Shadow Directors

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"Very good on technical issues", "he never fails to deliver, and his advice is always spot on…He is amiable and respectful and very nice to work with."
- Chambers & Partners

"Excellent attention to detail and technical expertise" - Legal 500

Michael's practice is rooted in commercial chancery and professional liability and he is ranked as a Leading Professional Negligence Junior by the directories.

Drawing upon his commercial chancery background in company law, trusts and property Michael has built a significant practice combining disputes in those areas and in related professional liability. His familiarity with the underlying areas of practice and sensitivity towards the commercial and reputational concerns of his clients enables him to deal effectively and knowledgeably with claims involving directors, trustees and other fiduciaries such as insolvency professionals as well as claims arising from a broad range of business transactions in relation to shares, real property, trust administration and financial investments.

Michael also has substantial experience of professional liability claims against solicitors, both as advisers but also as fiduciaries, and is regularly instructed in claims involving elements of fraud or equitable remedies such as rectification. He also acts in claims against financial advisers, tax consultants, accountants and valuers and has a particular interest in disputes arising in the art market. Michael is also an accredited mediator.

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- **What are they?**
- **What are their duties?**
- **What are the implications for:**
    - **Limitation periods?**
    - **Accessory liability?**
    - **D&O insurance?**

A. INTRODUCTION: TRANSPARENCY AND SHADOW DIRECTORS

1 In June 2013 the United Kingdom hosted the G8 summit at Lough Erne near Enniskillen in Northern Ireland, close to the border with the Republic of Ireland. Quite apart from the topicality of issues surrounding "the backstop" it is a useful place to start because the G8 put transparency about the ownership and control of corporate structures at the heart of the agenda.

2 A G8 action plan entitled "*Principles to prevent the misuse of companies and legal arrangements*" was signed. This set out eight "core principles" which were said to be "*essential to ensure the integrity of beneficial ownership and basic company information*".[1]

3 Of these eight core principles the first second and fifth contained the following wording:

> *"1. Companies should know who owns and controls them and their beneficial ownership and basic information should be adequate, accurate, and current. …"*

[1] https://www.gov.uk/government/publications/g8-action-plan-principles-to-prevent-the-misuse-of-companies-and-legal-arrangements (accessed 27 January 2019).

"2. Beneficial ownership information on companies should be accessible onshore to law enforcement, tax administrations and other relevant authorities including, as appropriate, financial intelligence units. …"

"5. The misuse of financial instruments and of certain shareholding structures which may obstruct transparency, such as bearer shares and nominee shareholders and directors, should be prevented."

4 Each of the members of the G8 committed to the preparation of national action plans to give effect to these principles. In the UK this led to the preparation of various proposals by the Department for Business, Innovation and Skills and in due course to new legislation in the form of the *Small Business, Enterprise and Employment Act 2015*.

5 Headed "*Company Transparency*", Part 7 of the 2015 Act makes a number of important changes to UK company law. Three particular changes stand out:

(a) First, there is the introduction of the obligation to maintain registers of people who have significant control over companies. This could be a talk in and of itself, but the reform was to introduce from April 2016 a new Part 21A to the CA 2006 to require companies to make investigations so as to identify persons with significant control over the company, to keep a register of such persons ("the PSC register") and submit that PSC information to Companies House.[2]

(b) Second, although this has not yet been brought into force, section 87 of the 2015 Act revokes section 155 of the CA 2006 (which provides that companies have to have at least one director who is a natural person) and introduces a new s 156A-C into the CA 2006. This new provision says that a person may not be appointed a director of a company unless the person is a natural person. There is a power given to the Secretary of State to make exceptions

[2] The meaning of a person with significant control is set out in the new schedule 1A to the CA 2006. There are various conditions any one of which can be satisfied; e.g. holding directly or indirectly more than 25% of the shares in a company; holding directly or indirectly more than 25% of the voting rights in the company; holding the right directly or indirectly to appoint or remove a majority of the board of directors; having the right to exercise, or actually exercising, "significant influence or control" over the company. Statutory guidance on that phrase has been issued by the Secretary of State under para 24 of schedule 1A which makes it clear that it extends to shadow directors, but with excepted roles for professional advisors and lenders.

by regulations, but, subject thereto, any directors who are not natural persons when and if these provisions come into force will cease to be directors on the relevant day. For present purposes what is noteworthy is section 156A(4) which states that none of these changes affects the liability of any person if they act as a shadow director. This preserves the possibility of a company acting as a shadow director of another company.

(c) Third, and of most significance in the context of this talk, is section 89 of the 2015 Act. This makes a small but significant change to section 170 of the CA 2006. That section is, of course, part of the statutory codification of directors' duties which defines the duties set out in detail in sections 171 to 177 as "*the general duties*" and states that those duties are owed by a director of a company. The change that was made by the 2015 Act was to the wording of section 170(5):

from:

> *"(5) The general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles so apply."*

to:

> *"(5) The general duties apply to a shadow director of a company where and to the extent that they are capable of so applying."*

6 What the Explanatory Note to the Act says is illuminating.

> *"603. At present the general duties of directors can only apply to shadow directors in the same way as the corresponding common law rules and equitable principles can. In future, the **starting point** for shadow directors will be that the general duties apply to them unless they are not capable of applying (removing the current restriction). This is achieved by replacing section 170(5) of the CA 2006. This **change in default position** is neither intended to preclude the courts from looking at the application of the duties on a case by case basis, nor from drawing on existing case law in any given case."* (emphasis added)

7 Two points might be made in this regard:

(a) In enacting the legislation, an alternative form of wording - to the effect that the general duties would apply "*to the extent it is reasonable, just and equitable for any such general duty to apply*" – was rejected. As a result the government's policy intention seems clear: to send a message to those who control UK companies that they should understand that they will be subject to the same extensive duties as properly appointed company directors and that they cannot evade the responsibilities for improper corporate behaviour by disguising their true role.

(b) However, this is not an absolute rule. This may be the default position but it leaves room for debate as to whether and if so to what extent the general duties apply in a specific case. Indeed, the Secretary of State is empowered to make regulations about the application of the general duties of directors to shadow directors and it is possible for these regulations to adapt the general duties or even disapply them: section 89(2)(3) of the 2015 Act. But no such regulations have been made.

8 The real difficulty here may not about determining if someone is a shadow director but what that means in terms of his or her duties to the company.

B. TYPES OF DIRECTORS AND THE DISTINCTION BETWEEN DE FACTO AND SHADOW DIRECTORS

9 Traditionally, of course, there has been a threefold distinction between (1) de jure directors; (2) de facto directors; and (3) shadow directors.

10 The concept of de jure directors is the easiest to explain. They are directors who are validly appointed and registered as directors and act as such. There is no question that they owe the full range of directors' duties.

11 As for de facto directors, traditionally this concept was used to describe persons who hold themselves out as directors and intend to act as such – in other words those intending to assume and assuming the role of director - but who were never formally

appointed at all or whose appointment was defective. Because they are directors "in fact" such de facto directors also owe the full range of directors' duties.

12 Shadow directors on the other hand are a creature of statute. As we explain in more detail, they are persons "*in accordance with whose directions or instructions the directors of a company are accustomed to act"*. In other words they direct or instruct the de jure or de facto directors to act in certain ways. The traditional metaphor that used to be deployed is of people lurking in the shadows acting as a puppeteer pulling the puppet strings of the directors. That remains the classic conception, but it is not a necessary way to think of them. Shadow directors can operate out in the open and the use of epithets has been said to be potentially misleading in suggesting a degree of control is required in excess of what the statutory definition requires: see *Secretary of State for Trade and Industry v. Deverell* at [36].

13 The distinction between de facto and shadow directors used to be considered a sharp one. It used to be assumed that there was no real possibility of someone being both a de facto and a shadow director, the two concepts being nearly always mutually exclusive. As Millet J said in *Re Hydrodan (Corby) Ltd*:

> *"… in my judgment an allegation that a defendant acted as de facto or shadow director, without distinguishing between the two, is embarrassing. It suggests … 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."*

14 The position is more nuanced now as a result of decisions on de facto directors such as *Re Kaytech* and in particular *HMRC v. Holland*. The concept is not simply about a defective appointment or how people refer to themselves but involves looking at all the circumstances and what someone actually does to determine if a person is "*a part of the corporate governing structure*" and has assumed the status and function of a company director. This is a multi-factorial test of which holding out is one factor. The distinction between de facto and shadow directors has therefore narrowed since both

are concerned with those who have real influence in a company's affairs: see *Holland* at [90-91].

15 What duties shadow directors owe and in particular whether they owe fiduciary duties, is not clear. As recently as 2014 Etherton LJ said "*the law is not entirely settled*": *Sukhoruchkin v. Van Bekestein* at [41]. What is reasonably clear, however, is the underlying policy of the law in relation to shadow directors. The law should concern itself with, regulate and hold responsible people who carry real influence in a company's affairs. Such people may in reality represent the true directing mind and will of the company. In the absence of any regulation or responsibility attaching to such people they could evade the various mechanisms of the law designed to prevent the mismanagement of a company's affairs, to the detriment of shareholders, investors, creditors and the public.

C. STATUTORY HISTORY OF SHADOW DIRECTORS

16 Although the terminology of "shadow director" was only introduced in 1980, the underlying concept can be traced back at least to the *Companies (Particulars as to Directors) Act 1917*. This said that for the purposes of various obligations in the prevailing company law as to the provision of information to the registrar of companies:

> "*the expression "director" shall include any person who occupies the position of a director and any person in accordance with whose directions or instructions the directors of a company are accustomed to act.*"

17 This really echoes the modern concern expressed by the G8 in 2013 to know the identity of those who are really in control of companies. Further companies legislation in 1928 and 1948 also included the same idea and gradually expanded its application.

18 It was in the *Companies Act 1980* that the definition "shadow director" was introduced. This provided in section 63 that that a person within the statutory wording ("*a person with whose directions or instructions the directors of a company are accustomed to act"*) should henceforth be defined as a "shadow director".

19 It also made clear there were two exceptions. First, professional advisors: a person would not be a shadow director by reason only that the directors were accustomed to act with his directions or instructions if this was "*on advice given by him in professional capacity*": section 63(1).[3] Second, parent companies: a body corporate would not be treated as the director of any of its subsidiary companies by reason only of section 63(1).

20 The prevailing definition has been through some further changes, not least as a result of the 2015 Act, but the core idea being a person with whose directions or instructions the directors of a company are accustomed to act remains. It is now found across our company and insolvency law:

(a) section 251 of the CA 2006;

(b) section 251 of the IA 1986;

[3] This proviso was originally introduced in the *Companies Act 1929*.

(c) section 22 of the CDDA 1986.

D. THE STATUTORY WORDING AND ITS INTERPRETATION

21 The definition to be found in section 251 of the CA 2006 is as follows.

> ***251 "Shadow director"***
>
> *(1) In the Companies Acts* "shadow director"*, in relation to a company, means a person in accordance with whose directions or instructions the directors of the company are accustomed to act.*
>
> *(2) A person is not to be regarded as a shadow director by reason only that the directors act*
>
> *(a) on advice given by that person in a professional capacity;*
>
> *(b) in accordance with instructions, a direction, guidance or advice given by that person in the exercise of a function conferred by or under an enactment;*
>
> *(c) in accordance with guidance or advice given by that person in that person's capacity as a Minister of the Crown (within the meaning of the Ministers of the Crown Act 1975).*
>
> *(3) A body corporate is not to be regarded as a shadow director of any of its subsidiary companies for the purposes of–*
>
> *Chapter 2 (general duties of directors),*
> *Chapter 4 (transactions requiring members' approval), or*
> *Chapter 6 (contract with sole member who is also a director),*
>
> *by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions.*

22 The leading case on shadow directors and the usual point of departure for any analysis of the subject is the judgment of Morritt LJ and the five propositions he set out (at [35]) in *Secretary of State for Trade and Industry v. Deverell*. As a result of this decision, as

well as numerous decisions of Chancery Judges before and afterwards, some aspects of the statutory wording are settled.

23 The first is that the definition refers to "*the directors*" of the company being accustomed to act. Although as a pure matter of language it is difficult to read that as saying "*some of* the directors" or "*a majority of* the directors" it has been accepted that the test is satisfied if "*a governing majority of the board*" is accustomed to act in accordance with the shadow director's directions or instructions: see *Unisoft* and *Ultraframe* at [1272]. As Lewison J said in the latter case:

> *"… the policy underlying the definition is that a person who effectively controls the activities of a company is to be subject to the same statutory liabilities and disabilities as a person who is a de jure director. Since a de jure director is subject to those liabilities and disabilities even if he is non-executive, or even inactive, it would undermine the policy of the definition if the fact that an inactive director did not act on the instructions of an alleged shadow director (because he did not act at all) could prevent that person from being a shadow director, even though in reality he controlled the activities of the company."*

24 The second is that the wording "*accustomed to act*" has to refer to acts on more than one individual occasion, but over a period of time and as a regular course of conduct. This gives rise to the question whether - when the point in time is reached that the directors have become "accustomed to act" – steps previously taken by the company before that point in time are caught. Lewison J answered that question negatively and held there is not in effect a retrospective aspect to this: *Ultraframe* at [1275-1277]. It should also be noted that unless or until the directors have "acted" no question of shadow directorship arises; the mere giving of directions or instructions does not make someone a shadow director, it is only when that is translated into action that the question arises: *Ultraframe* at [1278].

25 The third is that the words "*directions or instructions*" do not require influence to be exercised over the whole field of a company's activities.[4] Nor is there any need to prove

[4] It is this, together with the recognition in *Re Kaytech* that the concept of de facto director was wider than the simple idea of a non- or invalid appointment, which was said to have led to the erosion of the distinction between de facto and shadow directors: see *Holland* at [91]. As Lewison J said in *Re Mea Corp Ltd* once this is recognised there is no conceptual difficulty in concluding a person can be a de

the expectation or state of mind of the person giving the directions or instructions or the persons receiving them; there is no need to establish an additional ingredient such as the directors deliberately casting themselves in a subservient role or a degree of compulsion on the part of the person giving the directions or instructions. In many if not most cases it will be sufficient to prove the communication and its consequence.

26 Furthermore, the words "*directions or instructions*" connote "*guidance*" and as such do not exclude the concept of advice; the statutory proviso excepting advice given in a professional capacity appears to assume that advice generally is or may be included: see generally *Deverell* at [35]. As Morritt LJ said (at [63] in holding that Mr Hopkins was a shadow director:

> *"… his suggestions, to use a neutral word, when given were adopted. As the judge put it, the directors were accustomed to act on them. The fact that he did not at the management meetings tell the directors what to do is not sufficient to refute the case for the Secretary of State. It is clear that he had not need to be so direct."*

27 In short the real purpose of the legislation is to identify those, other than professional advisors, "*with a real influence in the corporate affairs of the company*": *Deverell* at [35].

E. WHO CAN BE SHADOW DIRECTORS?

28 There are some paradigm examples. The classic example is a bankrupt or disqualified director who installs his wife as sole director and tells her how to run the company. Other examples include:

- "*… a person resident abroad who owns all the shares in a company but chooses to operate it through a local board of directors … gives directions to the local board what to do, but takes no part in the management of the company himself*": see *Deverell* at [36]

facto director and shadow director at the same time. Morgan J recognised this possibility in the recent case of *Instant Access Properties v. Rosser* at [217] noting however the absence of a clear legal test.

- "*… the chief executive of a group of companies who openly gives directions to the board of a subsidiary company on which he does not sit*": Holland at [109][5]

29 As a result it is possible, indeed quite likely, for controlling shareholders to become shadow directors if over time they tell directors what to do and the directors obey. Most of the cases are a variant of this theme involving individuals in some sort of group structure dictating company policy.

30 The cases are all highly fact-specific and require a detailed comparison of what was said and done against the statutory test. What is important is to show that real influence is being brought to bear by a third party on some, but not necessarily all, important corporate policies (such as for example the application of trading income and payment of creditors: see e.g. *Re Mea Corp Ltd* at [106]).

31 So far as possible the evidence in support should cite specific instances of the communication and resulting action rather than generalised assertions of control which are difficult for the court to evaluate: see the comments of Rose J in *Smithton Limited v. Naggar* at [86-88].

32 Some particular situations are worth specific consideration.

33 Holding Companies: In relation to holding companies, section 251(3) of the CA 2006 states that a holding company cannot be a shadow director by reason "only" that the directors are accustomed to act in accordance with its directions or instructions for certain purposes (including the application of the general duties). However, this presupposes that for other purposes a holding company can be a shadow director. Moreover, there is nothing to stop an individual director of a holding company becoming a shadow director, although he would have to be shown to be doing more than simply discharging his duties as a director of the holding company. So long as the relevant acts were done by the individual entirely within the ambit of the discharge of his duties and responsibilities of the holding company it would be to that capacity that his acts would be attributed: see *Holland* per Lord Hope at [42] and Lord Collins at [96].

[5] Both examples were given to illustrate the fact that it is not a statutory requirement that shadow directors operate clandestinely.

34 Management Consultants and Advisors: In *Re Tasbian* a chartered accountant and experienced "company doctor" was introduced to the company by its main funder. His role was to advise and assist in the company's recovery and report to the funder. He was paid by the company. In that capacity, he negotiated with trade creditors and with HMRC, became a signatory on the bank account, advised on a proposed take-over and changes to the group structure. Vinelott J was urged to strike out the claim on the basis the accountant was merely an advisor but allowed it to proceed to trial stating:

> *"In summary, I think that Mr Heslop was right when he submitted that the dividing line between the position of a watchdog or advisor imposed by an outside investor and a de facto or shadow director is difficult to draw, and there is a serious issue whether, at some stage, Mr Nixon passed over it."*

Similarly, in relation to professional advice, there can be risk of "crossing the line" from simply advising on alternative courses of action and leaving the choice to the corporate client to assuming a decision-making function. It is very fact sensitive but if that happens the professional is in danger of being treated as shadow director.

35 Banks and Major Creditors: After *Ultraframe* it is much more difficult for a lender or major creditor to run the risk of being a shadow director. Lewison J accepted that funders had a right to protect their interests and keep a close eye – if necessary a very close eye - on what is done with their money and impose conditions for their continued support without assuming any shadow directorship. Such funders can in effect dictate terms to the directors but it would be an unfair and unnatural burden to impose duties on them as if they were directors. Nonetheless, there remains the possibility funders can overstep the mark if they move beyond setting terms for their continued financial support, and leaving it to the company to decide what to do, towards compelling the company to act in certain ways. In that case they may run the real risk of being treated as a shadow director.

F. DO SHADOW DIRECTORS OWE FIDUCIARY DUTIES?

36 There are a number of provisions in the CA 2006 which are applied to shadow directors: see section 187(1) (declarations of interest in existing transactions), section 223(2)

(transactions requiring members' approval), section 230 (directors' service contracts) and section 231(5) (contract with sole member who is also a director).

37 In addition, shadow directors are exposed to the risk of disqualification under section 6 of the CDDA 1986: see section 6(3C). Furthermore, various provisions of the IA 1986 expressly apply to shadow directors: see section 206(3) (fraud etc. in anticipation of winding up), section 208(3) (misconduct in winding up), section 210(3) (material omissions from statement of affairs), section 211(2) (false representations to creditors), and perhaps more significantly in the civil context section 214(7) (wrongful trading).

38 But the real issue here is the extent to which shadow directors owe fiduciary duties to the company in the same way that de jure and de facto directors do. We come back to the change to section 170(5) which I mentioned earlier:

> *"(5) The general duties apply to a shadow director of a company where and to the extent that they are capable of so applying."*

39 As intimated earlier the law is in a state of some confusion.

40 The view originally expressed in *Ultraframe* was sympathetic to the submission (made by Richard Snowden QC now Snowden J) that shadow directors were a pure statutory creation and owe no fiduciary duties. The argument was that the company should look to the de jure and de facto directors to honour fiduciary duties of loyalty and good faith since they had knowingly accepted such a relationship with the company. Any remedy against shadow directors should be by way of dishonest assistance or knowing receipt. This led Lewison J to hold that the mere fact a person falls within the statutory definition of shadow director was insufficient on its own for such a person to owe fiduciary duties. Unless the person could be shown to have undertaken or assumed an obligation of loyalty – which he regarded as the hallmark of a fiduciary relationship - or been entrusted with the stewardship of company property (by (as in that case) becoming the sole signatory on the company bank account) it would not be right to say that a shadow director owed such duties.

41 This was the subject of some academic criticism and Newey J took the opportunity in *Vivendi SA v. Richards* to express his views on the matter. In his view a person giving

directions or instructions to a company's de jure directors in the belief they will be acted upon can be said objectively to be assuming sufficient responsibility towards the company (at least in respect of the directions and instructions so given) to justify owing fiduciary duties.

> *"143. In the end my own view is that Ultraframe understates the extent to which shadow directors owe fiduciary duties. It seems to me that a shadow director will typically owe such duties in relation at least to the directions or instructions that he gives to the de jure directors. More particularly, I consider that a shadow director will normally owe the duty of good faith (or loyalty) discussed below [for the avoidance of doubt, I regard the duty of good faith as a fiduciary duty] when giving such directions or instructions. A shadow director can, I think, reasonably be expected to act in the company's interests rather than his own separate interests when giving such directions and instructions."*

42 The most recent judge to grapple with this was Morgan J in *Instant Access Properties v. Rosser*. It is fair to say he was troubled by this and sought a way around the problem.

43 In that case IAP ran a sort of property club whereby investors were introduced to property developments overseas. It received substantial commissions from the developers. However, it entered into agreements with third party companies to share that commission. Those companies were BVI companies owned by overseas trust companies of which Mr Rosser and Mr Moore were discretionary beneficiaries. Mr Rosser and Mr Moore were also discretionary beneficiaries of the shareholders in IAP. They were never directors of IAP, the only de jure directors being a Ms Gifford and a corporate director, Lumley Management Ltd.

44 On a claim by the liquidators for recovery of the commission paid away by IAP, Morgan J held that Mr Rosser and Mr Moore were both shadow directors but not de facto directors. They did not need to be de facto directors because the affairs of IAP which needed to be dealt with were dealt with by the de jure directors on the directions or instructions of Mr Rosser and Mr Moore.

45 Morgan J then turned to the question whether that meant they owed fiduciary duties to IAP. He saw real difficulties in resolving this as a point of general principle and

approaching the matter as if a shadow director had a status equivalent for all purposes to a de jure or de facto director. He identified two such difficulties:

- does a shadow director have to give a direction or instruction in relation to the act of the company which is impugned; in other words can a shadow director be liable for omissions to take positive steps which de jure directors are obliged by their duties to take (exercising care and skill and promoting the success of the company) or for abstaining from giving certain directions or instructions (for example in relation conflicts of interest or accepting benefits from third parties);

- if a court would be prepared to relieve a de jure director from liability under section 1157 of the CA 2006, a shadow director owing exactly the same duties could not be relieved because section 1157 can only be used in relation to an officer of the company (which does not include a shadow director).[6]

46 This led Morgan J to refuse to deal with the issue in general terms, but to focus on the specific facts and "*whether in all the circumstances of the case the individual owed fiduciary duties and, if so, what duties, to a company*" [at 259]. In this regard he took the view that "*the court is not confined to an all or nothing answer*" [at 273] and that it was quite possible for the court to hold that a person owed some but not all of the usual fiduciary duties or that the duties could be in a qualified form. For example in relation to the problem with section 1157 just identified he said at [274]:

> *"It is possible to avoid that result by holding that although the shadow director owes a duty to avoid conflicts of interest and ought to disclose his interest to the de jure directors of the company, the duty is to act honestly and reasonably in those respects so that an honest and reasonable shortcoming in these respects would not be a breach of fiduciary duty."*

47 This led Morgan J to find that there had been no breach of duty by Mr Rosser and Mr Moore in relation to their conflict of interest and declaring their interest. Had they been de jure directors there was no prospect that any declaration of interest would have

[6] Section 1157 provides that the court can relieve an officer from liability in whole or in part if it appears he acted honestly and reasonably and ought fairly to be excused.

made the slightest difference to the outcome and they could have been expected to be relieved under section 1157 as they had acted in good faith. As he concluded at [355-356]:

> *"… the flaw in [the liquidator's case] is to assume that the duty upon a shadow director is inevitably expressed in the same terms as the duty on a de jure director. … the real questions in this case are whether the individual being sued did owe a fiduciary duty at all and, if so, what was the extent of that duty. … Having regard to the responsibility which the law should regard Mr Moore and Mr Rosser as having undertaken … I hold that whatever fiduciary duty might be imposed on them, it would not place upon them a liability to account for profits when a de jure director in the same position would have been relieved from such a liability."*

48 Some argue that it makes no sense to distinguish shadow directors in this way from de jure and in particular de facto directors. A shadow director in effect controls the majority of the board whereas a de facto director need not do so and can be an equal member of a board. It is also arguable that this approach does not apply the new statutory wording which appears to suggest a more rigid approach. It is unlikely that this will be the last word on the subject.

G. ACCESSORY LIABILITY

49 One other implication of a finding (1) that a person is a shadow director of a company; and (2) that they owed fiduciary duties to the company, is that this potentially widens the net of persons against whom a claimant might wish to consider bringing a claim. Rather than claiming just against the shadow director who committed a breach of fiduciary duty, a claimant might consider claims against accessories who could be said to have assisted the shadow director. As Lord Nicholls said of the liability for dishonest assistance "*a liability in equity to make good resulting loss attaches to a person who dishonestly procures or assists in a breach of trust or breach of fiduciary duty*".[7]

50 In the case of *Instant Access Properties v. Rosser*, for example, causes of action for dishonest assistance were advanced against the tax advisors and solicitors who took

[7] *Royal Brunei Airlines v. Tan* at p.392.

part in setting up the structures by which the commission was paid to the BVI companies. Those claims were dismissed because Morgan J decided that Mr Rosser and Mr Moore had not committed a breach of fiduciary duty, and he was not prepared to find any dishonesty on their part, but one can see how third parties and professional advisors to shadow directors could be exposed to risk. If they have knowledge that their client gives directions and instructions to the board of directors, that the board is accustomed to act in accordance with the same and they have knowledge of nature of those directions and instructions, one can appreciate the problem.

51 Were it to be held, for example, that the directions and instructions were given at a time that a company was in financial difficulties and that they involved the removal of assets and that in some way the third party or professional advisor assisted in some way, the third party or professional advisor could clearly be implicated. In that regard, as a result of the various cases on the meaning of dishonesty in the context of dishonest assistance, the courts proceed on the basis that a person can be dishonest regardless of whether he appreciates that his conduct would be considered dishonest by ordinary honest people: *Vivendi* [at 183].

H. LIMITATION

52 The nature of a director's liability, especially to the company, may have an impact upon the operation of statutory limitation. Of particular note is section 21 of the Limitation Act 1980, which provides as follows:

> *"21* ***Time limits for actions in respect of trust property***
>
> *(1) No period of limitation prescribed by this Act shall apply to an action by a beneficiary under a trust, being an action—*
>
> *(a) in respect of any fraud or fraudulent breach of trust to which the trustee was a party or privy; or*
>
> *(b) to recover from the trustee trust property or the proceeds of trust property in the possession of the trustee, or previously received by the trustee and converted to his use.*

…"

53 A company's directors are entrusted with the stewardship of a company's assets, and are therefore to be regarded for all relevant purposes as trustees of those assets: see Patten LJ's judgment in *First Subsea Ltd v. Balltec Ltd.* at [50]

54 Thus the effect of section 21 is that no limitation period will apply where a company's assets are wrongfully appropriated by / distributed to a shadow director and the company subsequently seeks to recover from the shadow director either the assets or the proceeds thereof: see the Supreme Court's decision in *Burnden Holdings (UK) Limited v. Fielding*.

I. D&O INSURANCE

55 In general, Directors' & Officers' insurance provides an indemnity against "Loss" incurred by an "Insured Person" as a consequence of a "Wrongful Act". Like professional indemnity cover, D&O insurance is conventionally written, at least in the London market, on a "claims made" basis.

56 "Loss" is usually defined as:

(a) Including:

(i) Sums which the director becomes legally liable to pay as damages (including punitive and exemplary damages) [8] and/or to satisfy awards of costs in respect of a claim for a "Wrongful Act";

(ii) Defence costs;

(iii) The costs of legal representation in relation to any official enquiry or investigation (not including any routine regulatory supervision, enquiry or review);

[8] But not necessarily in all types of cases: for example, a liability to pay exemplary damages in employment cases may be excepted from cover.

(b) Excluding criminal fines or penalties.[9]

57 The term "Wrongful Act" is normally defined as including any actual or alleged breach of duty (including any fiduciary or statutory duty), breach of trust, negligence, defamatory comment, wrongful trading or breach of warranty of authority.

58 The term "Insured Person" is typically defined as including actual, *de facto* and shadow directors.

59 Although D&O policies may expressly provide an indemnity in respect of liability for breach of fiduciary duty, it does not follow that such an indemnity will always be forthcoming:

(a) First, on normal principles of construction, an assured cannot deliberately cause the event upon which the insurance money is payable: see *Beresford v Royal Insurance Co Ltd*, *per* Lord Atkin at p.595.[10] Thus, regardless of whether or not it includes any applicable exclusion, no policy will respond to criminal conduct or dishonesty on the part of the insured;[11]

(b) Second, most – if not all – D&O wordings expressly exclude liability for deliberate or dishonest acts.

60 The consequences of the common law rule set out in *Beresford* cannot be side-stepped by a claimant framing its claim so as to avoid making any allegation of dishonesty or deliberate breach of duty. It is now well-settled that:[12]

(a) A Court is entitled to have regard to the true nature of the claim against an insured in order to determine whether the resultant liability falls to be covered under the policy;

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[9] Some wordings expressly except civil and regulatory fines and penalties from cover; other wordings are silent on the point.

[10] Although Lord Atkin's speech was addressed to policies insuring against first party loss, the relevant principles have been applied to liability policies: see, by way of example, *Gray v Barr* at p.580H; *Charlton v. Fisher* at [25], [51], [82]ff

[11] See *Beresford* at pp.598-9. NB also that section 55(2)(a) of the Marine Insurance Act 1906 codifies a general exclusion in respect of any loss attributable to the wilful misconduct of an assured.

[12] See Christopher Clarke J's judgment in *Omega Proteins v. Aspen* at [49], subsequently approved by Christopher Clarke LJ in *AstraZeneca Insurance v. XL Insurance*.

(b) The insured must establish that it has suffered a loss which is covered by one of the perils insured against. This requirement may *prima* facie be satisfied by showing a judgment or an arbitration award against the insured or an agreement to pay;

(c) As a matter of practicality, the judgment, award, or agreement may settle the question as to whether the loss is covered by the policy because the insurers will accept it as showing a basis of liability which is within the scope of the cover;

(d) However, neither a judgment nor an agreement are determinative of whether or not a loss is covered by the policy (assuming that the insurer is not a party to either and that there is no agreement by the insurer to be bound);

(e) It is, therefore, open to the insurers to dispute that the insured was in fact liable, or that it was liable on the basis specified in the judgment; or to show that the true basis of his liability fell within an exception.

61 Accordingly:

(a) A shadow director may well be entitled to the benefit of any D&O insurance; <u>but</u>

(b) Such cover will be of no practical utility where the shadow director's liability arose as a consequence of any deliberate or dishonest breach of duty on her/his part.

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Disclaimer: *this handout is not to be relied upon as legal advice. The circumstances of each case differ and legal advice specific to the individual case should always be sought.*

Cases

Re Tasbian (No. 3) Ltd [1991] 435

Re Hydrodan (Corby) Ltd [1994] BCC 161

Re Unisoft Group Ltd (No. 3) [1994] 1 BCLC 609

Re Kaytech International plc [1999] BCC 390

Secretary of State for Trade and Industry v. Deverell [2001] Ch 340

Ultraframe (UK) Ltd v. Fielding [2005] EWHC 1638

Re Mea Corp Ltd [2007] BCC 288

HMRC v. Holland [2010] 1 WLR 2793

Vivendi SA v. Richards [2013] BCC 771

Smithton Limited v. Naggar [2013] EWHC 1961

Sukhoruchkin v. Van Bekestein [2014] EWCA Civ 399

Instant Access Properties Ltd v. Rosser [2018] EWHC 756

Royal Brunei Airlines v. Tan [1995] 2 AC 378

First Subsea Ltd v. Balltec Ltd. [2018] Ch 25

Burnden Holdings (UK) Limited v. Fielding [2018] UKSC 14

Beresford v Royal Insurance Co Ltd [1938] AC 586

Gray v Barr [1971] 2 QB 544

Charlton v. Fisher [2002] QB 578

Omega Proteins v. Aspen [2011] Lloyd's Rep IR 545

AstraZeneca Insurance v. XL Insurance [2014] Lloyd's Rep IR 509

NEW SQUARE

Shadow Directors: what are they, what are their duties, and what are the implications for limitation periods, accessory liability and D&O insurance?

Michael Bowmer

Shadow Directors: Transparency

G8 Summit 2013 Lough Erne, Northern Ireland

- G8 Action Plan: *"Principles to prevent the misuse of companies and legal arrangements"*

  "1. Companies should know who owns and controls them and their beneficial ownership and basic information should be adequate, accurate, and current. …"

  "2. Beneficial ownership information on companies should be accessible onshore to law enforcement, tax administrations and other relevant authorities including, as appropriate, financial intelligence units. …"

  "5. The misuse of financial instruments and of certain shareholding structures which may obstruct transparency, such as bearer shares and nominee shareholders and directors, should be prevented."

Shadow Directors: Transparency

Part 7 of *Small Business, Enterprise and Employment Act 2015*

- people with significant control – new Part 21A and sch. 1A of CA 2006
- no corporate directors – new s 156A-C of CA 2006 (not in force yet)
- change to section 170(5) of CA 2006:

from:

"(5) The general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles so apply."

to:

"(5) The general duties apply to a shadow director of a company where and to the extent that they are capable of so applying."

Shadow Directors: Transparency

Explanatory Note

"603. At present the general duties of directors can only apply to shadow directors in the same way as the corresponding common law rules and equitable principles can. In future, the ***starting point*** *for shadow directors will be that the general duties apply to them unless they are not capable of applying (removing the current restriction). This is achieved by replacing section 170(5) of the CA 2006. This* ***change in default position*** *is neither intended to preclude the courts from looking at the application of the duties on a case by case basis, nor from drawing on existing case law in any given case."* (emphasis added)

Types of Director

Three-fold Distinction

Shadow Director – The Key Phrase

"a person in accordance with whose directions or instructions the directors of a company are accustomed to act"

Shadow Directors – Statutory Definitions

- Section 251 of CA 2006
- Section 251 of IA 2006
- Section 22 of CDDA 1986

Shadow Directors – Section 251 of CA 2006

251 "Shadow director"

(1) In the Companies Acts "shadow director", *in relation to a company, means a person in accordance with whose directions or instructions the directors of the company are accustomed to act.*

(2) A person is not to be regarded as a shadow director by reason only that the directors act

(a) on advice given by that person in a professional capacity;

(b) in accordance with instructions, a direction, guidance or advice given by that person in the exercise of a function conferred by or under an enactment;

(c) in accordance with guidance or advice given by that person in that person's capacity as a Minister of the Crown (within the meaning of the Ministers of the Crown Act 1975).

(3) A body corporate is not to be regarded as a shadow director of any of its subsidiary companies for the purposes of–

Chapter 2 (general duties of directors),
Chapter 4 (transactions requiring members' approval), or
Chapter 6 (contract with sole member who is also a director),

by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions.

Who might be shadow directors

- Paradigm example
- Other examples

  "*… a person resident abroad who owns all the shares in a company but chooses to operate it through a local board of directors … gives directions to the local board what to do, but takes no part in the management of the company himself*": see *Deverell* at [36]

  "*… the chief executive of a group of companies who openly gives directions to the board of a subsidiary company on which he does not sit*": *Holland* at [109]

- Some particular situations

  - holding companies
  - management consultants and advisors
  - funders

Do shadow directors owe fiduciary duties

- Section 170(5) of CA 2006: "*The general duties apply to a shadow director of a company where and to the extent that they are capable of so applying.*" (from 26 May 2015)
- *Ultraframe (UK) Ltd v. Fielding* [2005] EWHC
- *Vivendi SA v. Richards* [2013] BCC 771

  "*143. In the end my own view is that Ultraframe understates the extent to which shadow directors owe fiduciary duties. It seems to me that a shadow director will typically owe such duties in relation at least to the directions or instructions that he gives to the de jure directors. More particularly, I consider that a shadow director will normally owe the duty of good faith (or loyalty) discussed below [for the avoidance of doubt, I regard the duty of good faith as a fiduciary duty] when giving such directions or instructions. A shadow director can, I think, reasonably be expected to act in the company's interests rather than his own separate interests when giving such directions and instructions.*"

Do shadow directors owe fiduciary duties

- *Instant Access Properties Ltd v. Rosser* [2018] EWHC 756
- Problems with equating shadow directors with de jure directors by status
  - the range of directions or instructions
  - what about omissions
  - the problem with section 1157 of CA 2006

Do shadow directors owe fiduciary duties

- *Instant Access Properties Ltd (cont'd)*
  - *"... whether in all the circumstances of the case the individual owed fiduciary duties and, if so, what duties, to a company"* [at 259]
  - *"... the court is not confined to an all or nothing answer"* [at 273]
  - *" ... avoid that result by holding that although the shadow director owes a duty to avoid conflicts of interest and ought to disclose his interest to the de jure directors of the company, the duty is to act honestly and reasonably in those respects so that an honest and reasonable shortcoming in these respects would not be a breach of fiduciary duty."* [at 274]
  - *"... the flaw in [the liquidator's case] is to assume that the duty upon a shadow director is inevitably expressed in the same terms as the duty on a de jure director. ... Having regard to the responsibility which the law should regard Mr Moore and Mr Rosser as having undertaken ... I hold that whatever fiduciary duty might be imposed on them, it would not place upon them a liability to account for profits when a de jure director in the same position would have been relieved from such a liability."* [at 355-356]

Accessory Liability

- Where X = shadow director owing fiduciary duties to the company, net of potential accessories (ie: defendants) is widened
- Thus, in *Instant Access Properties* claims advanced against tax advisors and solicitors for dishonest assistance
- While claims against professionals failed in *Instant Access Properties*, third party professional advisers may be seen as fair game by some claimants, especially where the advisers know that their client gives directions to the (actual) directors which they are accustomed to follow

Limitation

- NB:
  - All directors are "stewards" – and therefore trustees – of a company's assets: *First Subsea v. Balltec*
  - Sect. 21(1) of Limitation Act 1980: no limitation period applies to an action by a beneficiary to recover from a trustee either trust property or the proceeds thereof
  - Breadth of s.21(1), and applicability to directors, confirmed by UKSC decision in *Burnden Holdings v. Fielding*

D&O Insurance

- Provides an indemnity to an "Insured Person" in respect of "Loss" incurred as a result of a "Wrongful Act"
- "Loss" usually includes:
  - Sums which the "Insured Person" becomes legally liable to pay as damages and/or to satisfy a costs order
  - Defence costs
  - Legal representation costs
- "Loss" usually excludes criminal fines/penalties
- "Wrongful Act" normally includes breach of fiduciary duty / trust etc
- "Insured Person" normally includes *de facto* and shadow directors

D&O Insurance

- NB: no policy's insuring clause can be construed as providing an indemnity in respect of loss deliberately / wilfully caused by the assured:
  - Sect. 55(2)(a) of the Marine Insurance Act 1906
  - *Beresford v. Royal Insurance*
- In any event, standard London Market D&O wordings will contain an express exclusion in respect of liability for deliberate/dishonest acts by the assured
- Policy response will be determined by the true facts giving rise to the assured's liability and cannot be subverted by framing a claim so as to avoid alleging dishonesty etc: *Omega Proteins v. Aspen*

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