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ARTICLE

De Facto Directorships: Multiple Tests Prevail

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Introduction

For some 150 years or so the courts have been grappling with the vexed issue of how best to determine whether a person's conduct with respect to participating in the management of a company is such as to render him or her a de facto director notwithstanding that such a person is not a de jure director.[1] In the older case law the issue typically arises where the validity of a person's acts in relation to the affairs of a company is challenged in circumstances where that person's appointment as director was defective or his appointment as de jure director had ceased at some time prior to the conduct in question. In more recent times, the courts have been confronted with the situation where the claim involves a person whose activities are such as to make him an integral part of the company's governance and, therefore, a de facto director for the purposes of the insolvency legislation relating to wrongful trading by, and disqualification of, directors. Perhaps not surprisingly, given the variable factual situations encountered in this regard, the courts have long taken an open-textured approach and have developed a range of tests for determining the issue. These were recently subjected to detailed examination in *Revenue and Customs Commissions v Holland, Paycheck Services 3 Ltd, Re*,[2] where the Supreme Court, confirming that no single test was determinative, held that the respondent who was a director of one company, which was the corporate director of 42 'composite' companies, was not, on that basis alone, a de facto director of those companies.

The facts

The respondent, H, and his wife set up a complex structure of companies, including the 42 companies of which they were alleged to be de facto directors, by way of a tax avoidance scheme. Each held 50 per cent of the issued shares and were the only directors of Paycheck Services Ltd, which in turn held 100 per cent of the issued shares of Paycheck (Directors Services) Ltd and Paycheck (Secretarial Services) Ltd, which, respectively, acted as sole director and secretary of the 'composite' companies.[3] The idea behind the scheme was that H and his wife would manage the operation of both the business and the tax affairs of contractors working mostly in the IT industry. Each individual contractor was taken on as an employee of one of the composite companies and allotted a non-voting share. This enabled the employee to be paid both by way of salary and dividends. The contractors' services were provided to clients through an agency which paid the parent company. The intention was to provide the same tax advantages to the non-voting shareholders/employees as they would have enjoyed had they each set up and run their own individual service companies, while relieving them of the administrative burden of doing so. A central part of this scheme was that each

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1 A classic formulation of the issue is found in *Re Canadian Land Reclaiming and Colonising Co* (1880) 14 ChD 660, in which the liquidator brought a misfeasance action against two individuals who had acted as directors of the company in question despite not holding the requisite number of qualifying shares. Jessel MR observed: 'No doubt they were not properly elected and were, therefore, not *de jure* directors of the company; but that they were *de facto* directors of the company is equally beyond all question. The point I have to consider is whether the person who acts as *de facto* director is a director within the meaning of [s. 165 CA 1862 (misfeasance)], or whether he can afterwards be allowed to deny that he was a director within the meaning of this section. I think he cannot. We are familiar in the law with a great number of cases in which a man who assumes a position cannot be allowed to deny in a Court of Justice that he really was entitled to occupy that position. The most familiar instance is that of executor de son tort. In like manner, it seems to me, in an application under this section, the *de facto* director is a director for the purposes of this section.' For the distinction between de facto and shadow directorships, see *Re Kaytech International plc* [1999] 2 BCLC 351, at 424, where Robert Walker LJ noted that they 'do have at least this much in common, that an individual who was not a de jure director is alleged to have exercised real influence (otherwise than as a professional adviser) in the corporate governance of a company.'

2 [2010] UKSC 5.

3 Although s. 155(1) of the Companies Act 2006 now requires a company to have at least one director who is a natural person, the 1985 Act permitted a company to have a corporate director as a sole director. The transitional period for companies to appoint at least one natural person as a director expired on 1 October 2010.

of the composite companies would be liable to pay corporation tax at the small companies' rate provided their profits fell below the GBP 300,000 threshold, as laid down by the Income and Corporations Taxes Act 1988 (hereafter, ICTA 1988). However, the scheme failed because by virtue of s. 417(3) ICTA 1988, H, as the settlor of the one share in each company which had voting rights, could be treated as being in control of them. The composite companies were therefore treated as associated for tax purposes and because their collective turnover exceeded the GBP 300,000 threshold, each company was liable for higher rate corporation tax (HRCT). Since dividends had been paid after making provision only for corporation tax at the lower rate, there was a considerable deficiency in the liquidation of each company in respect of its HRCT liability.

HMRC, the only creditor in the liquidation, issued 42 originating applications against H and his wife under s. 212 of the Insolvency Act 1986 (hereafter, IA 1986). It was alleged that they were de facto directors of 42 insolvent companies, and that they had been guilty of misfeasance and breach of duty in causing the payment of dividends to the companies' shareholders between 24 April 2002 and 19 October 2004 when the companies had insufficient distributable reserves to pay their creditors. Orders were sought requiring them to contribute sums to the assets of the insolvent companies by way of compensation in respect of their misfeasance and breach of duty totalling some GBP 3.5 million.

Mr Mark Cawson QC, sitting as a Deputy High Court Judge of the Chancery Division, dismissed the claims against Mrs Holland.[4] With respect to H, he found that he was a de facto director of each of the 42 companies and was liable under s. 212 IA 1986, albeit not for the whole period claimed but only in relation to the period from 23 August to 19 October 2004. During this time the judge found that H had been guilty of misfeasance and breach of duty in relation to each company in causing the payment to its shareholders of the unlawful dividends. He ordered an assessment of the amount that H was liable to contribute to the companies' assets, but limited this amount to the HRCT that the companies had failed to provide for to meet the claims of HMRC in respect of their trading during that period only. H successfully appealed to the Court of Appeal (Ward, Rimer and Elias LJJ).[5] Rimer LJ, delivering the leading judgment, thought that there was no reason why a director of a *corporate* director who was doing no more than discharging his duties as such should thereby become a de facto director of the subject company. HMRC's appeal to the Supreme Court was unsuccessful by a majority of 3 to 2. Lords Hope, Collins and Saville delivered majority judgments. Lords Walker and Clarke gave dissenting judgments.

Determining de facto directorships

The considerable body of case law on the issue was subjected to extensive examination in the Supreme Court. Lord Collins, in particular, reviewed the history of the concept and considered much of the older jurisprudence which was not cited in argument.[6] The first mention in the cases of de facto directors was traced to the decision in *Mangles v Grand Collier Dock Co*,[7] a case concerning a company established by private Act of Parliament, in which Sir Lancelot Shadwell V-C took the view that the Act proceeded on the basis that persons whose formal appointment had not been proved were nevertheless 'directors de facto'. Lord Collins also notes that the first full discussion of the de facto director took place in *Foss v Harbottle*,[8] where Sir James Wigram V-C held that shareholders could serve notice requiring an EGM at the place where 'the board of directors de facto, whether qualified or not, carry on the business of the company at a given place… .'[9] His Lordship notes that the concept of de facto director is harnessed in the early case law to refer either to a person whose appointment as a director is defective (for example, through a lack of share qualification[10]), or to a person who had continued to act as a director after the expiration of his term of office. The issue confronting the courts in such circumstances was whether an act carried out by such persons on behalf of the company was nonetheless binding on it.[11]

As noted above, the focus of the modern case law has not been upon the validity of acts carried out by de facto directors, but rather on questions of liability under section 214 IA 1986 (the wrongful trading provision) and disqualification from holding office under the Company Directors Disqualification Act 1986.[12] In

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4 [2008] 2 BCLC 613.
5 [2010] BCC 104.
6 Above, n. 2, at [58].
7 (1840) 10 Simons 519.
8 (1843) 2 Hare 461.
9 *Ibid*, at 498.
10 *See*, for example, *Murray v Bush* (1873) LR 6 HL 37, discussed by Lord Collins, above n. 1, at [61].
11 Citing, by way of example, *Re County Life Assurance Co* (1870) LR 5 Ch App 288, in which Sir GM Giffard LJ explained, at 293, that: 'The company is bound by what takes place in the usual course of business with a third party where that third party deals bona fide with persons who may be termed de facto directors, and who might, so far as he could tell, have been directors de jure.'
12 Lord Collins traces the origins of the modern case law in this regard to *Re Eurostem Maritime Ltd* [1987] PCC 190 and *Re Lo-Line Electric Motors Ltd* [1988] Ch 477.

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this regard, Lord Collins noted that Millett J's reasoning in *Re Hydrodam (Corby) Ltd*,[13] has been particularly influential and has been the subject of much discussion in the subsequent case law. At first sight, the facts of the case are analogous to those before the Supreme Court. Hydrodam had two corporate directors which were companies incorporated in the Channel Islands. They went into compulsory liquidation. The liquidator brought claims for wrongful trading against a number of defendants, including two of the de jure directors of Eagle Trust plc of which Hydrodam was an indirect subsidiary. It was alleged that they were responsible for the wrongful trading of Hydrodam from the date when they were appointed to be directors of Eagle Trust. It was stressed by Millett J that the Channel Islands companies were Hydrodam's titular directors only.[14] The case was argued on the basis that sufficient facts had been pleaded to justify the inference that Eagle Trust plc acted as a shadow director of the company, and that as directors of the shadow director, they were collectively responsible for Eagle Trust's conduct in relation to the company as its de facto or shadow directors. Millett J held that the liquidator had failed to adduce any evidence to support the allegation that the directors of Eagle Trust plc were at any material time directors of Hydrodam, and the proceedings were struck out.

It was acknowledged by their Lordships that there are significant differences between *Hydrodam* and the facts before them. For instance, it is not alleged H was a shadow director and section 212 IA 1986, unlike section 214, does not extend to shadow directors. However, all of the judges discussed at length what Millett J said about what is needed to establish that a person is a de facto director. Accepting that liability for wrongful trading extended to de facto directors, Millett J emphasised that a de facto director is a person who 'assumes to act as a director' and that 'he has been held out as a director by the company, and claims and purports to be a director, although never actually or validly appointed as such.'[15] He concluded by emphasising that to a de facto director is a person who 'undertook functions in relation to the company which could properly be discharged only by a director.'[16]

Looking to the test formulated by Millett J, the majority of the Supreme Court took the view that to hold H liable for breach of the fiduciary duty not to dispose wrongfully of the company's asset, the key question is whether he had assumed the duties of director. Accordingly, for Lords Hope, Collins and Saville, the critical test was whether H was a part of the governing structure of the composite companies and whether he assumed a role in those companies which triggered the fiduciary duties of a director. They concluded he was not on the basis that there was no evidence that H was doing anything other than discharging his duties as the director of the corporate director of the composite companies. It did not follow from the fact that he was taking all the relevant decisions that he was part of the corporate governance of the composite companies or that he assumed fiduciary duties in respect of them.[17]

Lords Walker and Clarke dissented in robust terms. For Lord Walker, H was the 'guiding spirit of the whole Paycheck empire'.[18] He stressed that H was the only active director of both Paycheck (Directors Services) Ltd and Paycheck (Secretarial Services) Ltd and that it was him who took the decision, having taken professional advice, that the composite companies should continue to pay dividends without reserving for higher-rate corporation tax. He concluded, therefore, that:

> 'The repeated assertion that everything that Mr Holland did was done in his capacity as director of Paycheck Directors, and was within his authority as a director of that company, is no doubt "not pure sham" but it is, in my view, the most arid formalism. In my view Mr Holland was acting both as a de jure director of Paycheck Directors and as a de facto director of the composite companies.'[19]

Similarly, Lord Clarke thought the question in each case is whether the person in question did something more than participate in a collective decision. He thought there was 'no reason in principle why it cannot be held… that Mr Holland decided to pay the dividends both as a de jure director of Paycheck Directors and as a de facto director of each composite company.'[20] He therefore went on to find that H was a de facto director of the composite companies because 'he personally procured the payment of the unlawful dividends and is liable to restore them just as the de jure director is.'[21]

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13 [1994] 2 BCLC 180.
14 *Ibid*, at 183.
15 *Ibid*.
16 *Ibid*.
17 See, for example, above, n. 2, at [96].
18 *Ibid*, at [114].
19 *Ibid*.
20 *Ibid*, at [129].
21 *Ibid*, at [131]. In support of his conclusion, he cited, as did Lord Walker, *Standard Chartered Bank v Pakistan National Shipping Corpn* [2002] UKHL 43.

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Conclusion

The dissenting opinions are convincing. While the majority were inevitably persuaded by the reasoning of Millett J in *Hydrodam*, the judge's finding in that case is readily understandable because each of the individuals alleged to be de facto directors in *Hydrodam* was, as Lord Walker noted, one of about eight people who made up the board of directors of Eagle Trust plc. As his Lordship pointed out, whether or not a person is held to be a de facto director depends upon what that person does on his own initiative. H was clearly the directing mind of the composite companies. Indeed, he was the sole person directing their affairs and in this regard, it was him who made every decision relating to the payment of dividends. The majority opinions, on the other hand, do appear to be driven by the 'arid formalism' of that most fundamental principle of company law laid down over a century ago in *Salomon v A Salomon*.[22]

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22 [1897] AC 22.

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