Directors' Disqualification: Room for improvement

Insolvency Practitioners (IPs) are required to report to the Insolvency Service (IS) if they believe a company director's dishonest or blameworthy behaviour has exacerbated the company's financial distress. Directors' actions under this broad banner include: non-payment of crown debts, concealment or appropriation of assets, and personal benefits obtained by directors.

Insolvency trade body R3 is concerned that the IS investigates too few cases of alleged misconduct - the number of IPs' reports resulting in investigations by the IS has declined from almost half (45%) to just one in five (20%) since 2002-3.

We also believe that the IS only investigates cases that are 'low hanging fruit' due to a lack of resources, giving rise to a fear that 'easy cases' are taken on in order to meet targets.

This leaves blameworthy directors free to start up other companies, putting investors, suppliers and, in some cases, members of the public, at risk.

R3 believes that:

- More cases referred to the IS by IPs should be investigated, which may necessitate a realignment of resources between review and investigation within the Service.
- To this end, the IS should continue to work with stakeholders to implement a more effective system for establishing which cases are the most serious - therefore warranting priority attention - and to improve the efficacy of the reporting and reviewing system so that resources can be moved from 'review' into 'investigation'.
- The IS should consider levying fines for disqualified directors to help fund the disqualification unit.
- A programme of compulsory financial education should be introduced for disqualified directors.

What is 'Directors' Disqualification'?

By law, when a business fails, a report is made by the IP on the conduct of the director(s) of that business. If the IP believes that the behaviour of the director(s) has been 'dishonest' or 'blameworthy' or otherwise 'unfit to be concerned in the management of a company', they are required to submit a D1 report to the IS outlining areas of concern. On the basis of this report, the Secretary of State (through the Insolvency Service) will decide whether to initiate further investigation, in the public interest.

Depending on the seriousness of the case, the report could lead to legal proceedings in which a period of disqualification is imposed on the director(s) lasting between 2 and 15 years. The average disqualification period is around six years[1]. Directors who have been disqualified should not remain, or should not become, a company director or be included in the promotion, formation or management of a company for the time specified by the court order under the Directors Disqualification Act (1986).

Why is it important to disqualify blameworthy directors?

The disqualification process acts as a protection for the general public and other businesses by preventing directors who are 'dishonest' or 'blameworthy' from setting up another company. More than a quarter of corporate insolvencies (27%) are triggered by another company's insolvency - the 'domino effect'. Given that there are no 'entry requirements' to become a director, the disqualification process is a vital part of the 'checks and balances' designed to ensure that the UK's business community operates effectively and safely.

[1] http://www.publications.parliament.uk/pa/cm200809/cmhansrd/cm090716/text/90716w0008.htm#09071664002822

How many directors are disqualified?

In 2009-10, 7,030 reports were submitted to the Insolvency Service and just 1,387 directors were disqualified in the same year. Seven years ago, 45% of directors reported upon by IPs were disqualified; now this figure has fallen to 20%.

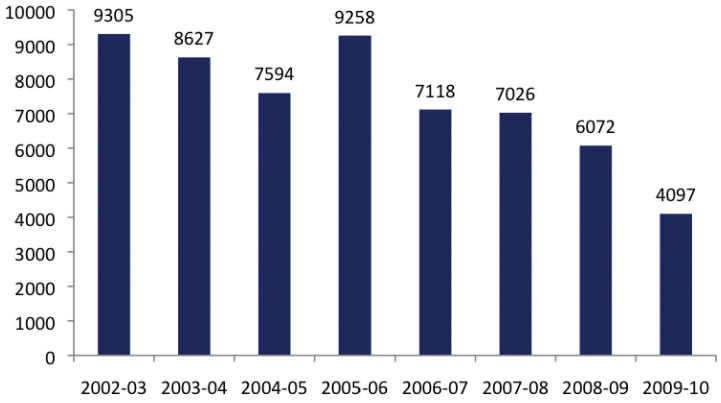
In each year, the number of investigations concluded may not correlate with the total number of reports submitted because the conclusion of an investigation may take some time (i.e. it may start in one year but finish in another). As such, direct comparison between these two figures may be less advisable than trends across a longer time period. To this end, the following table shows the average across two four year periods. **The trend is very clear: a 12% decline in the proportion of disqualifications**.

	2002-3	2003-4	2004-5	2005-6	2006-7	2007-8	2008-9	2009-10
Total reports	3,539	3,394	3,860	3,721	4,107	3,991	4,752	7,030
Investigations concluded	1,594	1,367	1,240	1,173	1,200	1,145	1,252	1,387
Percentage of reports taken forward (i.e. number of directors disqualified)	45%	40%	32%	32%	29%	29%	26%	20%

37% 25%

Budget allocation for the Service's disqualification effort

While the total budget for investigation and enforcement has remained relatively steady since 2002 (varying between £28 million and £34 million), the number of reports submitted to the Service has increased significantly over this time. The following graph shows the total budget allocated to all aspects of the Service's disqualification effort divided by the total number of reports submitted by IPs. It shows that in 2002, for every report submitted, there was a little over £9000; this now stands at just £4000.



R3's research into directors' disqualification

In May 2010, research agency ComRes surveyed over 300 R3 members. Respondents reported that:

- 75% of IPs had submitted a D1 report to the IS during the last year.
- Of these IPs, 79% believe that the IS's decision not to proceed with further investigations was wrong and/or that the director in question should have been disqualified.

Over 300 IPs were asked which aspects of the behaviour they had indentified in their D1 report they believed warranted further investigation or disqualification, but was not taken forward:

- 35% pointed to non-payment of Crown debts to finance trading;
- 28% highlighted personal benefits obtained by directors;
- 24% pointed to appropriation of assets to other companies;
- 19% spoke of attempted concealment of assets and the same percentage stated that preferences (paying off one creditor ahead of the others when the director knows the company is insolvent) were the area of concern;
- 13% stated that phoenix operations were involved in the case; and
- 12% pointed to use of delaying tactics.

Case studies

R3 has been collecting anonymous 'case studies' from IPs about cases which have **not** been taken forward by the IS where the IP felt it warranted further investigation or disqualification:

▼ CASE STUDY:

A retail company in Yorkshire, previously employing 20 staff.

Aspects of the director's conduct which the IP believed warranted a report to the IS and further investigation: misappropriation of funds, wrongful trading, preferential payments to connected company, non co-operation with the Officer Holder (IP), non payment of Crown debts to finance trading and failure to keep proper accounts.

The IP said: *"I received a three page letter from the Disqualification Unit explaining why each of the six major failings were not enough, on their own, to merit a disqualification - apparently they were unable to add up"*.

▼ CASE STUDY:

A company working in the airline industry, based in South East England.

Aspects of the director's conduct which the IP believed warranted a report to the IS: attempted concealment of assets. The IP stated: *"£250,000 was sent to a German company with no details… [this was] clearly a scam to remove money from the company to be paid back to the director."*

▼ CASE STUDY:

A joinery manufacturer based in the Midlands, employing around 30 people pre-insolvency.

Aspects of the director's conduct which the IP believed warranted a report to the IS: non payment of Crown debts to finance trading, personal benefits obtained by directors, preferential payments and appropriation of assets to other companies. The IP stated that the director was: *"A serial phoenixer….[who] subsequently left the country…. [the] IS view was that pursuing him was not in the public interest"*.

▼ CASE STUDY:

A company in the motor trade, based in London.

Aspects of the director's conduct which the IP believed warranted a report to the IS: attempted concealment of assets, personal benefits obtained by directors, overvaluing assets in accounts for the purpose of obtaining loans, or other financial accommodation, or to mislead creditors, dishonoured cheques and use of delaying tactics.

The IP said: *"Despite the director admitting he had not advised about assets subject to finance and had included third party assets in a valuation to obtain funding, and despite legal advice that this was fraud, [the] IS said it wasn't, and wouldn't be taking action"*.

▼ CASE STUDY:

An electrical company, located in London.

Aspects of the director's conduct which the IP believed warranted a report to the IS: appropriation of assets, preferential payments, personal benefits obtained by directors, overvaluing assets in accounts for the purpose of obtaining loans, or other financial accommodation, or to mislead creditors, loans to directors in making share purchases and dishonoured cheques.

The IP stated that: *"Funds were diverted to an associated company….which ran off with the money"*.

▼ CASE STUDY:

A financial services company in the South East.

Aspects of the director's conduct which the IP believed warranted a report to the IS: attempted concealment of assets, phoenix operations, appropriation of assets to other companies, personal benefits obtained by directors, overvaluing assets in accounts for the purpose of obtaining loans, or other financial accommodation, or to mislead creditors, and use of delaying tactics.

The IP said: *"In 20 years I have never seen such a clear cut case for disqualification and I remain bemused by the decision"*.

▼ CASE STUDY:

A manufacturing company, located in the South Midlands.

Aspects of the director's conduct which the IP believed warranted a report to the IS: attempted concealment of assets, phoenix operations, appropriation of assets to other companies, preferential payments, overvaluing assets in accounts for the purpose of obtaining loans, or other financial accommodation, or to mislead creditors, use of delaying tactics and non-payment of Crown debts to finance trading.

The IP stated that this was: *"probably the most clear cut case I have ever made a submission on"*.

R3's recommendations

We want to ensure that the Directors Disqualification process is not only fit for purpose, but the very best it can be. We would like to continue to work with the Insolvency Service to achieve this important objective.

1. More cases taken forward by the IS

R3 appreciates that it is not possible to take forward all cases due to a finite amount of resources and, in some cases, lack of firm evidence. However, the sheer decline in the proportion of cases taken forward indicates a worrying reduction in resources or approach at the IS. We believe that more cases referred to the IS by IPs should be investigated. R3 is in discussions with the IS to improve the D1 reporting and review processes so that IS resources can be moved from review into investigation.

2. A more effective strategy for flagging-up the most serious cases

There is a fear that "easy cases" are taken on by the IS in order to meet targets. Appreciating that the IS receives a considerable number of reports and that resources are limited, R3 is hoping to work with the IS to implement a more effective system for establishing which cases are the most serious, therefore warranting priority attention.

3. Working with the profession to improve the efficacy of the reporting system

In order to ensure that D1 reports operate as effectively as possible, the IS should work with R3 to:

- re-design the D1 forms so that they move from long verbatim boxes to clearly defined categories of information so that they are easier to complete and assess;
- introduce online versions of the D1 forms;
- complete their re-writing of the Guidance Notes on Directors' Disqualification[2] so they are up to date (they were last updated in 1999).

4. The levy of fines to help fund the investigation system

At present, a disqualification order usually carries with it an order to pay the costs and expenses of the Secretary of State or the Official Receiver or both, but directors are not subject to a fine. To bolster the funding of the disqualification unit, R3 would like the IS to consider the possibility of levying a court fine on disqualified directors.

5. Compulsory financial education for disqualified directors

There are no requirements for a director of a UK company to undertake any specific training to be a director and run a business, which means that directors can make simple mistakes which not only cut their own company's life unnecessarily short, but can have a detrimental effect on other businesses as part of their supply chain. R3 proposes financial and corporate governance education for disqualified directors who want to set up as a director again. It would help to prevent sequential failures and offer a measure of rehabilitation to directors who have, by definition, fallen below the standards of competence and integrity required from business people exercising the privilege of limited liability. The directors who can demonstrably absorb the financial 'education' they receive could qualify for a reduced period of disqualification. R3 would be happy to provide such education and we would expect directors themselves to pay for it.

About R3

R3, the trade body for Insolvency Professionals, represents over 97% of Insolvency Practitioners. R3 members are trained and regulated accountants and lawyers who have extensive experience helping individuals in financial distress.

Association of Business Recovery Professionals
R3
Rescue
Recovery
Renewal

[2] Company Directors Disqualification Act 1986, Guidance Notes for the Completion of Statutory Report and Returns