

## PROBLEMS IN THE IDENTIFICATION OF A COMPANY DIRECTOR

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### INTRODUCTION

Although a person may be described and held out by a company as acting in the capacity of a director, in law that person will not be recognised as such unless he/she is formally appointed to the company's board of directors,<sup>1</sup> or performs duties, responsibilities and exerts influence in the management of the company's affairs in a manner associated and expected of a *de facto* director.<sup>2</sup> Alternatively, a person may be identified as a "shadow director." A shadow director is defined by the companies legislation as a person in accordance with whose directions or instructions the directors of a company are accustomed to act.<sup>3</sup>

Traditionally, the ability to label a person as either a *de facto* director or a shadow director has been determined by examining the involvement, influence and control which that person exerted over corporate conduct and

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<sup>1</sup> Ordinarily, a company director will be appointed to hold office by the general body of shareholders, or in a manner which otherwise complies with the terms of the company's Articles of Association, see Table A, art 78, Companies (Tables A to F) Regulations 1985 (hereafter referred to as Table A). (In Northern Ireland see Companies (Tables A to F) Regulations (NI) (1986). A director formally appointed in this fashion is referred to as a *de jure* director.

<sup>2</sup> The Companies Act 1985 (hereafter referred to as the CA 1985), s 741 defines a director as any person occupying the position of director, by whatever name called. (In Northern Ireland see Companies (NI) Order 1986, art 9). While never formally appointed to hold office as a company director, a person may be identified as a *de facto* director in circumstances where he/she performs senior management responsibilities and duties at a level akin to a *de jure* director. The definition represented by CA 1985, s 741 is reproduced in the Company Directors Disqualification Act 1986, (hereafter referred to as the CDDA 1986) s 22(4), the Insolvency Act 1986, (hereafter referred to as the IA 1986) s 251, and the Financial Services Act 1986, (hereafter referred to as the FSA 1986) s 207 (1). (The Northern Ireland equivalents here are the Companies (NI) Order 1989, art 3(1) and the Insolvency (NI) Order 1989, art 5(1)).

<sup>3</sup> See, CA 1985, s 741 (2), a definition duplicated in the IA 1986, s 251, CDDA 1986, s 22 (4) and FSA 1986, s 207. The definition further provides that a person will not be classed as a shadow director where advice is exclusively tendered in a professional capacity. The exemption is limited and will not apply where the advice of a person acting in a professional capacity exceeds that normally expected from a person occupying a similar professional status, see *e.g.*, *Re Tasbian Ltd (No.3)* [1992] BCC 358 and *Re a Company (No.005009 of 1987)* (1988) 4 BCC 424. In this latter case, Knox J refused to hold, on a preliminary point of law, that a bank was incapable of acting as a company's shadow director. See generally, Fidler, "Banks as Shadow Directors" (1992) 7 *JIBL* 97.

policy. Given that distinct statutory definitions exist to identify the activities of either a *de facto* director or a shadow director, it would be a natural expectation for the factors and characteristics which establish these positions to be distinguishable. However, in practice such a distinction is often muddled to the extent that the judicial interpretation of the identifying characteristics of both a *de facto* director and a shadow director are devoid of any substantial disparity. The purpose of this paper is to analyse and consider issues relevant to a finding that a person's managerial activities were those of a *de facto* director or a shadow director. As a result of such analysis this paper will seek to advance proposals for the reform of the statutory identification of a company director.

While the statutory definitions relating to the classification of a director may be vague, such elusiveness does at least permit a degree of flexibility in the identification process.<sup>4</sup> In so far as fiduciary, common law, equitable and statutory duties have evolved to police an abuse of the execution of a director's corporate powers, the significance of establishing a person's role as a director is instrumental in determining that person's responsibility in the management of the company's affairs and his/her potential culpability<sup>5</sup> in respect of acts of corporate mismanagement. Notwithstanding that the nature and extent to which duties are owed to the company by a *de jure* director are reasonably well represented in the case law,<sup>6</sup> the same cannot be said in the context of a *de facto* director or shadow director, although it is contended that both should be deemed to owe duties to the company in a manner akin to a *de jure* director. While both a *de facto* director and a shadow director possess no formal agency agreement with the company, it is suggested that their ability to wield influence and authority in the management of a company's affairs is such as to justify a finding of a "hidden" or "presumed"

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<sup>4</sup> Notwithstanding the absence of any exact statutory definition of a director's role in the management of a company, the constitutional framework of a company dictates that, at the very least, a director will be expected to have a capacity to expressly or impliedly participate in the senior management of the company. See *e.g.*, Table A, art 70.

<sup>5</sup> Conversely, the identification of a person's activities as being those of a company director as opposed to, for example, a management consultant, may enable that person to evade liability in respect of acts of a contractual or tortious nature, see *e.g.*, *Williams v Natural Life Health Ltd* [1998] 1 WLR 830. Here, the House of Lords concluded that where a tort is committed in the name of a company, a director of that company will not be deemed liable for the wrongful act, save in a situation where the director expressly or impliedly assumed a personal as opposed to a corporate responsibility for the wrongful act.

<sup>6</sup> Although examples of the duties are well represented at common law, the classification of the specific types of duties has given rise to some uncertainty. In an attempt to clarify this situation the DTI have sought to codify directors' duties, see *Modern Company Law For a Competitive Economy – Final Report* (DTI, London, June 2001), Annex C. (The report is hereafter referred to as the *Final Report of the Steering Group*). The recently published White Paper *Modernising Company Law* (Cm 5553-I, July 2002), which is seen as a pre-requisite to the implementation of a new Companies Act, seeks to implement a majority of the recommendations contained in the *Final Report of the Steering Group*. The White Paper (see pp 26-32), mirrors the recommendations of the *Final Report of the Steering Group* in respect of the codification of directors' duties, with the exception of the suggested codification of directors' duties in respect of creditors.

agency relationship with the company, one which may be said to arise by operation of law.<sup>7</sup>

The identification of a person's activities as those of a company director may be especially crucial in a situation where a company falls into an insolvent state.<sup>8</sup> Here, although the separate legal identity of a limited liability company will ordinarily divorce the company's interests and responsibilities from those of its management team,<sup>9</sup> in exceptional circumstances, following the insolvency of a company, the companies legislation will sanction the imposition of personal liability against a company director.<sup>10</sup> While any personal liability imposed will take the form of a contribution to the company's assets as opposed to a contribution to an individual creditor, in some cases the contribution may at least allow an individual creditor to recover a portion of his/her losses.<sup>11</sup> The statutory provisions, which have the effect of imposing personal liability against a director of an insolvent company, are predominantly those concerned with misfeasance proceedings,<sup>12</sup> fraudulent trading,<sup>13</sup> wrongful trading<sup>14</sup> and phoenix

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<sup>7</sup> See further: Fridman, "Establishing Agency" (1968) 84 *LQR* 224. In the *Final Report of the Steering Group*, (at para 6.7) it was considered that liability for a breach of duty should extend to both a *de facto* director and a shadow director. However, no mention of this recommendation is contained in the recently published White Paper *Modernising Company Law* (Cm 5553-I, July 2002).

<sup>8</sup> A company may be viewed as insolvent where its liabilities exceed its assets (balance sheet insolvency), see IA 1986, s 123 (2). (In Northern Ireland see Insolvency (NI) Order 1989, art 103(2)). For the purposes of a winding up petition, a company may be viewed as insolvent where it is unable to pay its debts as they fall due (cash flow insolvency), see IA 1986, s 123 (1). (In Northern Ireland see Insolvency (NI) Order 1989, art 103(1)).

<sup>9</sup> See especially, *Salomon v A. Salomon Ltd* [1897] AC 22, *Adams v Cape Industries* [1990] Ch 433, *Ord v Belhaven Pubs* [1998] BCC 607 and *Trustor AB v Smallbone* [2001] 2 BCLC 436.

<sup>10</sup> Where a statutory provision seeks to disturb the separate legal identity of a company it will rarely have the effect of denying the distinct existence of the corporate entity. The statutory provision will, where applicable, penetrate the corporate entity to target company directors, penalising their delinquent conduct in the management of the company's affairs. See generally, Ottolenghi, "From Peeping Behind the Corporate Veil, to Ignoring it Completely" (1990) 53 *MLR* 338 and Mitchell, "Lifting the Corporate Veil in the English Courts: an empirical study." (1999) 3 *CfLR* 15.

<sup>11</sup> At present (but note the future effect of the Enterprise Act 2002), following the liquidation of a company, creditors whose interests are secured by way of a fixed or floating charge, or creditors classed as preferential creditors, will take any realised corporate assets in priority to unsecured creditors. However, assets recovered pursuant to actions instigated after a company's liquidation which formed no part of the company's assets prior to liquidation, *e.g.*, monies recovered from fraudulent or wrongful trading actions, will be paid into the general assets of the company for the benefit of the company's unsecured creditors.

<sup>12</sup> See IA 1986 s 212. (In Northern Ireland see Insolvency (NI) Order 1989, art 176). The provision provides an expeditious means, by way of a summary remedy, whereby an officer of the company who, prior to the company's liquidation was involved in the management of the company, may be held accountable for any breach of duty, or other act of misfeasance. Accordingly, both a *de facto* director and a shadow director will fall within the ambit of s 212, although a mere employee of the company will not, see *e.g.*, *Re Clasper Group Services Ltd* (1988)

companies.<sup>15</sup> In addition, a person established as a director of an insolvent company may, in circumstances where corporate misconduct is adjudged to have been of an unfit nature, be subject to a further penalty in the guise of a disqualification order.<sup>16</sup> Disqualification proceedings serve to protect the public interest<sup>17</sup> in so far as during the period in which a director is disqualified, the director's capacity to repeat his past misconduct is removed in respect of the future management of other companies.

### Identifying a De Facto Director

Historically, the courts have exhibited some inconsistency in determining the appropriate circumstances justifying the identification of a person as a *de facto* director.<sup>18</sup> In cases where a company's affairs have been conducted

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4 BCC 673. See further Oditah, "Misfeasance Proceedings Against Company Directors" [1992] *LMCLQ* 207.

<sup>13</sup> See IA 1986 s 213. (In Northern Ireland see Insolvency (NI) Order 1989, art 177). The provision is applicable in circumstances where a person knowingly participated in the carrying on of a company's business with an intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose. In practice, liability will fall on a director of the company, see *e.g.*, *Re Maidstone Building Provisions Ltd* [1971] 1 WLR 1085. See further Griffin, *Personal Liability and Disqualification of Company Directors* (1999, Hart Publishing, Oxford) pp 39-55.

<sup>14</sup> See IA 1986 s 214. (In Northern Ireland see Insolvency (NI) Order 1989, art 178). Liability under the wrongful trading provision will arise in circumstances where a company is in insolvent liquidation and where a person who was acting or who had previously acted as a director of the company, knew, or ought to have concluded at some time before the commencement of the winding up of the company, that there was no reasonable prospect that the company would avoid going into insolvent liquidation, see *e.g.*, *Re Produce Marketing Consortium Ltd* [1989] 5 BCC 569. See further Oditah, "Wrongful Trading" [1990] *LMCLQ* 205.

<sup>15</sup> See IA 1986 ss 216 & 217. (In Northern Ireland see Insolvency (NI) Order 1989, arts 180 & 181). The "phoenix company" describes a situation in which the controllers of a company place the company into liquidation or receivership with the objective of seeking to continue its business activities under the banner of a newly constituted company (the successor company). As a prerequisite to establishing liability it is necessary to show that the defendant acted as a director or shadow director of the liquidated company within the twelve months prior to its liquidation. See further Griffin, "Extinguishing the Flames of the Phoenix Company" (2002) 55 *Current Legal Problems*, (Ed. M. Freeman) O.U.P.

<sup>16</sup> In accordance with the CDDA 1986, s 6 (in Northern Ireland see Companies (NI) Order 1989, art 9) the court is under a duty to impose a mandatory disqualification order for between 2 and 15 years against any person in circumstances where: (a) that person is or has been a director of a company which has at any time become insolvent (whether while the person was a director or subsequently); and (b) that person's conduct as a director of the company (either taken alone or taken together with the person's conduct as a director of another company or companies) makes the person unfit to be concerned in the management of a company. See further Griffin, "The Disqualification of Unfit Directors and the Protection of the Public Interest" (2002) 53 *NILQ* 207.

<sup>17</sup> For issues relevant to determining the public interest in relation to insolvency proceedings see Keay, "Insolvency Law: A Matter of Public Interest?" (2000) 51 *NILQ* 509.

<sup>18</sup> While the term "*de facto* director" is not expressly defined by the companies legislation, its usage is well established in the law reports, dating back to at least

without a formally appointed board of directors,<sup>19</sup> the assertion that a person or persons acted in the capacity of a *de facto* director may be patently obvious.<sup>20</sup> However, in cases where the affairs of a company are *prima facie* under the guardianship of a validly appointed and active board of directors, the evaluation of the control deemed necessary to equate a person's activities with those of a *de facto* director may be especially difficult. This difficulty is particularly prevalent in cases where a person is appointed in a professional capacity to advise on matters connected with the internal and/or external management of the company<sup>21</sup> or where, for example, a substantial shareholder is able to influence the company's board of directors to the point of directly interfering with the internal management structures of the company.<sup>22</sup> Further, in the context of a large corporation, an additional complication may arise. While in a large corporation there will be little difficulty in identifying the company's board of directors, the board may not necessarily manage the company in the sense of directing corporate affairs on a day to day basis. Such powers may, in reality, reside in the hands of senior managers who, whilst not formally appointed to act as company directors, may for all intents and purposes act in a manner more consistent with a status ordinarily associated with a company director.

Although in more recent times the courts have sought to formalise guidelines to assist in the identification of a *de facto* director, such guidelines have been marred by inconsistency. In effect, two distinct tests emerged in relation to the identification of a *de facto* director, namely, the "equal footing test" and "the holding out test." In its original guise the former test identified a *de facto* director as a person who, in directing the internal arrangements of a company, acted on an equal footing with the company's formally appointed directors."<sup>23</sup> By contrast, the holding out test identified a *de facto* director as

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the Victorian era, see *e.g.*, *Re Canadian Land Reclaiming and Colonizing Co* (1880) 14 Ch.D 660.

<sup>19</sup> A company's board of directors is comprised of the individually appointed *de jure* directors. The board is the ultimate decision-making body of the company and determines the delegation of powers throughout the company. The company's articles determine the scope of a board's management powers. Subject to limited powers confined to the general meeting, articles akin to the format of Table A, art 70, will confer the general management powers of a company to the company's board. However, in respect of small private companies, the division of powers between the company's board and its shareholders will often be illusory because here it is common for the composition of the board of directors to be made up of the company's majority shareholder(s). As a matter of interest, in Germany, the division of powers between the directors of a limited liability company (GmbH) and its shareholders is weighted in favour of the latter to the extent that the directors must act on the instructions of its shareholders. Accordingly, a GmbH may often be managed by a majority shareholder(s) acting in the capacity of a *de facto*/shadow director.

<sup>20</sup> See *e.g.*, *Morris v Kanssen* [1946] 1 All ER 586, *Re Lo Line Electric Motors Ltd* [1988] BCLC 698..

<sup>21</sup> See *e.g.*, *Re Tasbian Ltd No.3* [1993] BCLC 297, *Secretary of State v Tjolle* [1998] BCC 282.

<sup>22</sup> See *e.g.*, *Secretary of State for Trade and Industry v Jones & Ors* [1999] BCC 336.

<sup>23</sup> See *e.g.*, *Re Richborough Furniture* [1996] 1 BCLC 507, *Secretary of State v Laing* [1996] 2 BCLC 324 and *Secretary of State v Hickling* [1996] BCC 678.

a person who, having been held out by the company as one of its directors, assumed the role of a director and performed functions in that capacity.<sup>24</sup>

However, these tests were open to criticism. The equal footing test was unduly restrictive of a finding of a *de facto* director as its attention was solely focused on the internal workings of the company without specific reference to any external perception of a person's managerial activities. Further, literally translated "equal footing" suggested that a person could escape being classified as a *de facto* director in circumstances where, despite performing functions akin to those of a director and being held out as such, the person's managerial functions were at a less substantive level than those of the company's formally appointed directors. The application of the "holding out" test was also limited. Although encompassing considerations relevant to both internal and external matters, the test's reliance on the latter precluded a finding of a *de facto* director other than where the company had, in external dealings with a third party, held out a person to be a director. As Warner J noted in *Re Moorgate Metals Ltd*<sup>25</sup> the expression "held out" was misleading because it may have been taken to imply that a *de facto* director must be someone to whom the label "director" had been expressly attached.<sup>26</sup>

However, in *Secretary of State for Trade and Industry v Elms*<sup>27</sup> the inconsistency resulting from the application of such disparate tests was, to a large extent, resolved. Here, Judge Cooke, while favouring the terminology attached to the "equal footing" test, re-defined the test to remove the requirement of establishing an equal standing in terms of power or authority in relation to the management of a company's affairs. Judge Cooke clarified the term "equal footing" as one which portrayed an equal right and ability to participate in the management and decision making process of the company via, for example, the mechanisms of board meetings. Further, the learned judge recognised the relevance of the holding out test as an evidential consideration in ascertaining whether a person had actually acted on an equal footing with the company's other directors. This impliedly merged the "equal footing" test and the "holding out" test into one. Judge Cooke advanced the following three guidelines to determine whether a person's activities were those of a *de facto* director:

- “(1)(a) Has the company held X out to be a director, *i.e.* allowed X to be cloaked with the indicia of directorship, and
- (b) has X claimed and purported to be a director?
- (2) Did X undertake functions that could properly be discharged only by a director and not just a manager?

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<sup>24</sup> See *Re Hydrodam (Corby) Ltd* [1994] 2 BCCL 180. For a detailed discussion on the tests to determine a *de facto* director, see Griffin (2000) 4 CfilR 126.

<sup>25</sup> [1995] 1 BCLC 503.

<sup>26</sup> Caution in this matter was obvious, although in all probability, misplaced, given that the consternation surrounding the interpretation of the term "holding out" over-looked the fact that a "holding out" may take place as a result of a company's acquiescence in the performance of a person's managerial functions, see *e.g.*, *Freeman & Lockyer Ltd v Buckhurst Properties* [1964] 2 QB 480.

<sup>27</sup> (16 January 1997, unreported).

(3) Is there clear evidence (a) that X was the sole person directing the affairs of the company or (b) if acting with others validly appointed or not, acting on an equal footing with the others and directing the affairs of the company?"

The learned judge described the three tests as disjunctive rather than conjunctive and opined that if there was any doubt as to the capacity in which X had acted, such doubt should be resolved in X's favour.

This revision of the "equal footing" test, was accepted by Jacob J in *Secretary of State v Tjolle*.<sup>28</sup> However, the learned judge declined to apply a single decisive test which exhibited the characteristics of a prescribed formula. Instead, Jacob J considered that in all cases the court should consider a number of factors and that the determination of a person's status, as a *de facto* director, should be resolved as a question of fact. The learned judge described the relevant factors, thus:

"Those factors include at least whether or not there was a holding out by the company of the individual as a director, whether the individual used the title, whether the individual had proper information (e.g. management accounts) on which to base decisions, and whether the individual has to make major decisions and so on. Taking all these factors into account, one asks 'was this individual part of the corporate governing structure?' answering it as a kind of jury question . . . There would be no justification for the law making a person liable to misfeasance or disqualification proceedings unless they were truly in a position to exercise the powers and discharge the functions of a director. Otherwise they would be made liable for events over which they had no real control, either in fact or law."<sup>29</sup>

In rejecting a single decisive test, the classification of a *de facto* director as one based upon a consideration of a number of factors, possesses the advantage of flexibility devoid of the constraints inherent in the application of a prescribed and rigid test. In *Re Kaytech International plc; Portier v Secretary of State for Trade and Industry*<sup>30</sup> the Court of Appeal endorsed the approach adopted in *Secretary of State v Tjolle*. Here the court emphasised that all relevant factors (which of course will in part vary from case to case) should be considered in calculating whether a person's activities were those of a *de facto* director.

Accordingly, following the Court of Appeal's acceptance of the approach advocated by Jacob J, the attributes of a *de facto* director will in future be ascertained as a question of fact. While matters relevant to both the equal footing test and the holding out test will naturally form an essential part of that question, the ability to determine the identification of a *de facto* director will be more elastic, free from the limitations of any specific, formally devised, test.

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<sup>28</sup> [1998] 1 BCLC 333.

<sup>29</sup> *Ibid* at p 344.

<sup>30</sup> [1999] BCC 390. This was the first case in which the Court of Appeal was called upon to consider matters relevant to the identification of a *de facto* director.

### Identifying a Shadow Director

A shadow director is defined by the companies legislation as a person in accordance with whose directions or instructions the directors of a company are accustomed to act.<sup>31</sup> Therefore, a shadow director may be expected to exert influence over the company's board of directors to the extent that his/her directions and instructions will ordinarily be followed. Consequently it would, at first sight, appear a logical assumption to conclude that a shadow director will be identified as any person who exerts a dominant and controlling influence over the company's affairs and who is responsible for engineering and directing corporate activity through what may be described as a "puppet" board of directors. Further, the term "shadow" would appear to imply that a person acting as a shadow director will operate in a hidden capacity, directing and controlling the activities of a company through persons who are expressly or impliedly held out by the company as its *de jure* or *de facto* directors. The aforementioned characteristics expound a position of superiority and control over the company's affairs. Indeed, prior to 2000, the said characteristics dominated the courts' identification of a shadow director.<sup>32</sup>

However, following the decision of the Court of Appeal in *Secretary of State v Deverell*<sup>33</sup> a controlling and dominant, but hidden influence in the affairs of a company must now be viewed as an exaggeration of the level and degree of involvement deemed necessary to identify a shadow director. The *Deverell* case concerned an application by the Secretary of State to disqualify D and H in accordance with section 6 of the Company Directors Disqualification Act 1986. It was contended that both had acted as shadow directors of E Ltd. In

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<sup>31</sup> *Supra*, n 3. It should also be observed that a person will not be classed as a shadow director if that person gives directions or instructions as an agent of another person or body, *e.g.*, a person will not be classed as a shadow director of company X where he gives directions or instructions in his capacity as a director of company Y. However in the given scenario it would of course be possible for company Y to be classed as a shadow director of company X, see *Re Hydrodam (Corby) Ltd* [1994] 2 BCCL 180. However, in the case of a holding company/subsidiary relationship, specific provisions of the CA 1985 preclude a holding company from being classed as a shadow director of its subsidiary company(ies) by reason only that the directors of the subsidiary are accustomed to act in accordance with the parent company's directions or instructions, see CA 1985, ss 309, 319, 320 to 322 and 330 to 346. (In Northern Ireland see Companies (NI) Order 1986, arts 317, 327, 328 to 330 and 338 to 354).

<sup>32</sup> See *e.g.* *Re Lo-Line Electric Motors Ltd* [1988] 2 All ER 692, *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] AC 187, *Re Unisoft Group Ltd* (No 3) [1994] 1 BCLC 609, *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180, *Sec of State v Laing* [1996] 2 BCLC 324 and *Re Kaytech International plc* [1999] 2 BCLC 351. The said characteristics have also been employed by academics in describing the identity of a shadow director, see *e.g.*, Davies, Gower's Principles of Modern Company Law (6<sup>th</sup> ed, Sweet & Maxwell, 1997), at pp 182-183. Notwithstanding a general absence of case law identifying examples of a shadow director, it is suggested that typical examples of persons who could have been identified as such prior to 2000 would have included; a substantial shareholder with a capacity to influence and direct corporate policy through a nominee board of directors or banks, financial institutions, and other creditors upon which the company's financial survival depended.

<sup>33</sup> [2001] Ch 340.



defending the proceedings, D and H argued that their involvement in the affairs of E Ltd had been as management consultants and not as directors.<sup>34</sup>

In relation to D, although he had never been formally appointed as a director of E Ltd, he had been involved in the management of the company from the time of its incorporation. As one of the signatories to the company's bank account, D was an active player and influence in the accounting and financial structures of the company and was its principal negotiator in business dealings. D's involvement and attachment to the company was substantial to the extent that he personally guaranteed a loan entered into by and on behalf of the company. In contrast to D's transparent involvement in the internal management structures of E Ltd, H's involvement in the company's affairs was more illusive. Having been made subject to a bankruptcy order, H was precluded from any involvement in the company's formal management structures. Nevertheless, irrespective of H's inability to expressly involve himself in the affairs of the company, his informal participation and influence in management issues was considerable, especially in the context of advising the company on its future direction. For example, notwithstanding the company's insolvent position and the concerns expressed by the company's board of directors in respect of the company's financial state, H had instructed the company's *de jure* directors to continue to trade, an instruction which had been obeyed.

At first instance,<sup>35</sup> Judge Cooke, sitting as a judge of the High Court in the Chancery Division, held that neither D nor H could properly be construed as shadow directors. In respect of D, the learned judge opined that while he was a prominent and powerful member of the company's management team, his participation was on a near equal footing with the company's *de jure* directors. Therefore, this equal participation could not properly be described as having cast the board of directors in a subservient role. In relation to H, Judge Cooke opined that while H had been an influential character, the board had not been accustomed to act on his advice, although on occasions his advice had been followed. Further, the learned judge considered that the giving of mere advice would not fall within the statutory definition of a shadow director unless it had been accepted and acted upon in a manner consistent with a direction or instruction. Judge Cooke concluded that although H had advised the company's board of directors, the board retained an ability to act independently and reject such advice, to the extent that H could not be described as having acted as the company's shadow director.

The Court of Appeal was to overturn the decision of Judge Cooke and as such both D and H were classed as shadow directors. Morritt LJ, who delivered the leading judgment of the court, considered that Judge Cooke had erred in the construction of the statutory definition of a shadow director. First, Morritt LJ rejected Judge Cooke's interpretation of a shadow director as a person who would always be in a position to cast the board in a subservient role.<sup>36</sup> Although Morritt LJ agreed that D would have clearly been identified as a shadow director had the board of directors constantly

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<sup>34</sup> Interestingly, both H and D received fees for their services to the company in an amount in excess of the salaries paid to the company's *de jure* directors.

<sup>35</sup> (Unreported 11 May 1998).

<sup>36</sup> *Supra*, n 33 at pp 354-355.

obeyed his instructions, he considered that the ability to establish a subservient relationship between a shadow director and the board of directors was not a pre-requisite to a finding that D had acted as a shadow director. His Lordship reached this conclusion on the basis that the use of the term “accustomed to act” should not be interpreted to mean that the board must always be compelled to obey the guidance of a shadow director. Accordingly, a person was capable of acting as a shadow director even if the board had a capacity to exercise independent judgment.

In respect of the finding that H had acted in the capacity of a shadow director and more specifically the issue of whether the giving of advice could be equated with a direction or instruction, Morritt LJ opined that if advice was given on a regular and consistent basis it could be considered in the same light as a direction or instruction because a direction, instruction, or the giving of advice all shared the common characteristic of an act of guidance.<sup>37</sup> Therefore, according to his Lordship, once it was established that there was a sufficient degree of guidance the court would be in a position to objectively ascertain whether the direction, instruction or advice so relied and acted upon by the board of directors carried real influence in relation to the business activities of the company. In so deciding, it would be immaterial that there was any expectation that the guidance would be followed. Further, according to Morritt LJ, it was unnecessary to establish that the “real influence” extended over the whole of the company’s business operations.<sup>38</sup>

Following the judgment of the Court of Appeal in *Deverell*, a shadow director may therefore be identified in the following manner, namely as a person who customarily tenders advice, instructions or directions to the company’s board, of a type which, as an act of guidance, carries real influence in relation to a part or the whole of the company’s business affairs. While the company’s board will normally adhere to the guidance tendered by a shadow director, it is not essential that it is habitually followed or that there is any expectation that it will be followed. A shadow director may be independent from or form a part of the internal management structure of the company. This reformulated definition now casts a wide net into which a person may be caught and labelled as having acted as a shadow director. However, although the new definition may be applauded in the sense that it increases the pool of persons who, as shadow directors, may be held personally accountable following a company’s demise, affording greater protection to the interests of creditors and the general public, the credibility of the reformulated definition may be doubted in the context of its interpretation of the companies legislation.

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<sup>37</sup> *Ibid.*

<sup>38</sup> *Ibid.* Morritt LJ agreed with the approach advocated by the Australian courts in the interpretation of the Australian Corporations Law, s 60. The said provision is drafted in similar terms to CA 1985, s 741 (2). More specifically his Lordship agreed with the statement of Finn J in *Australian Securities Commission v AS Nominees Ltd* (1995) ALR 1, at pp 52-53, where his Honour said: “. . . the reference in the section to a person in accordance with whose directions or instructions the directors are accustomed to act does not in my opinion require that there be directions or instructions embracing all matters involving the board. Rather, it only requires that, as and when the directors are directed or instructed, they are accustomed to act as the section requires.”

First, can mere advice be equated with a direction or instruction? Unlike the terms “direction” and “instruction” the statutory definition of a shadow director makes no mention of “advice” or for that matter “an act of guidance”. A direction or instruction is a positive command, whereas a communication imparting advice is devoid of any requirement on the part of its recipient to comply with the recommendation. While a direction, instruction or the giving of advice may all share the common characteristic of an act of guidance, a direction or instruction, as an act of guidance, implicitly carries an expectation of obedience. In contrast, “advice” is, as an act of guidance, couched more in the form of a suggested course of action and therefore is deficient of any expectation that it must ordinarily be followed. Although there may be occasions where advice is habitually followed to the extent that it merely masks what is in effect a direction or instruction, it is suggested that mere advice is indisputably distinguishable from a direction or instruction.

The second point of contention, closely related to the first, involves the statutory definition of a shadow director in its use of the term “accustomed to act.” In *Deverell*, Morritt LJ interpreted the term “accustomed to act” in a passive sense by indicating that it was unnecessary to establish that a person identified as a shadow director dominated the company’s *de jure* directors, thereby casting the board of directors in a subservient role. However, with respect, although the term “accustomed to act” may be interpreted in a manner whereby a company’s board need not *always* act in accordance with a direction or instruction, the term nevertheless implies that it would be unusual for a direction or instruction to be ignored. Therefore, if a board of directors is accustomed to act in accordance with a person’s directions or instructions, the board will indeed be placed in a subservient position, notwithstanding that it may be blessed with a minor degree of autonomy. Surely the question of whether a board of directors is “accustomed to act” will rest upon a case by case analysis of whether a person in directing or instructing the board of directors was obeyed on a regular basis, and more specifically, whether that person’s directions or instructions were ordinarily obeyed in relation to decisions crucial to the governance, direction and pursuit of the company’s internal, external and financial affairs.

The final point of contention arising from the *Deverell* case concerns the ability to label a person as a shadow director where that person’s influence in the management of a company’s affairs was as a participant in the internal management structures of the company. While the statutory definition of a shadow director fails to specifically distinguish between the giving of directions or instructions as either an internal or external contributor to a company’s affairs, is it not tacit in the use of the expression “shadow” that a person so classified will exert influence over corporate affairs from outside formal management structures? In *Deverell*, although D exerted considerable influence in the management of the company’s affairs and was identified as a shadow director, as a visible character exerting managerial influence from inside as opposed to outside formal management structures, should he not have been more aptly described as a *de facto* director or indeed a *de facto* managing director?

### Distinguishing Between A De facto and Shadow Director

Although a *de facto* director and shadow director share common characteristics in having a capacity to exert real influence in the management of a company's affairs, there is, surprisingly, little judicial consideration of any distinction between the two types of directorship.<sup>39</sup> Moreover, on occasions, the distinction has been portrayed as unnecessary and irrelevant.<sup>40</sup> While in some cases such ambivalence may perhaps be excused, for example, where a shadow director steps from the shadow to resolve corporate issues, thereby identifying himself as active in the conduct of the company's internal affairs and in a position akin to that of a *de facto* director,<sup>41</sup> surely, a general inability to distinguish between a person's activities as that of a *de facto* director or shadow director is unsatisfactory. Indeed, in *Re Hydrodam (Corby) Ltd*,<sup>42</sup> a case in which the significance of the distinction was actually stressed, Millett J observed that:

“... in my judgement an allegation that a defendant acted as a *de facto* or shadow director, without distinguishing between the two is embarrassing. It suggests . . . that the liquidator takes the view that *de facto* or shadow directors are very similar, that their roles overlap, and that it may not be possible to determine in any given case whether a particular person was a *de facto* or a shadow director. I do not accept that at all. The terms do not overlap. They are alternatives, and in most and perhaps all cases are mutually exclusive.”<sup>43</sup>

However, notwithstanding the above statement, post *Deverell*, the hallmarks of a shadow director have been modified to such an extent that they are now readily identifiable with characteristics assumed in the identification of a *de facto* director. For example, prior to *Deverell*, evidence to justify a person being labelled as a shadow director<sup>44</sup> required the exertion of a dominant and controlling influence over the company's affairs, a more daunting evidential requirement than establishing a person's capacity as a *de facto* director.

<sup>39</sup> See e.g., the comments Robert Walker LJ in *Re Kaytech International plc* [1999] BCC 390, 402.

<sup>40</sup> E.g., in *Re Tasbian Ltd No.3* [1993] BCLC 297 the Court of Appeal, in affirming the decision of Vinelott J at [1991] BCLC 792, made no attempt when analysing the facts of the case to distinguish between a person's involvement in the management of a company as a de-facto or shadow director. Instead, the court was quite satisfied to conclude that the evidence of the case was sufficient to establish that the person had acted as either a *de facto* director or a shadow director.

<sup>41</sup> *Ibid.*

<sup>42</sup> [1994] 2 BCLC 180.

<sup>43</sup> *Ibid.*, at pp 182-3.

<sup>44</sup> As with establishing the characteristics of a *de facto* director, the difficulty in attempting to distinguish between the activities of a professional advisor and a shadow director may be especially troublesome. To establish that a professional advisor acted as a shadow director one must first prove that the advisor exerted an influence over the company's affairs in a manner which exceeded his advisory status. It would appear that the advice and actions tendered by an advisor should be viewed objectively; such actions should be compared with those of a person of the same professional status and occupying a similar advisory role, see *Re Tasbian Ltd No 3*, *supra* n 40.

Following *Deverell*, a person's classification as a shadow director may, in common with that of a *de facto* director, be established without proof of a controlling influence. Secondly, prior to *Deverell*, a shadow director would have been defined as a person detached from the company's internal management, operating in a hidden capacity, directing and controlling the activities of a company through persons expressly or impliedly held out by the company as its *de jure* or *de facto* directors. After *Deverell*, a person may now be classed as a shadow director where he wields influence over a company's affairs irrespective of whether such influence is as a part of the company's internal management structure; a finding which could also equate to identify a person's capacity as that of a *de facto* director. Finally, prior to *Deverell*, a shadow director would have been expected to be in a position to give directions or instructions which would ordinarily be obeyed by the company's board. Following *Deverell*, the giving of advice is now equated with directions or instructions. In this respect a shadow director may be viewed as on an "equal footing" with the company's *de jure* directors in a sense previously construed as relevant solely to the identification of a *de facto* director. In effect, post *Deverell*, the ability to distinguish between a shadow director and a *de facto* director is, in practical terms, marred by such a similarity in characteristics that the distinction is now largely irrelevant. The only exception to this is where a person exerts managerial influence from outside internal management structures; such activity is incapable of falling within the definition of a *de facto* director but is nevertheless appropriate to the definition of a shadow director.

Although, in a practical sense, the inability to distinguish between a person's activities as either a *de facto* director or shadow director is, at present, unlikely to be relevant in calculating the extent of a person's potential culpability in respect of acts of corporate wrongdoing, in a linguistic sense, such a failure makes a mockery of legislation which persists in the retention of distinct provisions purporting to identify and separate the two categories of directorship. As there is currently no differentiation in sanction for an abuse of either position then there would appear little, if any point, in maintaining the statutory distinction pertinent to the identification of a *de facto* or shadow director, a fact evidenced by cases *post Deverell*. In the said cases the courts, in concluding that a person's management activities were those of a company director, have failed to specifically distinguish between the activities of a *de facto* director and a shadow director, instead, they have been content to "sit on the fence" by finding that the management activities were those of either a *de facto* director or shadow director.<sup>45</sup> However, despite the practical irrelevance of the statutory distinction between a *de facto* director and a shadow director, it is most probable that the distinction will be maintained.<sup>46</sup>

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<sup>45</sup> See e.g., *MCA Records Inc v Charly Records Ltd* [2002] EMCR 1 and *The Official Receiver v Zwirin* [2001] WL 825078. Indeed, it is pertinent to note that in *Deverell* Morritt LJ expressly declined to express any view on whether the categories of *de facto* director and shadow director were mutually exclusive.

<sup>46</sup> See, the Final Report of the Steering Group, para 6.7.

### Suggested Reform

If, as is most probable, the courts observe the definition of a shadow director as advanced in *Deverell*, then the characteristics establishing a finding of a shadow director will also incorporate those which portray the identity of a *de facto* director. Accordingly, the necessity of maintaining the present statutory distinction between a shadow director and a *de facto* director will become unnecessary. To this end it is submitted that it would be logical to merge the current statutory definitions of a *de facto* and shadow director into one, all embracing, statutory provision, thereby abandoning the present classification of a director as either a *de facto* director or shadow director. It is suggested that the unified definition could be identified by the term “ordinary director”. The definition of an ordinary director could take the following form:

“An ordinary director is any person, by whatever name called, who performs managerial functions as part of the governing structure of a company and/or issues directions or instructions which are acted upon, from time to time, by the company’s board of directors.”

In eradicating the statutory distinction between a shadow director and a *de facto* director, the reforming definition would confirm the acceptance of the union between the characteristics of the two types of office as impliedly portrayed in *Deverell*. The aforementioned reform, in giving logic to the reality of the situation, would end the embarrassment of maintaining the distinct statutory categories of a *de facto* director and shadow director.

However, while the removal of the statutory distinction between a *de facto* director and a shadow director may be necessary to the reality of the present order, the removal of the distinction would eradicate any ability, in respect of the classification of a director, to differentiate between a person’s level and degree of involvement in the management of a company. Nevertheless, given that the culpability attached to the delinquent conduct of both a *de facto* director and shadow director is dependent upon the consequences and extent of any delinquent conduct rather than the specific classification of the type of directorship held, it may be argued that the need to so distinguish the degree of influence and control exerted by a person in the management of a company’s affairs is unnecessary. Yet, as a matter of justice, if not logic, where a person’s involvement in the management of a company’s affairs is of a dominant and commanding nature, should not that person potentially suffer a greater sanction for a corporate wrongdoing than a person who, in relation to a similar act of delinquent conduct, acted on an equal footing with the company’s other directors? Should not the law specifically distinguish, in terms of potential culpability, between persons who are in a position of control and dominance as opposed to those who merely impart advice and/or exert a more limited influence in the affairs of a company?

In suggesting affirmative answers to the aforementioned questions it is submitted that a more substantive legislative reform should be introduced to differentiate between the different levels and degrees of involvement which may identify a person’s activities as those of a company director. To this end, it is contended that a distinct classification of a director as a “dominant director” could be introduced. While the *Deverell* interpretation of a shadow

director could be maintained as forming the crux of a person's potential liability in respect of the suggested reformulated definition of an ordinary director, it is suggested that a dominant director could be defined in the following manner:

“A dominant director is any person, by whatever name called, who directs or instructs a company in the management of its affairs and whose directions or instructions are habitually obeyed and acted upon by the company's board of directors.”

In accordance with the above definition, a person would be classified as a dominant director in circumstances which would have previously justified a finding of a shadow director prior to *Deverell*. However, a person would also be defined as a dominant director in any situation where, as either an external or internal influence in the management of a company's affairs, that person exerted a dominant and controlling influence. Therefore, a person acting in the capacity of a *de jure* director, or as currently defined, a *de facto* director, could also be classified as a dominant director where that person's authority and control over a company's affairs was of a type whereby the company's other directors were subservient to the will of that person. As a consequence of a distinction being drawn between an ordinary director and a dominant director, it is contended that any potential liability which attached itself to the latter would be expected (in keeping with the influence and control that person exerted over the management of a company's affairs) to be greater than that which would have been applicable had the particular type and degree of delinquent conduct been attributable to a person acting in the capacity of an ordinary director.

### CONCLUSION

As the law now stands, the ability to label managerial conduct as affirmative of a person's conduct as either a *de facto* director or shadow director will be determined by examining the nature of the person's involvement, influence and control over corporate conduct and policy. Although the companies legislation defines a shadow director in terms distinguishable from those of a *de facto* director, following the case of *Deverell*, the practical worth of this distinction is now without substance and as such its maintenance is both confusing and an unnecessary embarrassment. Following *Deverell*, a shadow director may be established, in common with a *de facto* director, without proof of a controlling influence, devoid of a need to establish the shadow director as a hidden influence in the affairs of a company and finally, without proof of any expectation that the shadow director's directions or instructions will be obeyed. Accordingly, in a manner akin to that of a *de facto* director, a shadow director's role in the management of a company may be viewed to be on an equal footing with the company's *de jure* directors.

As the characteristics which ascertain a person's managerial activities as those of a shadow director now incorporate the identifying attributes of a *de facto* director, a logical step would be to merge the two distinct definitions into one (so defined as the ordinary director). However, the need to differentiate between persons who exert a dominant controlling influence over a company's affairs, as opposed to persons who may impart partial influence on an equal footing with the company's *de jure* directors, is such that a reforming provision (the dominant director provision) should be

introduced to take account of any disparity in respect of the degree of control exerted over a company's affairs by the company's directors. It is submitted that a dominant director, in exerting a greater degree of control and influence over a company's affairs, should shoulder a greater level of responsibility than that expected of an ordinary director; a fact which should always be reflected in the calculation of a director's personal liability and/or period of disqualification.

To conclude, the statutory definitions of a company director are at present confusing and inept and as such are in need of reform. Further, given that a current trend of corporate law reform is directed at re-evaluating the governance of companies and the responsibilities and duties attached to company directors, it is surely, as a logical and imperative co-requisite to such reforms, necessary to modify and restructure the statutory definitions and classification of company directors. While the confusion and uncertainty concerning the distinction between a *de facto* director and shadow director prevails, the law, as it currently stands, resembles something of a tangled web.