IDENTIFYING DE FACTO DIRECTORS AFTER *PAYCHECK*

Holland v Revenue & Customs [2010] UKSC 51

Nicholas Briggs & Hugh Sims, Guildhall Chambers

Introduction

1. There are said to be three categories or types of director, and it was previously thought they might all be mutually exclusive in concept. The first is the de jure director, a director who has been properly appointed and is recorded at Companies House as being a director of the relevant company. The second is a de facto director, a director in fact, whether or not properly appointed and recorded as such. Thirdly, the shadow director, said to be lurking in the shadows and directing the board of directors from there. In this paper we consider the decision of the Supreme Court in *Paycheck*. In light of the decision we consider how to identify de facto directors. We also consider the differences between shadow and de facto directors and question what substantive differences remain between the two. The talk will be given in the form of an argument which balances the views of the minority and majority in the Supreme Court.

2. As is well known a shadow director has been defined by legislation for some time, but a de facto director has never had the benefit of any statutory definition.

3. As alluded to above, the category of directors known as de facto directors has developed from failed or irregular de jure director appointments; those who traditionally have been appointed as de jure directors but the appointment was somehow defective, or who continued to act after resignation. At some point after the introduction of the 1986 Insolvency Act ("IA") that position changed. The significance of this change can be traced through case law, but first it will be useful to consider the facts in *Paycheck,* the decision made, and set out some of the statutory provisions that are relevant to the discussion that follows.

The facts in *Paycheck* and the decision

4. Mr Holland and his wife were in the business of providing administration and tax services to contractors – many in the information technology industry – who did not want to go to the trouble of setting up their own company. Mr and Mrs Holland set up a complex company structure which had the following features:

   - Mr and Mrs Holland owned all the shares in, and were directors of Company A;
   - Company A owned the shares in Company B and Company C. Mr and Mrs Holland were the directors of Company B and Company C; and
   - Company B and Company C acted, respectively, as the corporate director and the corporate secretary of 42 companies.

5. This structure was designed to ensure that each of the 42 companies only paid corporation tax at the small companies' rate. It did not work and the 42 companies went into insolvent administration.

6. The HMRC brought claims for the unpaid tax against Mr and Mrs Holland on the basis that they had been acting as de facto directors of each of the 42 companies, and had breached their duties as directors. The High Court allowed the claim against Mr Holland but dismissed that brought against Mrs Holland. The Court of Appeal allowed Mr Holland's appeal, a decision now confirmed by the Supreme Court. The majority (Lords Hope, Collins and Saville) ruled that Mr Holland had been doing no more than carrying out his duties as a director of Company B. HMRC could not point to anything he had done which had not been done by him in his capacity as a director of Company B. It followed that Mr Holland had not been a de facto director of the 42 companies.

7. The precise situation that arose in the *Holland* case is unlikely to recur. Section 155 of Companies Act 2006 now requires a company to have at least one director who is an individual. The temporary exemption for companies in existence on 8th November 2006 expired on 30th September 2010.

Relevant statutory provisions

8. The claim made in *Paycheck Services Limited (Paycheck)* by HMRC was pursuant to section 212 IA for misfeasance. The Supreme Court was asked to consider the width of the discretion provided by section 212 IA, the extent of any relief from liability under section 727 Companies Act 1985 (now section 1157 of the Companies Act 2006) and whether the payment of dividends was a strict liability offence.

9. The primary question however was whether an individual director or a corporate director of another company was a de facto director of the other company, and so liable for the payment of unlawful dividends by the other company.

10. Section 212 IA 1986 as amended by para 18 of Schedule 17 to the Enterprise Act 2002, provides, so far as relevant, as follows:

"(1) This section applies if in the course of the winding up of a company it appears that a person who:

(a) is or has been an officer of the company;

(b) has acted as liquidator or administrative receiver of the company; or

(c) not being a person falling within paragraph (a) or (b), is or has been concerned, or has taken part, in the promotion, formation or management of the company, has misapplied or retained, or become accountable for, any money or other property of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company.. . .

(3) The Court may, on the application of the official receiver or the liquidator, or of any creditor or contributory examine the conduct of the person falling within subsection (1) and compel him:

(a) to repay, restore or account for the money or property or any part of it, with interest at such rate as the Court thinks just; or

(b) to contribute such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty as the Court thinks just."

11. As is immediately apparent section 212 IA 1986 applies to a person who is or has been an "officer" of the company. It does not apply to shadow directors because, unlike section 214, the statute does not provide for this. Section 251 IA 1986 (incorporating the definition in section 1173 CA 2006), as amended, provides that "officer", in relation to a body corporate, includes a director, manager or secretary. "Director" is defined in section 251 IA 1986 as including "*any person occupying the position of director, by whatever name called*". It was conceded in *Paycheck* that although a shadow director is excluded from section 212 by dint of the fact that such a person is not expressly included (in contrast to other sections of the IA 1986 mentioned above and below), a de facto director is included as such a person is an 'officer' of a company. Whether this concession is correct, and can now be sustained, is questionable following *Paycheck*. Or at any rate, its practical impact can be limited by a well advised applicant who may assert (following *Paycheck*) that the shadow director has assumed the responsibilities of office and can properly be described as a de facto director.

12. Section 741(2) CA 1985 (see now section 251 IA 1986) provides: *"In relation to a company, 'shadow director' means a person in accordance with whose directions or instructions the*

directors of the company are accustomed to act" (section 251 goes on to add the qualification in parentheses as follows "(*but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity*)".

De facto director-development of category & principles

13. One of the Law Lords (Lord Collins) traces the history of de facto directors to at least 1840 where it was held that the fact that the board of directors were invalidly appointed did not prevent the company convening a proper meeting as the board was de facto. The courts were often asked to consider the validity of those who purported to act as directors where it was discovered after the event that there was a defect or error in appointment.

14. The nineteenth century saw three cases reach the highest court in the land for its decision. The first was *Murray v Bush* (1873) LR HL 37 where the House of Lords gave a split decision on the issue of whether the fact that three directors who had been appointed and acted as directors were in fact directors, even though they had failed to execute a deed binding upon themselves. But as the directors had held themselves out as directors a third party should not be prejudiced and so they were treated as de facto directors.

15. In *Mahony v East Holyford Mining Limited* (1875) LR HL 869 Lord Penzance said:

"*In the present case, from the time when the East Holyford Mining Company came into existence, that is after the registration of the memorandum and articles of association, three persons usurped the position of directors (I say 'usurped', because they do not seem to have been regularly appointed) and another person usurped the office of secretary. This they did in the face of the subscribers to and shareholders in the company, as well as of persons dealing with the company; and both before the company was legally formed, and after it was formed, they publicly advertised themselves in the prospectus as directors and secretary respectively. They occupied the offices designated in the prospectus and they opened an account with the bank therein named. During the six months following they assumed, to the exclusion of all others, the executive functions of the company; no subscribers, nor shareholders, nor strangers dealt with any one else, and no one questioned their authority. Therefore, during the whole of the time that this company was acting as a company, these individuals were ostensibly directors and secretary respectively, and they were the de facto directors and secretary…. It seems to me, therefore, my Lords, that we have here the case of three individuals being de facto directors, and one being de facto secretary*."

16. The third decision of the House of Lords on de facto directors, *Morris v Kanssen* [1946] AC 459, was concerned with the validation provision in section 143 of the Companies Act 1929. It was held that the appointment of X as a director at a board meeting attended by A and B, and the allotment of shares to X, were not validated by the section in a case where A and B had falsely claimed that B had been duly appointed a director, and where A had ceased to be a director in accordance with the company's articles because no general meeting had been held in the relevant year. Lord Simonds said (at p 475) that there was no authority for the proposition that a director or de facto director could invoke the rule so as to validate a transaction which was in fact irregular and unauthorised.

17. These are very different cases to the type of cases that present to the courts today in which it is claimed that an individual has acted as a de facto director. As Lord Collins pointed out, "*there is not a single case prior to the 1980s in which the term de facto director was applied to anyone other than one who had been appointed a director, but whose appointment was defective, or one who had been, but had ceased to be, a director*."

18. The first case that considered whether or not an individual could be caught for the purposes of disqualification and wrongful trading, even though they were not validly appointed as directors was *Re Lo-Line Electric Motors Ltd* [1988] Ch 477. The respondent had been a director of company A. He resigned as a director but continued as production manager. After the sole remaining director had absconded to the United States, the respondent took over the running of the company, but was not appointed as a director. The respondent also acted as a director of company B, although he was never appointed as such. The obvious line of argument was

that as there was no invalid appointment A B was not a de facto director. The court held that regard had to be had to the conduct of a person acting as director whether "validly appointed, invalidly appointed, or just assuming to act as director without any appointment at all."

19. In *Re Hydrodam* [1994] 2 BCLC 180 a trial concerning wrongful trading came before Millett J. He took the opportunity to expound a view which was treated as correct until the *Paycheck* case went to the Supreme Court. He first explained what a de facto director was as opposed to a shadow director. He went on to state that the two types of director should be treated entirely separately (that it would be embarrassing to allege a person was a de facto or shadow director without distinguishing the two), and that the courts should apply certain tests to ascertain whether or not an individual truly acted as a de facto director in relation to a company. In particular he stated:

"*Liability for wrongful trading is imposed by the Act on those persons who are responsible for it, that is to say, who were in a position to prevent damage to creditors by taking proper steps to protect their interest. Liability cannot sensibly depend upon the validity of the defendant's appointment. Those who assume to act as directors and who thereby exercise the powers and discharge the functions of a director, whether validly or not, must accept the responsibilities which are attached to the office*."

20. He went on:

"*A de facto director is a person who assumes to act as a director. He is held out as a director of the company, and claims and purports to be a director, although never actually or validly appointed as such. To establish that a person was a de facto director of a company it is necessary to plead and prove that he undertook functions in relation to the company which could properly be discharged only by a director. It is not sufficient to show that he was concerned in the management of the company's affairs or undertook tasks in relation to its business which can properly be performed by a manager below board level*."

21. In subsequent decisions the distinction or differences between shadow and de facto directors was not argued. The later decisions (later than *Hydrodam*) all concerned the test for de facto directors, and consideration of the facts of the case. Each case was fact-sensitive. In *Secretary of State for Trade and Industry v Tjolle* [1998] BCC 282, Jacob J thought that it was difficult to postulate any one decisive test for determining whether someone had acted as a de facto director:

"*I think what is involved is very much a question of degree. The court takes into account all the relevant factors. 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 (eg 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. In deciding this, one bears very much in mind why one is asking the question. That is why I think the passage I quoted from Millett J is important. There would be no justification for the law making a person liable for 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 in law*."

22. This statement of the law was approved by the Court of Appeal in *Re Kaytech International plc* [1992] 2 BCLC 351:

"*I do not understand Jacob J, in the first part of that passage, to be enumerating tests which must all be satisfied if de facto directorship is to be established. He is simply drawing attention to some (but not all) of the relevant factors, recognising that the crucial issue is whether the individual in question has assumed the status and functions of a company director so as to make himself responsible under the 1986 Act as if he were a de jure director*."

Shadow director

23. The statutory definition for a shadow director has already been set out above. The name was first introduced by the 1980 Companies Act. A shadow director is mentioned specifically in the following sections of the IA: ss 206, 208, 210, 211, 214, 216 and gets a mention in section 249 (concerning connected parties, and therefore has a knock-on effect on the transaction avoidance sections of sections 239, 240 and 245).

24. The case law equivalent to *Re Hydrodam* for shadow directors is the judgment given by Morritt LJ in *Secretary of State for Trade and Industry v Deverell* where he set out the following propositions:

> *"(1) The definition of a shadow director is to be construed in the normal way to give effect to the parliamentary intention ascertainable from the mischief to be dealt with and the words used. In particular, as the purpose of the Act is the protection of the public and as the definition is used in other legislative contexts it should not be strictly construed because it also has quasi-penal consequences in the context of the Company Directors Disqualification Act 1986. I agree with the statement to that effect of Sir Nicolas Browne-Wilkinson in Re Lo-Line Electric Motors Ltd [1988] Ch 477, [1988] 2 All ER 692 at 489 of the former report.*
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> *(2) The purpose of the legislation is to identify those, other than professional advisers, with real influence in the corporate affairs of the company. But it is not necessary that such influence should be exercised over the whole field of its corporate activities. I agree with the statements to that effect of Finn J in Australian Securities Commission v AS Nominees Ltd (1995) 133 ALR 1, 52/3 and Robert Walker LJ in Re Kaytech International plc [1999] BCC 390, 402.*
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> *(3) Whether any particular communication from the alleged shadow director, whether by words or conduct, is to be classified as a direction or instruction must be objectively ascertained by the court in the light of all the evidence. In that connection I do not accept that it is necessary to prove the understanding or expectation of either giver or receiver. In many, if not most, cases it will suffice to prove the communication and its consequence. Evidence of such understanding or expectation may be relevant but it cannot be conclusive. Certainly the label attached by either or both parties then or thereafter cannot be more than a factor in considering whether the communication came within the statutory description of direction or instruction.*
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> *(4) Non-professional advice may come within that statutory description. The proviso excepting advice given in a professional capacity appears to assume that advice generally is or may be included. Moreover the concepts of "direction" and "instruction" do not exclude the concept of "advice" for all three share the common feature of "guidance".*
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> *(5) It will, no doubt, be sufficient to show that in the face of "directions or instructions" from the alleged shadow director the properly appointed directors or some of them cast themselves in a subservient role or surrendered their respective discretions. But I do not consider that it is necessary to do so in all cases. Such a requirement would be to put a gloss on the statutory requirement that the board are "accustomed to act in accordance with" such directions or instructions. It appears to me that Judge Cooke, in looking for the additional ingredient of a subservient role or the surrender of discretion by the board, imposed a qualification beyond that justified by the statutory language."*

The aftermath of *Paycheck*

25. The lines tightly drawn between a shadow director and a de facto director, the 'embarrassment' of pleading alternatives raised by Millett J, and the requirement to bring a 'shadow director' within a provision of the IA or Companies Act to gain liability traction, or de facto within the frame of 'officer' did not put Claimants or their advisors off claiming an individual was either a 'shadow director' or 'de facto director'. In many cases leading up to 2010 (when the Supreme Court heard *Paycheck*) the courts have treated a shadow and de facto director as the same animal:

"*Indeed, the similarity in defining characteristics of both a shadow director and a de facto director are such that in many cases, the court's desire to actually draw a distinction between the classification of a person as either a de facto director or a shadow director is portrayed as unnecessary and irrelevant to the point, as in reality, the two positions may be viewed absent any difference*." (Stephen Griffiths writing in Insolvency Intelligence 2011 citing a plethora of cases reported since 2006 to support his view).

26. Lord Collins (in the second judgment) traced the line of cases dealing with de facto directors since *Hydrodam* and found that the expression 'holding out as a director' had generally not been the reasoned basis for a finding that an individual had been found to be a de facto director. Searching for a relevant test to apply to a person who had been involved in a company's management so as to label them a director was not straight forward. The 'holding out' test can be seen as a direct import from Partnership law. Lord Collins considered a different test appropriate - one borrowed from the law of probate (and, as discussed below, also from the law of tort).

27. First, however, the distinction between de facto and shadow directors needed to be dealt with. And he said that "*once the concept of de facto director was divorced from the unlawful holding of office, there were two consequences. The first consequence was that the distinction between de facto directors and shadow directors was eroded*." Dealing directly with the authority that had distinguished the roles of de facto directors and shadow directors he went on to say:

"In Re Hydrodam [1994] 2 BCLC 180, 183, Millett J said that de facto and shadow directorship "do not overlap. They are alternatives and in most and perhaps all cases are mutually exclusive." But the distinction was impossible to maintain with the extension of the concept of de facto directorship and the consideration of such matters as the taking of major decisions by the individual, which might be through instructions to the de jure directors, and the evaluation of his real influence in the affairs of the company."

28. Lord Clarke (in a dissenting judgment) also saw no difficulty with the two concepts being treated with equal measure at times "*I agree that, as Lewison J said in Re Mea Corpn Ltd (in the passage quoted by Lord Walker), there is no conceptual difficulty in holding that a person can be both a shadow director and a de facto director simultaneously and that the real purpose of each is to identify those, other than professional advisers, with real influence in the corporate affairs of the company*."

29. Accordingly the distinction between de facto and shadow directors has been eroded to such an extent that it cannot realistically be wrong to bring a case in the alternative. The terms are not mutually exclusive but may overlap so that a person can come within both concepts.

30. As regards the relevant test to ascertain whether a director may be treated as having assumed personal liability for a corporate act, Lord Hope expressly adopted the reasoning of Rimer LJ in the Court of Appeal. Rimer LJ in the Court of Appeal dealt with the distinction between companies and individuals and considered that the unlawful dividends were directed by the corporate director in *Paycheck*, and not by Mr Holland.

31. Lord Hope (giving the leading judgment) considered (at para 39) that all relevant factors needed to be considered when deciding whether a person was acting as a de facto director. He thought that guidance could be gleaned from considering the purpose in imposing liability, endorsing the approach of Millet J in *Hydrodam*. The critical enquiry being to look at whether the person has assumed to act as a director, exercising the powers and discharging the functions of a director.

32. Lord Collins (giving the second judgment) said that the role of director whether de jure or de facto is one that is assumed by the director. The key issue is not what the individual does but whether there is an assumption of responsibility by him or her to act as a director (see paragraph 93).

33. This line of reasoning ties in well with Millett J's description of a de facto director in Re *Hyrdodam*:

"*A de facto director, I repeat, is one who claims to act and purports to act as a director, although not validly appointed as such*."

34. The tasks that a person performs in the course of their role within the company provide the court with evidence as to the assumed responsibility.

35. This line of reasoning also ties in with the law as developed by the House of Lords in *Williams v Natural Life Health Foods Ltd* [1998] 1 WLR 830, which provides that unless a director by his statements or conduct crosses the line in demonstrating that he is assuming personal responsibility, as distinct from responsibility as an agent and officer of a limited liability company, then he or she will not be found to be personally liable.

36. That said, a move towards the "assumption of responsibility" test creates its own difficulties. Notwithstanding the observation of Lord Goff in *Henderson v Merrett* [1994] 2 AC 145 at 181B-C, that an objective test must be applied, that is easier said than done.

***Re Mumtaz Properties Ltd* [2011] EWCA Civ 610**

37. This case is worth a brief mention here since it is the first reported decision in the Court of Appeal following *Paycheck* where consideration is given to the test to apply to identify whether or not a person was a de facto director, outside the context of corporate directorships.

38. The first instance decision was made before the Supreme Court *Paycheck* judgment was available, and the judge followed the guidance provided in *Gemma Ltd v Davies* [2008] BCC 812 at para 42. In that case it was stated that in order to show that a person was a de facto director so as to fix them with liability under section 212 the following guidance applied:

The applicant must plead and prove that the respondent undertook functions in relation to the company which could properly be discharged only by a director;

1. Holding out is not a necessary characteristic, though it may be important evidence to support the conclusion;

2. Holding out is not a sufficient characteristic. What matters is what the person did;

3. The person must have participated in directing the affairs of the company, and not in some subordinate role;

4. The person in question must be shown to have assumed the status and functions of a director and to have exercised real influence in the corporate governance; and

5. If it is unclear whether the acts are referable to an assumed directorship or some other capacity then the director is entitled to the benefit of the doubt.

39. In *Mumtaz* there had been no holding out by the persons in question, but nevertheless the judge at first instance concluded that they were de facto directors. The Court of Appeal declined to interfere with this decision and the judge's approach to the law, as guided by the decision in *Gemma Ltd v Davies*, was substantially approved.

40. That said the decision in *Paycheck* undoubtedly provides the applicant with a greater degree of flexibility, and the first of the six guidance points in *Gemma* is not the main focus. There was express recognition in *Paycheck* (by Lord Collins in particular) that the Court faces a difficult task in identifying the functions which are the sole responsibility of a director. Thus the emphasis must now be on guidance point 5, namely on the assumption of the status and functions of a director.

41. Interestingly whilst not mentioned by Lord Hope in *Paycheck* it is arguable that the decision in *Paycheck* is a manifestation of guidance point 6, namely the benefit of doubt point.

Other points

42. Whilst strictly speaking obiter dicta, the Supreme Court (and Lord Hope in particular) offered the (persuasive) observations as regards the following points:

    1. the better view was that a director was strictly liable to repay any unlawful dividends paid out by a company, though the director could have recourse to relief under section 1157 of the CA 2006 (formerly section 727 CA 85) in appropriate circumstances (para 47);

    2. the appropriate remedy for a breach of duty in causing or allowing an unlawful dividend to be paid was a restoration order, not damages referable to the loss suffered (para 49), but that (according to Lord Hope) a judge had a discretion under section 212(3) to limit the amount to be repaid to that required to make up the deficiency (and notwithstanding that the Court had declined to grant relief under what was section 727). Arguably Lord Hope's view on this last point was a minority in the Supreme Court; Lord Walker offered the observation that if it were him he would not have limited the amount required to be paid (unlike the deputy judge at first instance) (para 125), and Lord Clarke concurred with him in this respect; and

    3. in any event the discretion under section 212(3) was a discretion as to amount only, and could not be used to provide relief from liability in toto (para 51). In this respect the three law Lords who commented on this were all in apparent agreement (Lords Hope, Walker and Clarke).

Conclusion

43. In conclusion, the distinction between shadow and de facto directors have blurred. Further the test for identifying a director, when he is not a de jure director, has now been clarified at the highest level and is unlikely to be re-visited for a substantial period of time. In these respects *Paycheck* is a landmark case. The case provides strong guidance which is useful for insolvency practitioners and solicitors when gathering evidence, both in respect of identifying directors and making claims for unlawful dividend payments. Though it must be said in relation to the latter that the conflicting views offered by the different Lords offers scope for further debate on the applicability and discretion afforded under misfeasance claims pursuant to section 212 IA 86.

Nicholas Briggs
Hugh Sims
Guildhall Chambers
June 2011