THE COMPARISON OF EFFICIENCY OF DISQUALIFICATION OF DIRECTORS IN NEW CZECH BUSINESS CORPORATION ACT AND IN THE LEGAL SYSTEM OF ENGLAND

Tomáš Moravec¹, Petr Valenta¹

¹ Department of Business and European Law, Faculty of International Relations, University of Economics in Prague, nám. W. Churchilla 4, 130 67 Praha 3, Czech Republic

Abstract


The article deals with regulation of director's disqualification in the new Czech Business Corporation Act and in the Company Directors Disqualification Act in England. The cornerstone of this article is to perform the economic analysis of the disqualification of directors according to the theory of Law and Economics. There are defined common and different points in both regulations. Furthermore this article derives and forecasts the probable number of court proceedings concerning disqualification before Czech courts in 2014. Moreover this article discusses the examples of a situation when the member of company body breaches the law or not. Last point of research is focused on asymmetric information and positive externalities of public register of disqualified persons. The article also provides future recommendation for legislator to create more effective rules.

Keywords: disqualification of directors, bankruptcy, business commercial act, company directors disqualification act

INTRODUCTION

On 1st January 2014 new civil legislation including the new Czech Civil Code (NCC) and the new Czech Business Corporation Act (BCA) became effective. This new legislation introduced new rules relating to the diligent care of the statutory body and the liability of statutory body. Furthermore new legislation created new rules concerning the consequence of declaration of bankruptcy. One of the consequences of declared bankruptcy might be the disqualification of the member of statutory body or directors.

The rules regulating the disqualification of directors were significantly changed. Old regulation involved principle that the director or directors of bankrupted company are not able to be appointed as director of company. This automatic legal obstacle of appointment was applicable on the directors or members of supervisory body that performed their function at least one year before declaration of bankruptcy. This automatic legal obstacle lasts for three years. The article 38l paragraph 4 and 5 of the old Czech Commercial Code involved exceptions when this obstacle is to be disregarded.

New regulation is based on the principle that court decides about disqualification of members of body. The inspiration for new regulation was the CDDA.

As mentioned above the issue of disqualification of company body members is new and has not been explored completely yet. Because of the inspiration of new legislation was the CDDA the article presents a comparison of Czech and England regulation. The article focuses on the Law and Economics analysis of both regulations.

The goal of this article is to carry out an economic analysis of the new Czech disqualification regime for the members of company body, the awareness about it and related consequences and comparison with
the England disqualification regime. We suppose that the incentives of influenced persons are same in both regimes and these incentives are affected by examined rules. Therefore the differences of legal systems are not important for research performed in this article.

In the context of the study the article also provides the prediction of future potential Czech court cases concerning the issue of disqualification of member of company body based on England datasheet. On other side the article does not provide legal comparison of both legal regimes. The article is focused on economic analysis of substantial law, the rationality of person that breaks the legal rules only and examines whether these rules are socially desirable. The comparison of Czech and England regulation of disqualification involves also analysis of effectiveness of each legislation based on the Law and Economics scholars.

**MATERIALS AND METHODS**

The methodology of article is based on theory of the Law and Economics by Polinsky (2003). The issue of disqualification of directors has gained on importance with adoption of new legislation in Czech Republic. Moravec and Valenta (2014) analyse the amendment of legal rules connected with insolvency caused by changing of private law in Czech Republic and focused on the pros and cons of the new rules. Furthermore Hurychová (2014) deals with directors' disqualification in the England and new Czech regulation from legal point of view. She focuses mostly on description which rules were taken over into the Czech legislation.

The method of analysis is primary used in this article and authors deal with regulation of director's disqualification under the new BCA and under the CDDL in England from the perspective of the Law and Economics theory. From this perspective new Czech regulation has not been analysed yet.

The cornerstone of this article is to carry out the analytic description of the regulation of director's disqualification in UK and Czech Republic. This method was originally published by Czeżowski (2000). Firstly there are defined common and different rules in both regulations. These partial results are subsequently used for the economic analysis of both regulations, especially in the areas where rules differ. Polinsky and Shavell (1998) introduced a theory of optimal liability and extended basic model. The following part of our research involves derivation and prediction of probable number of court proceedings related to the disqualification of directors before Czech courts. The analogy method is used and authors predict the number of bankruptcies of entrepreneurial subjects according to prediction the models based on macroeconomic variable which was used also by Moravec (2013).

The analysis is also based on Shavell (2005) research that describes decision process of person breaching contract. We suppose that this decision process can be also applicable to breach of law or another rule. So we use this concept to describe behaviour of directors. Moreover we focus on the efficiency of breach of rules causing disqualification. The efficiency of breach also depends on accuracy of liability. The value of accuracy is analysed by Kaplow (1994) and Kaplow and Shavell (1994). The concept of accuracy regards to a wide range of legal rules involved an effort to strike a balance between accuracy and legal cost. Special burden of proof in particular area of law is the most obvious. Calabresi and Melamed (1972) presumed that property rules are more efficient than liability rules when transaction costs are low. Subsequently this article shows when the member of company body breaches the law or not. This prediction is based on the theory of Polinsky (2003).

Last point of our research is focused on asymmetric information and positive externalities of public register of disqualified persons. This part of analysis is based on the model of Akerlof (1970). We assume that information about disqualification is important for the market and regulation should minimized “lemons” problem.

We also discuss the liability rules as incentives to reduce risk and cost of liability systems, consider public enforcement and magnitude of sanctions.

**The Economic Analysis of Disqualification**

**Regulation of Disqualification**

**Czech Disqualification**

According the new Czech BCA the one of the consequences of declaration company bankruptcy is disqualification of member of company body. About the disqualification and whether statutory requirements are met insolvency court will decide. The power of insolvency court was chosen because this court decides about bankruptcy and it is supposed that this court has also information and knowledge about reasons of bankruptcy.

The court could decide on application of the person that has legal interest on decision or also ex officio. The period of disqualification is fixed for three years according the BCA.

The court disqualifies the member of company body in the case of: i) performance of members duties contribute to bankruptcy, ii) misappropriation of assets and transaction to the detriment of creditors, iii) breach of due managerial care (BCA § 64).

The court is not obliged to disqualify the member of company if the member proves that became member of company body at the time when company was insolvent or proves that act with reasonable care.
When the court decision about disqualification comes into legal force the member of company body is excluded from all offices in company body and his offices are terminated.

If the person breaches disqualification order this person could be disqualified for the period of ten years and this person is also liable for the debts of corporation.

**UK Disqualification**

An English court may make a disqualification order prohibiting the person from acting as a director of a company, or being involved in the management of any company, for the period of the disqualification. The minimum period of disqualification is 2 years, and the maximum period is 15 years in the case of company bankruptcy (Section 6 par. 4 CDDA).

English court shall make a disqualification order against a person in any case where, on an application, when legal requirements are satisfied. Legal condition for disqualification are met by director of company when he was or has been a director of a company which has at any time become insolvent and his conduct as a director of that company makes him unfit to be concerned in the management of a company. (Section. 6 CDDA) The director is responsible for the causes of the company becoming insolvent, responsible for any failure by the company to supply any goods or services which have been paid for and responsible for the company entering into any transaction or giving any preference, being a transaction or preference.

Directors may prove in court proceeding that company has not been insolvent at any time or his conduct has not been made unfit to be concerned in the management of a company. Also company director may introduce and prove mitigating factors with a view to reducing the period of disqualification.

The application for disqualification might be made by The Insolvency Service, Companies House, the Competition and Markets Authority, the courts and company insolvency practitioner.

The applicant must apply for disqualification within 2 years of the date of the winding-up order or any earlier voluntary liquidation, administrative receivership or administration, unless the court extends the time.

In the case that English court order disqualification of director the person shall not be a director of a company nor act as receiver of a company's property, nor be concerned or taking part in the promotion, formation or management of a company nor be an insolvency practitioner. The disqualification order must be notified to the Company Registrar and information about disqualification must be shown in register.

A person who is subject to an order or undertaking may apply to the court for permission to act as a director or to act in the promotion, formation or management of a company (Section 17 CDDA). The court may grant permission but will need to be satisfied that there are adequate safeguards to protect the public interest and may impose conditions.

If the disqualified person breaches a disqualification order or is involved in the management of the company or acts or is willing to act on instructions given without the leave of the court by a person whom he knows at that time to be the subject of a disqualification order the disqualified person is personally responsible for all the relevant debts of a company.

**Comparison**

English legislation concerning director's disqualification was pattern of the new Czech legislation on disqualification. In the regulation of disqualification are similarities and differences.

Both regulation of disqualification are based on the issuing of court decision in the case of company insolvency and improper care of directors.

The difference of regulation lies in the possibilities of court to determine the length of ban to act as director of company.

The similarity of both regulations is also responsibility of directors in the case of violation of disqualification order. If the director fails to maintenance disqualification order became liable for the debt of companies.

Czech legislator did not take the English rules regarding to register of disqualified person. The register contains information about the disqualification orders, disqualified person and the period of disqualification.

**Prediction of Number of Disqualification in Czech Republic**

As above mentioned both regulation of disqualification are based on the issuing of court decision in the case of company insolvency and improper care of directors. We assume that the number of disqualification in Czech Republic and England could correspond to same ratio.

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I: The number of bankruptcies and court proceeding concerning disqualification in England

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<tr>
<td>England</td>
<td>36,491</td>
<td>32,642</td>
<td>30,902</td>
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<td>1517</td>
<td>2164</td>
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Source: The Insolvency Service, own elaboration
between number of bankruptcies and number of disqualified directors or number of allegation.

Tab. I shows the number of Bankruptcies in England from half 2008 to half 2014. We would like to point out that English data comprise half of previous and half consequent year. We assume that this difference is not statistically significant.

Tab. II contains the average number of bankruptcies per year during the period from half 2008 to half 2014. The average number of bankruptcies per year in England is 31,149. Tab. II also contains number of disqualified directors and number of allegation regarding to disqualification. The average number of disqualified directors per year is 1,260. The average number of allegation per year is 1,498.

According to data in Tab. II directors in 4% of all insolvencies did not act with due diligence.

Comparison of the average number of allegation regarding to disqualification and the average number of disqualified directors set that in 83 percent of all court proceeding is decided about director's disqualification.

Next step of analysis is prediction of number of allegation and number of disqualified person in Czech Republic.

Tab. III shows the number of declared company bankruptcies in the Czech Republic in period from 2008 to 2014. The number of bankruptcies involved prediction according statistical model based on macroeconomic variable (Moravec 2013: 123).

Tab. III contains also prediction of assuming number of allegation regarding to disqualification for 2014 and prediction of assuming number of disqualified directors for 2014. This numbers are based on assumption that ratio between declared bankruptcies and number of disqualified directors or number of allegation is same or similar in Czech and England.

Risk-neutral individuals decide whether commit to breach. If an individual commits the breach, he obtains a gain and cause harm. Sanctions that are involved should also cover the social costs. The social cost involve cost connected with monitoring, enforcing or intensity of investigation.

**Period of Disqualification**

As above mentioned difference of regulation lies in the possibilities of court to determine the length of ban to act as director of company. The Czech regulation set fix period of three years for disqualification of directors. The England regulation set in case of insolvent company minimum period of disqualification for 2 years and maximum period of disqualification for 13 years. The length of disqualification period is based on court decision that takes into account seriousness of acting and its consequences. The judge discretion to set the disqualification period increases the costs of procedure according to Kaplow and Shavell (1994) but on the other hand decreases the probability that individual commit a breach.

The following section includes the Law and Economics analysis of different rules on length of disqualification period in each country. This analysis is based on comparing the potential gains and losses of directors in different variations. The analysis presumes that directors decide in economic rational way.

The director in decision making process whether breach of duty of due diligence or not will compare potential gain and potential loss. Potential gain involves income for breaching of regulation. The potential loss includes loss due to disqualification. In the situation that potential gain exceed the potential loss the director breach the duty of due diligence. Contrary in the situation that potential loss exceed potential gain the director refrain from breach the duty of proper care.

In our hypothetic example 1 that is shown in Tab. IV suppose that potential gain from breach the duty of due diligence is 100 € and suppose that potential loss from disqualification is 20 € per each year. In our example if the period of disqualification is less than 5 year director is motivated to breach his
duty. The English judge could adjust the period of disqualification and directors might be motivated to refrain to breach his duties. According example 1 Czech directors has higher profit if breach his duty because of potential gain exceed loss for three years. In example 1 the Czech regulation leads to ineffective output to breach managerial duties.

In our hypothetic example 2 that is shown in Tab. V suppose that potential gain from breach the duty of due diligence is 100 € and suppose that potential loss from disqualification is 40 € per each year. In our example if the period of disqualification is less than 2 year director is motivated to breach his duty. As above mentioned according the English regulation could be adjusted the period of disqualification and period of disqualification in example 2 might be appropriately set up to 3 years. In example 2, also the Czech regulation leads to the fulfilment of duties by directors. So in example 2 both regulation leads to effective output to follow legislator rules.

The adjusting the disqualification period is important element in legislation. As above shown the Czech regulation could lead to ineffective outcome and could not fulfil prevention matter. The England datasheet set, that average period of disqualification is 6 year and therefore might be the Czech disqualification period too short.

We have also tried to predict the number of allegations of directors. According the datasheet from England the average period of disqualification is 6 years. So we assume that number of allegations in the Czech Republic will be higher than in England because of ineffective outcome of the Czech regulation and shorter period of disqualification.

The system of allegations is considered as effective under the condition that the costs of allegations are less or equal then benefits of disqualified directors and they could not cause any harm to society at the same time.

Furthermore we propose to change the Czech regulation and set the period according to court decision. We suppose that the maximum period of disqualification should be at least ten years. The variable period of disqualification with the range limited by law should lead to effective outcome and should prevent directors to breach his duty and protect creditors and shareholders.

It is important to mention that exact period of disqualification – in words of Kaplow (1994) accuracy of liability decrease cost of proceeding and could lead to optimal output in the situation of low number of disqualification allegations. The cost of allegation and adjudication might be analysed in further research.

### Public Register of Disqualified Person

As above mentioned Czech legislator did not adopt the English rules regarding to register of disqualified person. Czech directors have obligation to inform shareholders about ban to act as directors. If the Czech director breaches the ban to act as directors, director is liable for the debts of company. Furthermore the Czech court might decide about director’s disqualification for the period of ten years as the punishment for violation of law.

There could arise a problem resulting from information differences and conflicting incentives between directors and shareholders and creditors. All of them are rational and value contracts conditional on their own information. Directors has obligation to inform shareholders about disqualification. Creditors so cannot distinguish between company that is managed by disqualified directors or by non disqualified directors. On one hand the disqualified directors is liable for the debts of company but on other hand he has own property to be able to pay company debts. Realizing this possibility, creditors will value both contracts concluded with disqualified or non disqualified directors at an average level. Therefore, if the lemons problem is not fully resolved, the capital market will rationally undervalue some contract with non disqualified directors (Akerlof, 1970).

There are several well-known solutions to the lemons problem. Optimal regulation can provide incentives for full disclosure of information about disqualification. Another potential solution to information asymmetry problem is disclosing information through public register.

Both possibilities are use in the legal system of England. Firstly England regulation punishes disqualified directors for the breach of ban act as directors through higher liability and through criminal law. As above mentioned, greater liability of director could not be effective in case disqualified director without property. Secondly England regulation also minimizes information asymmetry through the public register of disqualified directors.

This England regulation is effective only on national level but disqualified directors might circumvent this rule by moving residence.

Unfortunately Czech legislator did not adopt these rules concerning criminal liability and public register although these rules solve some economic problems. Therefore the Czech legislation of disqualification will not be created optimal output and also the Czech regulation of disqualification is less effective than the English regulation of disqualification.
We assume the cost on functioning of registrar, social benefit from registrar, probability to find the information about disqualification, cost of finding information and potential loss of individual. Rational individual take into account probability to find the information about disqualification and potential loss. In the case of registrar the probability to find information is close to 1 because only very low number of owner of corporation does not check registrar. The sum of cost of finding information creates potential benefit from registrar. When social benefits are higher than cost of functioning the legislator should implement the registrar into legislation.

We predict that the number of allegations of directors in Czech Republic should be about 286 cases per year. In this situation could be possible that the cost of functioning of registrar could be higher than social benefit of registrar. Accordingly to exact data there should be set a breakeven point in which the registrar is effective to be implemented.

**DISCUSSION**

We have found that the Czech regulation of director's disqualification adopts the English regulation of director's disqualification. There were deepened recent studies on director's disqualification in the Czech Republic in the article. We do not agree with Hurychová (2014) concluded that the Czech regulation is ambitious. We thought that Czech legislator adopted English regulation improper and in very inefficient way. We focused on effects of legal rules on behaviour of directors and whether effects of legal rules are sociable desirable.

As main problem we see the impossibility of Czech court to have discretionary power to decide about length of the disqualification period and on the contrary it is known, that the disqualification period would be three years. These could lead to ineffective outcome and could encourage breach of proper managerial care in the Czech Republic. The quantification of losses from this ineffective regulation might be examined in future. We conclude that the maximum period of disqualification should be at least 10 years because this length of disqualification period could preclude to fail proper managerial care.

It was also criticized that under the Czech regulation there was not created public register containing information about disqualified directors. Subsequent research could also focus on quantification of losses and transaction costs of creditors caused by insufficient information about disqualification of directors.

Furthermore we have suggested legislative change to achieve more effective regulation. First proposal is to give Czech judges the discretionary power to decide about the length of disqualification period. Second proposal that has been presented is creation of public register about disqualified persons. Third proposal we have concluded is to introduce personal criminal responsibility for person breaking the ban of act as director. On other hand it is important to mention that these proposals should be taken into consideration only if the breakeven point is reach. In this situation it is optimal to invest the resources into legislative changes to achieve higher relative effectiveness. Rationale parties will respond to threat of liability and response will promote social welfare or fail.

The limitation of article is its focusing only on national regulation and the fact that it does not take into account cross-border aspect of disqualification. The cross-border aspects of disqualification and its regulation on European Single market could be suggestion for future research because of disqualified directors might move his residence to another country without any limitations now. Also the article focuses only on substantial legal rules and does not involve procedural aspects.

**CONCLUSION**

If the activity of a member of the statutory body leads to the corporation's bankruptcy, or he does not take the necessary measures to avert the corporation's bankruptcy through his inaction or the unqualified performance of his office, the court can disqualify the relevant member of the statutory body from the performance of his office on a motion in insolvency proceedings, but even without such a motion. The disqualification of a member of a statutory body means his forced exclusion from the performance of office in all business corporations for a period of up to 15 years in England. In Czech Republic is set fix 3 years period of disqualification.

In this article there is also to provide the prediction of future potential Czech court cases concerning the issue of disqualification of member of company body based on England datasheet. We concluded that number of disqualified directors in England consists of 4% of all insolvencies. We predict the number of Czech insolvencies of entrepreneurs will be 5940 cases and therefore the number of disqualified directors in Czech Republic should be 240. Moreover comparison of the average number of allegation regarding to disqualification and the average number of disqualified directors set that in 83 percent of all court proceeding is decided about director's disqualification.

The main goal of article is to provide the comparison of the Czech and the England regulation of director's disqualification which involves also the economic analysis of effectiveness of both legislations based on the Law and Economics scholars as mentioned above. We stated that English regulation is more effective from economic point of view. Discretion power of English judges could
prevent directors from fraudulent acting. Also English register provides information for third persons and improves their ability to evaluate contract with company for fair value. The Czech regulation is ineffective in the cases in that the director receives a huge gain.

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Contact information
Tomáš Moravec: tomas.moravec@vse.cz
Petr Valenta: valenta.pe@gmail.cz