February 2016

Court of Appeal Decision – Disqualification of Directors

Introduction

On 20th January 2016, the Irish Court of Appeal (the "**Court**") handed down an important decision in the case of *Director of Corporate Enforcement v Walsh & ors [2016] IECA 2* in relation to the law on the disqualification of directors. This judgment provides useful clarity on the law in this area.

Background

This case involved an appeal by the Director of Corporate Enforcement (the "**DCE**") against a decision of the High Court in which the Barrett J refused to make either a disqualification or restriction order against three company directors. The directors were accused of having failed to file annual returns for two companies, namely Walfab Engineering Limited ("**Walfab**") and RPB Products Limited ("**RPB**"). This failure resulted in the companies being struck off the Register of Companies (the "**Register**"). An application for disqualification of the directors was brought by the DCE under Section 160(2)(h) of the Companies Act 1990 (the "**Act**"). This section is applicable to company directors who have permitted an insolvent company to be struck off the Register in circumstances when they should have proceeded to wind up the relevant company.

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Defence of the directors

The directors of Walfab and RPB admitted their failure to file annual returns. However, they blamed the economic downturn for the financial position of the companies. They claimed that they had at all times acted in an honest and responsible manner in their dealings in respect of the companies and that when the companies became insolvent, they did not have sufficient resources to enable them to liquidate the companies.

One of the directors argued that she had never been actively involved in Walfab nor had she ever received any payment for acting as a director of Walfab.

Decision of the Court

Kelly J, in rejecting the directors' arguments, relied heavily on the judgment of Finlay-Geoghegan J in *Re. Clawhammer* where she stated:

> "*There is potential prejudice to creditors of an insolvent company if the directors, by default, permit it to be struck off the register rather than taking steps to wind it up. In such circumstances such assets of the company as remain are not applied, as a matter of course, in the discharge of creditors according to statutory priorities… Accordingly, I accept the submission made on behalf of the Director that the Oireachtas regards the fact that directors may have permitted a company to be struck off the register as a result of their failing to make annual returns as more than a technical breach of their obligations under the Companies Acts.*"

Kelly J noted that Finlay-Geoghegan J's decision was one which had been endorsed and followed in subsequent applications under Section 160(2)(h). He further held that he could see no reason why the trial judge had departed from this approach in this case. He dismissed the argument from the directors that financial difficulty or difficult trading conditions somehow operated to change the purpose of Section 160; the aim of which is to promote responsible corporate governance. In addition, Kelly J refused to accept that difficult financial circumstances somehow operate to alter or dilute the statutory obligations placed upon directors in circumstances where the companies of which they are directors become insolvent. In such cases, it is the duty of those directors to take the relevant actions to facilitate the orderly winding up of the company.

Kelly J stated that the "*scale of enterprise and qualification of directors*" and the "*context in which director transgression*" occurred were not relevant factors in determining whether it was appropriate for the Court to exercise its discretion under Section 160 and that neither of these were mitigating factors where a director of an insolvent company had not proceeded with the orderly winding up of that entity.

Past behaviour of directors

In rejecting the reasoning of Barrett J, Kelly J took the view that Section 160(2)(h) does not impose any burden on the DCE to establish any instances of past bad behaviour in order to justify the making of a disqualification order and further stated that it would run contrary to the legislative intent if a burden was placed upon the DCE to furnish the Court with historical evidence of same. Moreover, in many cases where annual returns have not been filed by the company and no Section 56 report (a liquidator's report in respect of an insolvent company) is available (as the company has not been placed into liquidation), the DCE would not be in a position to establish how directors have carried out their obligations in the past.

Passive Directorships

Kelly J then moved on to consider the issue of passive directorships. He stated as follows:

"*It would be contrary to the whole notion of proper corporate regulation that passive directors would be exonerated from liability or relieved from disqualification or restriction on the basis of the passive nature of their role*."

He then reiterated that all directors, to include "passive" directors, have an obligation to undertake all reasonable steps to file annual returns. He went on to reject the contention that the disqualification or restriction of passive directors should be restricted to circumstances involving "*real moral blame*" on their part.

Court's discretion under section 160(9A)

Kelly J then considered the Court's discretion pursuant to Section 160(9A) of the Act to make a declaration of restriction under Section 150 of the Act as an alternative to a declaration of disqualification. He rejected Barrett J's view that Section 160(9A) only allows the court to make a Section 150 declaration where such could be made on foot of a Section 150 application. Kelly J,

was satisfied that Section 160(9A) vests the Court with the discretion to impose the lesser sanction of a Section 150 declaration on a Section 160 application, provided that it is appropriate to do so in the particular circumstances. On a consideration of the evidence, Kelly J concluded that this was a case where the Court ought to exercise its discretion in favour of making a restriction order rather than a disqualification order and accordingly, he imposed a restriction of five years against each director.

Implications of the Court's Decision

This decision moves away from a number of recent High Court decisions and endorses the previously well-established case law in this area stemming from the decision of Finlay-Geoghegan J in *Re. Clawhammer*. It should serve as a useful reminder that passive directors will not be afforded any preferential treatment when an examination of their duties as directors is being undertaken by the court. Moreover, neither the scale and complexity of the company's operations nor the financial and trading conditions that are prevalent at the time will be afforded significant weight in determining whether a disqualification or restriction order should be made in circumstances where there is a clear breach of a director's obligations under Irish company law.

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