrook and Fischel, *supra* note 639 chapter 2.
[691] See chapter 3, *supra*.

9.4.4.2 Contracting Around Liability Status and Information Gathering.

A further advantage of liability insurance would be to reduce the incentive for *creditors* to bargain away from an entrepreneur's liability status because liability insurance ought to provide greater security that their debts would be paid without the need to adjust interest charges to risk or to take security over corporate and personal assets. Indeed, the fact that an entrepreneur obtained insurance under market conditions could reduce information gathering and *ex post* monitoring by creditors in so far as indicated that indicate that the risk associated with advancing credit to the entrepreneur was not excessive. Instead of costly inquires into the creditworthiness of entrepreneurs creditors would only need to check that the firm had an adequate insurance policy in place to pay his claim in the event of insolvency.

However, whilst liability insurance *may* reduce transaction costs for creditors, it has been claimed that liability insurance would not bring about a reduction in overall transaction costs[692], but instead merely transfers them from creditors to an insurer. It has even been argued that liability insurance could increase transaction costs[693]. The contention that insurance increases transaction costs is based on a claim that it is often cheaper for creditors to gather information than an insurance company. Halpern Trebilcok and Turnbull give the example of employees who are familiar with a company's

[692] Halpern, Trebilcock and Turnbull, *supra* note 668, page 139.
[693] *Ibid.*

financial situation is given to support their view that 'creditors' will often find it easier to obtain information due to their frequent contact with the company[694]. However, even in the given example, it is far from certain that transaction costs facing creditors would *always* be lower than those faced by insurers, much must depend on the degree of familiarity employees have, the completeness of their knowledge as to the future direction of the company, and the ability to interpret any information they have. However, even if it was accepted that such creditors were efficient gathers of information, employees who are 'in the know' are likely to be only one small group of creditors amongst many not least other employees who are not so privileged with their access to information. The majority of a company's creditors without detailed financial knowledge will be forced to incur transaction costs information gathering, in spite of the savings of knowledgeable employees. In short, the low transaction costs incurred by one narrow and privileged class of creditor simply does not demonstrate that overall transaction costs under a regime of liability insurance would rise. Indeed, it is much more plausible to state that transaction costs would be *reduced* information gathering was restricted to a single entity (i.e. the insurer) rather than where it is carried out by many creditors. For, the overall costs of information gathering are bound to be higher where the same information gathering tasks are repeated, which is likely because in the real (imperfect) market, individual trade creditors, banks, employees and consumers are not able to pass information freely between themselves. This

[694] *Ibid.*

is likely to lead to wasteful repetition of information gathering. Where market insurance is purchased however, a single entity – the insurer- is responsible for information gathering and consequently wasteful repetition should be eliminated. Similar savings could also result in the monitoring of entrepreneurs conduct post-contract.

9.4.4.3 Moral Hazard.

Despite its potential advantages in terms of transaction costs a potential drawback with liability insurance, is the moral hazard that is likely to give rise to i.e. that once liability has been limited the entrepreneur has an incentive to engage in unforeseen risky activities, increasing the probability that the insured event will occur[695]. Insurers would therefore be faced with the task of controlling moral hazard through contract and monitoring[696]. In term of their ability to control moral hazard through monitoring, Halpern, Trebilcock and Turnbull imply that insurers are in a less advantageous position than ordinary creditors due to the fact that they are unlikely to be in daily contact with the insured entrepreneur[697] and therefore incur costs of yet more information gathering. However, whilst this may be true in some cases, many creditors will not be in such daily contact. As such the *overall* cost of monitoring could still be lower under a regime of insurance where monitoring is undertaken by single an insurer rather than many creditors, some of whom may be close to the company and therefore incur relatively small coats but many others who will not. In any case insurers are likely to

[695] Halpern, Trebilcock and Turnbull, *supra* note 668 pages 140-141, Freedman, *supra* note 654, page 340.
[696]

develop a degree of expertise in monitoring and are also able to monitor conduct when renewing insurance contracts and are likely. Indeed, the necessity to renew insurance creates an incentive for insured entrepreneurs *not* to exploit moral hazard, in so far as unforeseen conduct under one insurance contract leads to an increase in premiums under a subsequent one. Insurers could maximise this potential control on moral hazard by insisting short contracts, especially in the case of individuals who are largely unknown to them.

In terms of contractual controls on moral hazard, insurers, unlike creditors on the receiving end of statutory limited liability, can easily create incentives for entrepreneurs not to engage in unforeseen risky activity by including a clause in the insurance contract excluding reckless, negligent, dishonest activity from the insurance cover[698]. Such uses of contractual terms to limit to exclude 'moral hazard' are widespread in many areas, such as home and motor insurance contracts. However, whilst such clauses in liability insurance contracts would benefit insures and create an incentive not to engage in risky conduct, any limitation on insurance cover would act as an incentive for *creditors* to continue monitoring director's behaviour, to ensure that their activities were within the terms of their insurance. As such any exclusion clause in an insurance contract is likely to give rise to repetitious creditor monitoring, thereby reducing monitoring cost savings. Insurers obviously have a strong incentive to exclude excessively risky (or

[697] *Ibid,* page 141,

unforeseen) conduct and it is likely that complex exclusion clauses would be routinely included in liability insurance contracts[699]. Therefore, the extent to which liability insurance could reduce monitoring costs is likely to be limited.

9.4.4.4 Risk.

The difficulty in predicting the risk involved in liability insurance for entrepreneurs is another ground upon which such a regime could be criticised. Finch has noted that a difficulty in predicting risk has been a perceived problem with the market for directors' liability insurance[700] and similar problems in relation to liability insurance could lead to insurers simply declining to offer liability insurance or problems associated with 'adverse selection' i.e. insurers charging set premiums to certain classes of creditors that may over, or under-estimate risk in individual cases.[701] Where adverse selection leads insurance premiums to be too high, desirable entrepreneurial activity may be stifled, whereas when it is too low excessive risk taking may result.

The challenges faced by insurers in assessing risk stem from the same information deficits and transaction cost considerations that afflict

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[698] Freedman *supra* note 654 , page 340, V. Finch, *Personal Accountability and Corporate Control: The Role of Directors and Officers Liability Insurance*, (1994) 57 MLR 880, page 888. Halpern, Trebilcock and Turnbull, *supra* note 670, page 140.
[699] See Finch *ibid* , who notes the problems caused by exclusion clauses for directors' liability insurance in the US.
[700] Finch, *supra* note 622 , page 894. On adverse selection generally see T. Baker, Containing the Promise of Insurance: Adverse Selection and Risk classification (2003) 9 Conn. Ins. LJ 371 and S. Chandeler, Visualising Adverse Selection: an Economic approach to the Law of Insurance, (2002) 8 Conn Ins. LJ. For a critical view see P. Sieglerman, Adverse Selection in Insurance Markets: An Exaggerated Threat, (203) 113 Yale. LJ 1223.
[701] Halpern, Trebilcock and Turnbull *supra* note 668, pages 141-142.

ordinary creditors, and which have been considered above[702]. However, whilst information asymmetry and the impact of transaction costs will undoubtedly be of relevance to insurers, their concerns would not be of the same magnitude as those of ordinary creditors.

The practice of dealing with many similar firms means that insurers are likely to quickly develop a degree of expertise in interpreting the information obtained from firms in a manner that ordinary creditors cannot[703]. In developing the ability to turn raw information into an accurate assessment of risk, insurers are also aided by having greater resources to spend on information gathering than individual creditors and through having the ability to pass on such cost through the insurance premium. Significant benefits must also derive from one organisation holding information of companies' trading histories. In addition to the benefits associated with dealing with many firms and having better resources insurers, as suppliers of a valuable commodity to entrepreneurs who wish to incorporate, would be more likely to obtain the disclosure of information than individual creditors, for the same reasons that banks are able to obtain disclosure of information under the current system of statutory limited liability[704]. Insurers are also more likely to be efficient at sharing information amongst themselves. Therefore, compared to a disparate group of creditors, insurers are likely to be more efficient estimators of risk.

[702]

[703] Finch notes the ability of insurers to develop their expertise and information sources. Finch, *supra* note 622, page 890.
[704] See 3.3 *supra*.

I do not, however, argue that a regime of liability insurance would always secure optimal allocations of risk. Some adverse selection, for example, is bound to occur in an imperfect insurance market. All I seek to demonstrate is that information asymmetry would be less of an obstacle to a single insurer than a group of creditors. Consequently insurers could be more efficient than individual creditors at forcing entrepreneurs to pay appropriate compensation for the privileges of limited liability. Thus, in an insurance system the riskiest entrepreneurs are more likely to be excluded from limited liability. Therefore, the growth of a market for insurance liability for firms with a default status of *un*limited liability could be a desirable occurrence.

9.4.4.5 'Market Failure'.

Several authors have commented on the fact that liability insurance would create barriers to incorporation for small companies, especially where entrepreneurs have no record of running a business on which an insurer could rely[705]. However, the fact that many owner-managed companies would fail to obtain liability insurance under market conditions is not, as some have claimed[706], an example of the failure of insurance markets. Rather it is evidence of their success. For, where insurance markets would not provide limited liability it is likely that creditors would not grant companies limited liability either, if they were given the choice.

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[705] Freedman, *supra* note 654, page 340, Easterborrok and Fischel, *supra* note 664 page 61.
[706] See, Halpern, Trebilcock and Turnbull, *supra* note 668, page 143.

There are essentially two reasons why an entrepreneur may fail to obtain liability insurance. First he may not obtain it because insurer refuses to insure. This may occur either because the risk associated with his venture was too high for the insurer, or because insufficient information exists for the insurer to accurately price risk. Secondly the entrepreneur may fail to obtain insurance because he unable to afford the premium demanded. In either scenario there is no market failure because individuals will not obtain limited liability because the risk of assuming responsibility for their actions it is greater than its likely benefit, i.e. the risk of them defaulting is greater than the compensation they can pay. Were liability to be assumed in such circumstances, an uncompensated transfer of risk would result in sub-optimal risk taking. The situation indeed, is the same as that which would exist under a system of unlimited liability between entrepreneurs and creditors. For there also entrepreneurs would not obtain limited liability where the risk to the creditor from it was greater than the compensation that could, or would, be paid. Therefore there is no market failure where entrepreneurs would not obtain limited liability in an insurance market, on the contrary there is a market success because individual are prevented from affecting an uncompensated transfer of risk. There is however, a clear failure caused by statutory limited liability that permits entrepreneurs to invoke limited liability without risk pricing ever becoming relevant.

9.4.4.6 Problems with Insurance Markets.

However, whilst insurance liability affords the prospect of more efficient allocation of risk, formidable drawbacks to the operation of an insurance market are likely to be encountered. Many factors may prevent insurance from being a more efficient mechanism to determine liability status than individual negotiation. For example, insurers may seek to limit their exposure to risk by offering only short-term insurance contracts to entrepreneurs, which would lead to considerable uncertainty for creditors[707]. The creditors of an entrepreneur who is unable to re-new his insurance, for example, would find themselves bearing a sudden and uncompensated risk if the removal of liability insurance in so far as a claim on an entrepreneurs assets is less secure than a claim on an insurance company. In most cases assets of the entrepreneur are likely to be less than those of the insurer and as such creditors would be exposed to greater risk by the ending of the insurance contract. Assuming that liability insurance could be terminated, creditors would have an incentive to make contingency for a change in insurance status, at the time of contracting with the entrepreneur but in doing do would be compelled to undertake the information gathering as to the creditworthiness of the entrepreneur without insurance. In which case, insurance would not greatly reduce the transaction costs incurred by the creditor (as compared with simple regime of unlimited liability). In the event that the parties had not made contingency for the ending of an insurance contract, creditors are likely to attempt to renegotiate their terms of credit in line with the new level of risk, causing costs to be incurred by all parties.. The likely operation of an insurance market therefore suggests that the

[707] Finch notes that short term cover has been a problem in the market for directors and officers' liability insurance in the US and Canada, Finch, *supra* note 622, page 893.

apparent transaction cost savings of a liability insurance regime would be illusory. Similarly the possibility that an insurance contract would be ended would create an incentive for creditors to monitor entrepreneurs' conduct, reducing another apparent benefit of insurance. Thus, an insurance system could prove just as costly for creditors as individual liability negotiations.

Finch's study of directors' and officers' liability insurance highlights other problems with insurance markets, such as the instability of such markets and their vulnerability to shocks and uncertainties, both domestically and globally[708]. Indeed, cyclical increases in corporate insolvencies would be likely to cause increases in insurance premium, leading to more pressure on small businesses and increased uncertainty for creditors (in that some firm may lose their insurance due to an inability to pay increased premiums). This would be particularly dangerous during in periods of the economic cycle where insolvencies tend to increase for the consequent rise in insurance premiums could force *more* companies into insolvency thereby magnifying a slow down.

Therefore, a compulsory insurance requirement is not certain to be more advantageous than the simple removal of limited liability from high risk individuals which are currently allowed to incorporate and at which disqualification is aimed. However, that is not to say that is should be discounted, but it would be unwise to suggest that a compulsory insurance requirement is the most desirable method of reducing unfit conduct. Rather, liability insurance may have some benefit but it would be unwise to compel entrepreneurs to obtain it. Thus, it is merely contended that within a system that required more entrepreneurs to have unlimited liability, insurance *could* provide an advantageous mechanism by which some entrepreneurs could obtain limited liability more cheaply than through negotiation with individual creditors. However, the development of an insurance system must ultimately develop without compulsion.

9.6 Statutory Limited Liability and Companies that are not Owner-Managed.

Throughout this chapter I have considered the modification of the current approach to limited liability as a desirable method to reduce unfit conduct by owner-manager directors. I have not directly addressed the question of limited liability and unfit conduct in larger companies with diversified ownership and control[709]. I have not done so because the main regulatory problem addressed by disqualification is unfitness in small owner-managed companies. Nonetheless, as it is clear that disqualification is as unsatisfactory a remedy for undesirable conduct in larger companies, as it is in small companies the issue of how best to deal with unfit conduct by directors of larger companies cannot be ignored.

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[708] Finch, *supra* note 622, page 896.

[709] Research carried out by Andrew Hicks suggests that around 25% of disqualified individuals were directors of companies that could not be characterised as owner-managed. See Hicks, ACCA Report, *Disqualification of Directors: No Hiding Place for the Unit?* (London, Certified Accountants Educational Trust, 1998).

9.6.1 Larger Companies and Limited Liability.

The different nature of unfitness in larger companies necessitates a different form of regulation to that in owner-managed firms. Directors of companies that are not owner-managed do not benefit directly from limited liability. It is therefore incorrect as a matter of fact to describe unfitness in large companies as an 'abuse of limited liability' because directors who do not own the companies they manage do not benefit from limited liability *per se*. Directors of such companies benefit only from separate corporate personality, because it is that which protects them from personal responsibility for their acts, not limited liability. Limited liability protects shareholders in insolvency; it does not benefit directors (unless they happen to be shareholders as well). Thus, the recurring claim that disqualification is meant to address 'abuse of limited liability' only demonstrates its focus on owner managers. As far as directors of companies that are not owner-managed are concerned, any regulation directed against them should properly be termed regulation to prevent 'abuse of office' or 'abuse of separate personality'. Therefore, reform of limited liability would not be an effective strategy in larger companies, as it is not directly relevant to the problem of unfit conduct whether limited liability was, or was not, to remain for shareholders. Although it should be noted that the removal of limited liability would increase shareholders' incentive to monitor directors, more effectively[710]. However, the transaction costs of monitoring may limit the

[710] See D. Campbell and S. Griffin, *ENRON and the End of Corporate Governance, supra* note **Error! Bookmark not defined.**.

actual monitoring that takes place. Nonetheless, it is clear the issues raised by the failure of disqualification in larger companies is whether separate corporate personality rules can be reformed to eschew undesirable conduct.

9.6.2 Separate Corporate Personality.

The effect of corporate personality in larger firms is very similar to the effect of limited liability in owner-managed firms in that both are statutory interventions that divest corporate controllers of personal liability for their actions. As such, both interventions oust market forces that may prevent excessively risky conduct[711], which in the words of Adam Smith can lead to 'negligence and profusion'[712]. However, controlling the moral hazard created by the intervention is central to the prevailing model of the company, as has been shown earlier in this thesis. Thus, the conduct of directors in large companies is subject to the control of shareholders, through fiduciary duties and directors' contracts of employment that are supported by many company law rules. Thus, the likelihood of unfit conduct occurring and going unremedied is less for directors of larger companies than it is for owner-manager directors. However, where private controls fail to protect shareholders (and indeed creditors) from misconduct, some form of public regulation may be needed. Disqualification's attempt to respond to this need can be seen from the disqualification cases that resulted from the

[711] *Ibid.*
[712]A. Smith, An *Inquiry into the Nature and Causes of the Wealth of Nations*, R. H. Campbell. and A.S, Skinner (eds). (Oxford, Clarendon Press, 1976).

collapse of Bearings Bank[713] and PollyPeck[714] amongst others. Thus what is needed in place of disqualification in larger companies is a measure that effectively protects the 'public and commercial world' from unfit conduct where other control mechanisms fail.

A possible way to achieve this objective that follows the approach advocated for small companies would be to again remove the statutory intervention that creates scope for unfit conduct, which in this case is the separate personality of the company from its directors. However, removing the intervention would require directors to be personally liable for all of their acts and would be a disproportionate response to the problem of unfitness in larger companies, especially as there are devices built in to the structure of larger companies and various legal rules that ought to reduce the likelihood of unfit conduct. It would also be an undesirable response as it would make the risks of directing any reasonably large company exceed its likely benefits by far and would seriously compromise the legal personality of the company. However, whilst wholesale personal liability would not be a desirable response to unfit conduct[715], it could be a more effective sanction than disqualification in circumstances where reform of limited liability is not a viable option. Because personal liability would at least restore a measure of market control over directors' conduct and create disincentives for them to exploit their position. A personal liability provision would also be more

[713] *Re Barings Plc (No. 3)* [1999] 1 All ER 1017, *Re Barings Plc (No. 4)* [1999] BCC 960 and *Re Barings Plc (No. 5)* [1999] 1 BCLC 433.
[714] *Re PollyPeck Plc (No. 3)* [1996] 2 All ER 433.
[715] See 8.4.2, *supra*.

valuable to shareholders and creditors as it would allow them some opportunity to recover money lost through reckless or negligent conduct[716].

Therefore it is submitted that if the State wishes to effectively 'protect' from unfit conduct in larger companies is should develop a system that allowed the Secretary of State to seek personal liability orders on directors whose conduct is unfit and who have caused loss to creditors. Personal liability is likely to have a much more beneficial effect for creditors and avoid the waste of disqualifying individuals who are unlikely to commit future misconduct.

However, it must be emphasised that unfitness in owner-managed companies is the primary concern of disqualification and that the more radical reform proposed to deal with that problem is the most desirable way to protect the public for the sort of activity that section 6 disqualification currently tries, and fails, to do.

9.7 Concluding Remarks.

The removal of limited liability from owner-managers is the most desirable way to remedy the problem of unfit conduct that disqualification fails to resolve. However, stating that limited liability is the cause of 'the problem' and that it should be removed from owner-managed companies is the simple conclusion that can be reached from this study of section 6 disqualification. Much more difficult is suggesting how limited liability should best be denied to such companies.

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[716] As discussed in chapter 8 above.

An appropriately high minimum capital requirement is one way in which owner-managers could be prevented from obtaining limited liability, how the success of a capital requirement depends on it being set such an appropriate level. If it were set too low, high-risk individuals would still be able to obtain limited liability. If it were set too high it could prevent desirable enterprises from obtaining it. Therefore, no precise figure for such a minimum capital requirement could be suggested without extensive empirical research.

An alternative strategy would be to replace statutory limited liability for owner-managed firms with a mandatory liability insurance requirement for owner-managed firms. Insurance would bring the benefit of market determinations of liability status but significant question marks over the efficient operation of liability insurance make it unwise to conclude that compulsory insurance is a desirable path to proceed down. A workable definition of owner-management that brought the sort of firms that disqualification currently deals with within the insurance regime could also prove costly to formulate and indeed, to enforce.

Nonetheless, it is clear that reform of statutory limited liability, which prevented the sort of firms that characterise disqualification cases from obtaining limited liability, is needed. Whilst none of the methods of preventing undesirable firms from obtaining limited liability considered in this chapter is clearly favourable, it is submitted that if the State is serious about 'cracking down' on unfit directors the time and money to establish a regime of limited liability that reduced losses from unfit conduct could be found.

Conclusion.

The Purpose of Section 6.

Through its use of disqualification under section 6, the State seeks to regulate the moral hazard created by its policy of allowing free access to limited liability. It does so to prevent confidence in limited liability being undermined by the losses inflicted on creditors by 'unfit' persons. The objective of the sanction is therefore economic because it seeks to protect creditors from loss by the disqualification of persons whose conduct in the management of a limited liability company is likely to cause such loss.

The Need for Disqualification and Its Focus on Owner-Managed Companies.

Section 6 is a sanction that focuses on 'unfit' conduct in owner-managed companies, because such companies lack effective control mechanisms on directors which, combined with the limited liability, gives rise to a particularly acute hazard for creditors. Of course, problems with shareholder monitoring and market regulation can also arise in larger companies, in which case public regulation through section 6 may also be needed. However, other forms of regulation such as disclosure regulation and promoting the effectiveness of institutional investors and independent directors remain the focus of effects to prevent dishonest, reckless or negligent conduct by directors of larger companies.

Regulatory mechanisms that have traditionally been viewed as methods of controlling directors' conduct are based on a model of the company that simply does not apply to where there is absolute unity of ownership and control. Shareholder monitoring, either *ex ante* through contractual bargaining or *ex post*, through on the job monitoring, for example, is a monitoring strategy that simply does not apply to companies where the shareholders and directors are the same people. The control of various markets, such as the market for corporate control and the market for directors also do not apply to such entities because they do not seek capital from the public, have no tradable shares and do not seek to purchase the services of outside directors. However, the failure of these monitoring mechanisms creates a regulatory problem that is different to the 'problem' that which has traditionally preoccupied commentators in the field. For, the majority of monitoring devices are primarily aimed at controlling the agency problem that can a arise between directors and *shareholders*. However, in the sort of owner-managed company with which disqualification is preoccupied this 'agency problem' will not arise because there is unity of ownership and control. Therefore the pressing 'need' for regulation created by the failure of monitoring in owner-managed companies (and the consequent increased likelihood of undesirable conduct that it brings) does not arise because undesirable conduct may reduce the welfare of shareholders. Rather it arises because undesirable conduct in owner-managed companies can significantly harm the welfare of creditors.

The Importance of Limited liability to Section 6.

The harm that can be inflicted on creditors because of the absence of controls on the conduct of owner-managers is magnified by limited liability. The lack of monitoring of in owner-managed companies creates scope for self-interested conduct that harms the welfare of the business and it creditors, however, limited liability exacerbates this problem by allowing the entrepreneur to shift the risk of financial loss from such conduct to his creditors. Limited liability is therefore central to the need for disqualification, as evidenced by the fact that section 6 is described as a measure to 'protect creditors from abuse of limited liability' and the fact that disqualification does not prevent a person from managing an unincorporated business.

As such it is clear that section 6 is made necessary because of limited liability and that it focuses on owner-managers because the State's policy of allowing entrepreneurs to freely invoke statutory asset partitioning creates enormous scope for creditors to suffer loss from the combined effect of a lack of control on the conduct of incorporated entrepreneurs *and* their right to shift virtually all of the risk of their activity on to creditors. The State, however, regulates not because it views limited liability as undesirable, rather it does so for precisely the opposite reason, i.e. because it views it as a *desirable* method of wealth creation and regulates to prevent confidence in limited liability being undermined through the spectre of loss inflicted by unfit persons. However the State's belief that limited liability creates wealth by stimulating increased entrepreneurial risk-taking can be challenged, if as Richard Posner has argued, it is accepted that creditors will not passively accept transfers of risk affected by limited liability. Because if creditors reacted to limited liability by demanding compensation that is at least equivalent to the risk transferred to them by the rule then limited liability would not lead to significantly higher levels of entrepreneurial risk-taking than unlimited liability. However, if Posner's thesis were correct there would also be no need of disqualification because creditors would be able to effectively control the activities of directors through their demand for compensation or contracting around limited liability. In which case, no moral hazard would arise from statutory limited liability. However, it is precisely because Posner's thesis does not apply exactly as envisaged in the real market place that some form of regulation is necessary. Nonetheless, that does not mean that the thesis is worthless because there is strong evidence to indicate that, where they are able, creditors will do exactly as Posner suggests, i.e. demand compensation from limited liability entrepreneurs that reflects the extra risk of transacting with them. The propensity of the banks to demand higher charges for credit and to contract around limited liability indicates this. It is only creditors who lack contractual muscle (such as trade creditors, customers and employees) who will not demand compensation for the effect of limited liability or who will demand insufficient compensation.

Therefore the amount of risk-taking stimulated by the State's policy of allowing free access to limited liability is likely to be limited by powerful creditors' demands for compensation or contracting around the rule. The only 'extra' risk-taking that is likely to result from the policy is therefore that which comes at the expense of creditors who are unable to demand compensation. However, whilst this loading of risk onto creditors may stimulate some increased risk taking, it also creates the moral hazard that disqualification under section 6 is intended to control.

Therefore, it is clear that limited liability is responsible for the need for disqualification under section 6 and, as such, it is the harm that results from abuse of limited liability that the sanction needs to protect the public from if it is to be successful. However, the fact that limited liability creates this need whilst only stimulating a limited amount of risk taking must raise questions about the benefits of the current approach, because the price is a significant moral hazard for creditors, which regulation is then necessary to control.

The Objective of Section 6.

However, taking the control of this moral hazard as the objective of section 6 it is clear that the harm disqualification must seek to reduce if it is to protect the public is financial loss. The argument that disqualification is intended to go beyond this economic goal is not born out by any coherent body of evidence. And despite some judicial sentiment suggesting that disqualification is intended to eschew conduct that is socially undesirable, it is clear that loss lies at the heart of the judicial understanding of 'unfitness', even if it is sometimes expressed in pluralist language.

The disqualification cases show that the standard of 'unfit conduct' is used to condemn act that harm the economic welfare of creditors and that in some instances, the courts gone to some lengths in order to justify sanctioning certain forms of conduct by reference to economic goals. The breach of accounting and disclosure obligations, has for example been treated as evidence of unfitness because the rules are seen as 'safeguards set down by Parliament'[717] for the protection of those who deal with limited liability companies. Similarly, the Court of Appeal has held that misconduct on relation to the Crown can only be cited as evidence of unfitness when accompanied by evidence of some aggravating factor indicting unfitness, such as insolvent trading at the crowns expense or preferring other creditors over the Crown.

Therefore given the clear economic focus of section 6 on protecting 'the public and commercial world' from loss, the section must at least afford the prospect of producing a benefit, through reduced loss, which is greater than any costs its generates to be regarded as successful. However, in terms of both a qualitative and quantitative analysis this is something that the section manifestly fails to do.

The failure of Section 6.

The vagueness of the standard used to sanction undesirable conduct in section 6 has generated high litigation because the courts have been required to determine the exact parameters of unfit conduct. This has

[717] *Re Swift 736 Ltd* [1993]BCC 312

inevitably led to judicial u-turns and conflicting lines of authority, which can only increase the costs of the section. The vagueness of the standard will also have lead to higher compliance costs for those who wish to comply with it because of the need to study numerous, and sometimes conflicting, precedents. The list of 'relevant matters in schedule 1 of the Disqualification Act is unlikely to have significantly reduced the cost of the standard.

However, the choice of the unfitness standard in section 6 has not had a wholly negative impact, for the standard is flexible and capable of application to all possible instances of conduct that results in loss. However, that said, the flexibility of the standard could give rise to misinterpretation, if not misuse of the standard. This is a particular concern in the age of disqualification undertakings where the Secretary of State has gained control of the power to determine unfitness in a system that provides for few safeguards against the rather obvious scope for bias on her part. Indeed, the results of the empirical research carried out for this thesis indicates that the standard was most frequently to sanction conduct that does not impose great loss on creditors even before the Secretary of State gained control of the determination of unfit conduct in most cases.

The effectiveness of sanctioning a breach of disclosure and accounting obligations in almost a half of all disqualifications, for example, can be questioned because the provisions 'enforced' are so weak in that they are likely to be of little use to creditors. Consequently, greater compliance with them would bring little protective benefit to creditors. Similarly, the non-payment of tax is a matter of unfitness that was cited in almost two-thirds of disqualifications, but which may be of dubious utility to creditors. There is evidence to suggest that the court's effort to limit disqualification for not paying tax to instances where mere 'non-payment' is accompanied other conduct that could cause loss is not being strictly adhered to. Therefore any 'misuse' of section 6 to sanction conduct that does not cause loss because it is of interest to the State would harm the effectiveness of disqualification because it will bring no 'benefit' to the public from reduced loss. Indeed, it will only bring costs from wasted resources spent on the disqualification and possible desirable business activity prevented by an erroneous disqualification.

Therefore the costs generated by the choice of a general standard in section 6 are likely to be high. However, in addition to the high costs of the section, the analysis of the conduct sanctioned in the disqualification cases shows that even where conduct that causes more direct loss to creditors is sanctioned, the only benefits of disqualification under section 6 are *future* protection and *general* deterrence. Section 6 disqualification brings no direct benefit to the victims of unfit conduct in terms of recovering losses caused by unfit conduct. Therefore, disqualification affords less protection to creditors than the civil recovery sanctions contained in the Insolvency Act 1986, for example, which provide for the direct recovery of loss imposed on creditors by many types of 'unfit' conduct. Indeed, the most direct financial impact that disqualification has on creditors is to impose a cost on them because it is they who bear the costs incurred by Insolvency Practitioners and Official Receivers in fulfilling their reporting obligation under section 7 of the Disqualification Act. Therefore, it is essential that disqualification produces real benefits from future protection and general deterrence that outweigh not only the qualitative costs of the section but also its quantitative costs if it is to be regarded as a successful form of regulation.

Unfortunately for section 6, the research carried out for the NAO's 'follow up' report indicates that it actually produces very little in terms of a benefit from either future protection or general deterrence. The 'direct' savings to creditors from disqualification that the NAO was so eager to emphasise, actually accounted for only one half of the 'direct' costs of administering the disqualification, which hardly indicates that disqualification is an efficient piece of regulation. Indeed, if the costs imposed upon creditors by statutory reporting obligations were taken into account, the direct costs of disqualification would be even higher than the figure cited by the NAO. There is no evidence to suggest that the direct cost-benefit inefficiency of disqualification has significantly changed since the NAO's follow up report and if the calculations of the NAO are repeated using today's disqualification figures, the direct costs of section 6 to the State remain higher than its estimated benefits.

The reason why the direct costs of disqualification are higher than its direct benefits to creditors is largely because most disqualifications under section 6 appear to be erroneous and wasted in that they do not prevent future insolvencies and therefore provide no direct protective benefit. Indeed, the estimated number of future insolvencies from which the public is protected by disqualification is derisory when compared to the annual number of insolvencies. In 2003-2004, for example, over 15,000 insolvencies were recorded in England and Wales yet disqualification under section 6 in that same year is only likely to have prevented 109 future insolvencies, according to the NAO measure. Still more detrimental to the success of disqualification is the fact that the 85% or so of disqualifications that provide no protective benefit may stifle potentially beneficial entrepreneurial activity. Leave of disqualification orders has the potential to limit loses which flow from disqualifying individuals who could go on to rum successful businesses, however empirical research shows that leave is rarely granted. The costs caused by procedural constraints on leave applications are likely to explain the low incidence of leave, but under the current statutory framework where all leave applications have to be made to court, there would seem to be little prospect of increasing the number of leave orders. As such, section 6 disqualification remains likely to bring significant collateral costs. Therefore, not only does disqualification produce more direct costs than it brings in benefits, but it is also likely to impose significant costs through erroneous disqualifications.

In terms of its deterrent effect, it is also highly unlikely that disqualification brings significant benefit. A survey carried out for the NAO 'follow up' report showed that knowledge of disqualification was low (and in fact that it had declined since the first report). This low awareness of disqualification itself, let alone the precise sorts of conduct that are classified as unfit, is likely to be a consequence of the general vagueness of section 6 and the high compliance costs faced by directors who wish to comply with it. Nonetheless, the low awareness of the section means that it is unlikely to have a significant deterrent effect. However, the deterrent effect of the section could also be explained by the fact that, as a post-insolvency measure, the chances of a director becoming subject to section 6 are slight. On rational deterrence assumptions directors are only likely to take note of disqualification when insolvency is a real and pressing prospect; by which time much 'unfit' conduct may have already been committed.

Therefore, disqualification is unlikely to be a successful remedy due to its high costs and low benefit. And the recent introduction of disqualification undertakings is only likely to have increased this inefficiency. Despite the fact that it was offered as a way to lower the 'direct' cost of disqualification and increase its benefits through speeding up the disqualification process, it is likely that any increased efficiency has been more than offset by an increase in the indirect costs of disqualification. The oppressive conduct of the Secretary of State combined with pre-existing problems which directors faced in resisting a disqualification application, and the lack of procedural fairness in the undertakings system are all factors that are likely to increase the number of erroneous disqualifications. Therefore, the 'benefits' of the undertakings system are likely to have been bought at the expense of an increase in disqualifications that provide no protective benefit.

Consequently, there are fundamental weaknesses in disqualification under section 6 which mean that it is most unlikely to successfully 'protect the public' from unfit conduct in terms of producing a benefit from reduced instances of such conduct, over its costs. Similarly, it is unlikely to deter instances of 'unfit conduct' due to the limitations inherent in post-insolvency disqualification, which may indeed explain why awareness of disqualification amongst directors is low.

Punishment and Reform.

The manifest failure of disqualification under section 6 means that reform of the State's policy of using disqualification to 'protect' creditors from abuse of limited liability is highly desirable. However, as well as making a pressing case for reform, failure of the section to meet its declared goal also raises questions about the motivation of the State in its use of section 6 that cannot be ignored. Whilst the State's continued faith in section 6 makes little sense in terms of the declared objective of protecting creditors, it makes rather more sense in terms of a desire to punish directors. Nonetheless, whilst it is logical to infer that the State is not motivated by a desire to protect in its use of the section, there is little hard evidence that State is motivated by a desire to *punish* directors. In any case, the economic nature of the harm inflicted by 'abuse of limited liability' means that protection is the most desirable goal for any regulatory measure designed to combat it. Therefore, despite the logic of the State's approach to section 6 in terms of a desire to punish, the success of the section ought to be judged against the goal the State professes to follow (i.e. protection) and any reformed method of regulation should also have protection as its objective.

Given the failure of disqualification for unfitness under section 6 to deliver any direct benefit to the victims of unfit conduct, replacing disqualification as the sanction for unfit conduct with a personal liability provision could be thought of as a desirable reform. However, whilst personal liability could be more a more effective way to protect the victims of unfit conduct by directly reducing uncompensated loss, the success of the sanction could be limited by several factors, such as assets insufficiency on the part of directors and problems of enforcement. Personal liability would also be likely to suffer from similar problems to disqualification due to the fact that it too would be an *ex post* control on the conduct of directors that attempted to deal with the aftermath of unfit conduct. As such the failure of section 6 would seem to call for more radical reform of the State's approach to abuse of limited liability.

Reform of Limited Liability.

The failure of section 6 disqualification only highlights difficulties surrounding the State's policy of allowing free access statutory limited liability. The policy creates only limited scope for increased risk-taking at the cost of moral hazard for creditors on whom risk is loaded and the regulation that is intended to control this hazard fails spectacularly. However, not only does it fail to prevent the destruction of wealth by abuse of limited liability, it is actually likely to *increase* it. Therefore, the failure of section 6 must raise questions about the utility of allowing entrepreneurs free access to limited liability, particularly in respect of owner-managed companies where the chances of undesirable conduct occurring are greatest. In short, the policy appears to bring limited benefits but significant risk and costly regulation. In essence the policy creates a lottery of risk taking played at the expense of creditors. Each individual entrepreneurial 'gamble' may or may not pay off, much will depend upon the characteristics of the gambler. However, the fact that regulation to control undesirable gambles is felt necessary, indicates that the lottery creates an unacceptable amount of loss.

The failure of disqualification ought therefore to necessitate a review of free access to limited liability. In short free access to statutory limited liability *creates the need for regulation* of directors of 'undercapitalised' owner-managed companies that disqualification fails to satisfy. Therefore, the most effective and efficient way to protect creditors from abuse of limited liability would be to restrict access to it is such a way as to prevent unfit individuals from obtaining its benefits. Statutory limited liability brings few benefits in owner-managed companies and if there were no limited liability for owner-managers there would be no risk loading on to creditors creating a moral hazard and hence, the need for expensive (and failed) *ex post* regulation.

There are various ways in which access to limited liability could be restricted in order to prevent unfit individuals from obtaining limited liability, such as a minimum capital requirement or replacing statutory limited liability with insurance liability for incorporated individuals or small groups of individuals. However, neither of these methods is guaranteed to be successful as significant practical problems in their operation are likely to be encountered (especially in the case of liability insurance). However, I have not sough to demonstrate in this thesis that either approach would be guaranteed to operate successfully, rather I have merely sought to demonstrate that alternative approaches to limited liability could have the benefit of returning many of the undercapitalised owner-managed companies, which bring such risk of loss to creditors to the natural state of *unlimited* liability where regulation to 'protect the public' from unfit conduct is apparently unnecessary.

Ultimately the failure of disqualification under section 6 presents the State with a straightforward choice. Because if, as the prominence of section 6 suggests, it believes that the risk loading and moral hazard brought by free access to limited liability creates unacceptably high losses, then the policy itself ought to be reviewed as the only sure way to 'protect the public and commercial world' from abuse of limited liability. If however, the State believes that 'free access to limited liability creates more wealth than it destroys, then loss from 'unfit abuse' ought to be accepted as an unwelcome, but inevitable, side effect of a generally desirable policy. The current attempt to reduce loss through *ex post* regulation fails to bring any real benefit. Therefore, it is simply untenable for the State to continue to press ahead with a policy that manifestly fails to fulfil its objective of protecting the public and commercial world from loss due to undesirable use of limited liability.

Appendix 1

COMPANIES HOUSE RECORD OF DIRECTOR GRANTED LEAVE.

Companies House — for the record —

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Disqualified Directors Register
To obtain further details click on the appropriate Director
Information correct to 15/11/2005

Name: NEIL JOHN FISHENDEN

Address:

THURLESTONE HOUSE

1 GATESDENE CLOSE

LITTLE GADDESDEN

HERTFORDSHIRE

Postcode : HP4 1PB

Date of Birth : 10/03/1960

Nationality: BRITISH

Number of disqualification orders: 1

Disqualified From: 21/08/2003
To: 20/08/2006

Reason: CDDA 1986 S7

EXEMPTIONS

Company Number	Start Date	End Date
04687817	18/08/2003	18/11/2003
04687817	18/11/2003	20/08/2006

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Appendix 2

SECTION 16 'NOTIFICATION OF PROCEEDINGS' LETTER.

PRIVATE AND CONFIDENTIAL

Disqualification Unit
PO Box 203
21 Bloomsbury Street
LONDON
WC1B 3QW

DX address : 120875 Bloomsbury 6DX
Fax: 020 7636 4709

Direct Line: 020 72916816
Our Ref:
Your Ref:
Date: 19 June 2001

Dear Madam

RE:

NOTICE PURSUANT TO SECTION 16 OF THE COMPANY DIRECTORS DISQUALIFICATION ACT 1986 ("CDDA") OF INTENTION TO COMMENCE PROCEEDINGS TO DISQUALIFY YOU

I give you notice that the Secretary of State for Trade and Industry ("Secretary of State"), intends to apply to the Court for a disqualification order to be made against you.

This proposed disqualification application is based upon your conduct as a director of the following company:

X Limited – which went into liquidation on 16 December 1999

Further Information on Enclosures

For your information there is enclosed with this notice the following:

- Guidance produced by The Insolvency Service entitled "Information for defendants in proceedings under section 6 of the Company Directors Disqualification Act 1986".
- Details of the procedure and the information required on any application for permission to act.
- Information setting out the effect of a disqualification order or disqualification undertaking.

30.04.01

- Outline disqualification undertaking and accompanying schedule.

Matters of Unfit Conduct

A summary of the conduct that the Secretary of State intends to rely on in support of his disqualification application is set out in the schedule to this letter at Annex 1.

Action You May Wish to Take

- You may wish to seek professional advice on receipt of this letter.
- If there are any matters that you want the Secretary of State to consider you should contact Ms Lowther (tel. 0870 903 1000) of Wragge & Co, the solicitors acting on behalf of the Secretary of State.
- Instead of a disqualification order being made against you it is possible for you to offer the Secretary of State a disqualification undertaking which, if and when accepted, would have the same effect as a disqualification order being made against you. An outline disqualification undertaking is enclosed.
- If you want to make any representations or offer a disqualification undertaking you should contact the solicitors acting on behalf of the Secretary of State no later than 1 June 2001. If you fail to contact them within this time, the disqualification application will proceed against you and the claim form, together with the supporting evidence, will be served on you in due course.

Period of Disqualification

If a disqualification undertaking is offered by you and is accepted by the Secretary of State prior to the issue of disqualification proceedings then, and on the basis of his current information, the Secretary of State considers a period of disqualification of nine years would be appropriate.

- If the disqualification application is contested by you and the Court makes a disqualification order, the period of disqualification will be that which the Court considers appropriate.

- If the disqualification proceedings are issued against you and, after issue, you wish to offer a disqualification undertaking or otherwise settle the disqualification proceedings, the Secretary of State will determine what is, in his view, the appropriate period of disqualification in the light of current information at that time including any matters raised in evidence by you.

Costs

- If a disqualification undertaking is offered by you and accepted by the Secretary of State prior to the issue of proceedings, the Secretary of State will not usually seek to recover any costs from you.
- Once proceedings are issued, the award of costs is at the discretion of the Court. Costs are usually awarded against the unsuccessful party.

30.04.01

- If you offer a disqualification undertaking after the issue of proceedings, the Secretary of State will usually ask the court to order that you pay the Secretary of State's costs associated with the disqualification proceedings.

- For your information, costs already incurred **to date** total £X

Publicity

It is the Secretary of State's usual practice to issue a press release upon the making of a disqualification order. This practice will also be followed with a disqualification undertaking. The disqualification undertaking together with the agreed schedule will be a public document in the same way as a Court Order .The press release will be based on their contents. Both the schedule and the disqualification undertaking will be available to the Court if you were to make any application for permission to act following disqualification or to vary the period of the disqualification undertaking. It is only the Court that can give you permission to act or vary your disqualification undertaking.

Acknowledgement of Receipt

Please acknowledge receipt of this letter by signing and returning the enclosed receipt form as soon as possible.

Yours faithfully

MARK BRUCE
Chief Examiner

30.04.01

Appendix 3

Response to Research Questions put to the Chief Examiner of the Disqualification Unfit of the Insolvency Service.

(The questions put to the Service are in normal type; the responses received are in italics)

Q. 1 The Vetting Procedure.

Are limits imposed on the amount of time DU staff can devote to the initial vetting of unfit conduct reports?
If so, how much time is allocated?

There are no enforced time limits during the initial vetting procedure of submitted D1 Reports from IPs. That is to say that a vetting examiner in the Case targeting Team stationed in Birmingham does not have to stop reading submitted documents once they have reached 2 hours. However, the time spent is monitored and experience indicates that an average of 2 hours is devoted to each case in order to make the Secretary Of State's decision whether to target the case for further investigation. Some D1 are so bereft of valuable information that a rejection can be decided fairly swiftly. At the other extreme some D1 reports are excellent and it is fairly obvious that further investigation is required. The cases that demand the most time are those 'at the margins'. With these it is often a requirement to gather further brief information, either from the IP or third parties, in order to make the decision.

Q. 2 Undertakings.

(i) In respect of a particular case, would the Secretary of State differentiate between the disqualification period she would be prepared accept if an undertaking was offered and that which she would seek if the case was contested?

(ii) Does the Secretary of State offer to waive all costs against a director if he/she offers an undertaking within a set time period?

If so, how strictly is the time limit enforced?

If not, what is the Secretary of State's policy in regard to costs if a director offers an undertaking?

In short, yes. However, in practice it does not come down to a 'credit scoring guide' approach. Basically, once the investigation is complete and the SoS is in a position to determine the allegations she wishes to put to the director in a section 16 notice an assessment of the appropriate period is made by the Chief Examiner responsible for the decision. Whilst the SoS can never be certain that the court would ratify the period sought at court, a nominal 'discount' of one year is made to that period (½ year for 3 or 4 year cases). This is based on the premise that, if the director offers an undertaking for that period fairly quickly and prevents the need for protracted discussions (including meetings and correspondence over many weeks) the public are protected earlier at a reduced cost to the public purse. Those directors who make representations as to why certain allegations should be withdrawn and consequently require a reduction in disqualification period are also able to avail themselves of the original discount unless they are successful in having the period reduced. Where these directors are at a disadvantage is in costs. An undertaking accepted without much fuss will basically ensure that the director is not required to pay any of the SoS' costs. Those that cause extra work to be done by the SoS *will have an assessment done on whether a proportion of the post s16 costs should be charged. It is not a science but an art!*

Those cases that do not attract the offer of an undertaking from the director and which proceed to trial will not have the benefit of the discount. In effect, SoS will attempt to persuade the court to attach the original period assessed if successful on all counts

Q. 3.

Since the introduction of disqualification undertakings, has the Secretary of State been stricter in the allegations of unfitness she includes in affidavits given that her role has changed from prosecutor to *de facto* arbiter of unfitness in most cases.

I think I will need to have a brief discussion with you as to what you mean by 'stricter' here. The SoS does not have a crystal ball and cannot be sure which director is likely to offer an undertaking although we have naturally built up some experience here. The SoS decided during the discussions prior to the enactment of the Insolvency Act 2000 that any disqualification investigation would have to be completed before undertakings were negotiated. As such, all potential allegations are thoroughly investigated. If a director 'offers' an early end to an investigation by suggesting a period (even 15 years) they will be told that the investigation must be concluded before a decision on period is made. Early acceptance of a low period would be wrong if an investigation would have uncovered serious unfitness demanding a lengthy period whereas acceptance of the maximum would also be wrong, in the public interest. The latter would leave upon the chance of a later appeal or a section 8A application to vary the period. If the SoS has not conducted a full investigation she would be unable to inform the court of the basis on which 15 years was appropriate.

As I said, you may wish to call me to discuss this one further if I have misinterpreted your question.

Q. 4. Crown Debts.

Would it be possible to supply a statement of the 'test' that the Secretary of State applies when deciding whether to allege non-payment of Crown debts as evidence of unfitness?

We abide by precedent case law, in particular, Sevenoaks Stationers and Structural Concrete. In true lawyer-speak, we treat each case on its own facts.

Q. 4 Press Releases.

Would it be possible to confirm that the matters of unfit conduct stated in press releases are taken *verbatim* from court judgments in contested cases and from the schedule of 'matters not disputed' annexed to undertakings and *Carecraft* disqualifications?

That is certainly the policy. However, what actually ends up being produced by a particular newspaper is often subject to their editorial adjustment (at their peril!). It is important that the exact wording is used when we issue a press release and that the matters of unfitness are not admitted but 'not disputed' by the director for the purpose of the undertaking.

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