The identification of shadow directors under English law: what guidance might Buzzle provide?

INTRODUCTION

Section 251 of the Companies Act 2006 (UK) relevantly states that:

“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. A person is not to be regarded as a shadow director by reason only that the directors act on advice given by him in a professional capacity.”

Under English law shadow directors are subject to onerous obligations, albeit not the same obligations as directors. So they must not engage in fraudulent or wrongful trading.

As straightforward as the statutory test appears to be, the case law on the meaning of shadow director remains in a “confused state” under English law. This is problematic because in the absence of clear and consistently applied legal principles in this area, there is a risk that shadow directors might not be identified when they should be and vice versa.

Directors’ duties play a vital role in protecting the interests of creditors and shareholders and in regulating corporate conduct in the public interest generally and so it is important that there is a clear threshold to identify who is acting in this capacity. The threshold needs to be flexible enough to identify those who are acting as directors, regardless of the circumstances. Conversely, the test should not be too easy to fulfill otherwise parties properly giving advice to or exerting commercial pressure on the board of a company will erroneously be deemed shadow directors, with unjust consequences.

THE KEY ENGLISH AUTHORITIES

Re Hydrodan (Corby) Ltd [1994] BCC 161

The liquidator of Hydrodan alleged that Hydrodan’s ultimate parent, Eagle Trust, and the directors of Eagle Trust, were guilty of wrongful trading on the basis that they were shadow directors or de facto directors of Hydrodan. Further, if Eagle Trust was found to be a shadow director, then all the directors of it would also be shadow directors.

Millett J disagreed that if Eagle Trust was a shadow director, then all of its directors were ipso facto shadow directors.

Millett J clarified that a shadow director does not purport to be a director; “he lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself” [at 163]. By contrast, a de facto director purports to be a director without having been validly appointed as such.

To establish that a defendant is a shadow director Millett J said it is necessary to allege and prove:

- who are the directors of the company, whether de facto or de jure [ie validly appointed];
- that the director defendant those directors how to act in relation to the company or that he was one of the persons who did so;
- that those directors acted in accordance with such directions; and
- that they were accustomed so to act.

He stated: “What is needed is first, a board of directors claiming and purporting to act as such; and secondly, a pattern of behaviour in which the board did not exercise any discretion or judgment of its own, but acted in accordance with the directions of others” [at 163].

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

The Secretary of State for Trade sought to disqualify certain individuals as directors and needed to prove that the activities of these individuals in previous failed companies were “as directors”.

The Court of Appeal (Morritt LJ gave the leading judgment, Potter LJ and Morrison J agreeing) considered the statutory definition of shadow director and laid down the following key propositions (as cited with approval in Ultraframe (UK) Ltd v Fielding & Ors [2005] EWHC 1638 (Ch)):

- interpretation of the term “shadow director” must give effect to parliamentary intention;
- the purpose of the legislation is to identify those, other than professional advisers, with real influence in the corporate affairs of the company. However, it is not necessary that such influence should

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A recent Australian case – Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd [2011] NSWCA 109 provides useful guidance, including that a high threshold must be met before a party (eg lenders/creditors) will be considered a shadow director and that there must be a causal connection between the putative shadow director giving the instruction and the directors acting on it.

Whether the English courts will apply the principles adopted in Buzzle is not yet known. Accordingly, lenders and other creditors of insolvent companies should not be complacent about the risk of being held a shadow director under English law.

KEY POINTS

- Under English law, the principles governing when a person or entity is considered a “shadow director” are not yet settled.
- A recent Australian case – Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd [2011] NSWCA 109 provides useful guidance, including that a high threshold must be met before a party (eg lenders/creditors) will be considered a shadow director and that there must be a causal connection between the putative shadow director giving the instruction and the directors acting on it.
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be exercised over the whole field of its corporate activities;
- 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;
- non-professional advice may be an instruction;
- it is not necessary to show that the validly appointed directors "cast themselves in a subservient role or surrendered their respective discretions".

Here, certain parties were deemed to be shadow directors owing to their substantial role in the governance of the company and the fact that the validly appointed directors consistently acted upon their instructions.

Morritt LJ held that the position of Mr Deverell in the company "gave to his advice the potency of directions or instructions" even though he did not tell the directors what to do [at 116]. He observed that the concepts of "direction" and "instruction" did not exclude the concept of "advice" for all three shared the common feature of "guidance"; "Both men appeared as men of importance whose words were listened to, and the directors were accustomed to acting on their advice" [at 112]. Accordingly, they were held to be shadow directors.

**Ultraframe (UK) Ltd v Fielding & Ors [2005] EWHC 1638 (Ch)**

A Mr Fielding, the alleged shadow director, became substantially involved in the affairs of a company, "Northstar", including the planning of projects, setting up of accounting systems and offering advice on budgets. As time progressed, he became part of the corporate governance of Northstar.

Lewis J clarified that a person at whose direction a governing majority of the board is accustomed to act is capable of being a shadow director even though not all of the directors were accustomed so to act [at 1272]; this is because "a person who effectively controls the activities of a company is to be subject to the same statutory liabilities and disabilities as a de jure director" and "it would undermine this policy if the fact than an inactive director did not act on the instructions of an alleged shadow director could prevent that person from being a shadow director" [at 1272].

However, here, the board or a majority were not "accustomed" to act on Mr Fielding's instructions. Accordingly, Mr Fielding was not a shadow director.

**Re Kaytech International plc [1999] BCC 390**

Re Kaytech was an appeal against disqualification for 15 years of a "de facto" director.

Considering whether he was in fact a "de facto" director, the Court of Appeal held that there was no one test of de facto directorship and cited with approval the observations of Jacob J in *Secretary of State for Trade and Industry v Tjolle & Ors* [1998] BCC 282. In that case, Jacob J (similarly considering an allegation of de facto directorship) had declined to formulate a single test and stated that what is involved is very much a question of degree, "taking into account all the relevant factors" [at 290].

The Court of Appeal commented that the concepts of shadow director and de facto director "had in common that an individual... is alleged to have exercised real influence (otherwise than as a professional adviser) in the corporate governance of a company. Sometimes that influence may be concealed and sometimes it may be open. Sometimes it may be a mixture" [at 402].

**Holland v The Commissioners for Her Majesty’s Revenue and Customs (Appellant) v Holland and another [2010] UKSC 51 (Re Paycheck)**

The Supreme Court considered the test for a de facto directorship and touched on the concept of shadow directorship.

Considering how to identify a "de facto" director, Lord Hope stated: "How is this to be done? It is plain from the authorities that the circumstances vary widely from case to case... All one can say, as a generality, is that all the relevant factors must be taken into account" [at 39].

Lord Collins [at 91] revisited the development of the law on de facto directors and observed that whilst Millett J in *Hydrodan* had used expressions such as "purports to be a director" or "held out as director" to describe de facto directors, more recent cases such as *Re Richborough Furniture Ltd* [1996] BCC 155 [at 168] and *Tjolle* [at 289] had held that these were relevant but not "necessary" factors.

Consequently, his Lordship stated that "once the concept of de facto director was divorced from the unlawful holding of office, there were two consequences. The first was that the distinction between de facto directors and shadow directors was eroded... the distinction was impossible to maintain with the extension of the concept of de facto directorship" [at 91].

Accordingly, with both de facto and shadow directors, it was necessary for the court to consider "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".

Accordingly, under English law there is arguably no longer a distinction between the concepts of de facto and shadow directorship. Moreover, the Supreme Court appears to be moving away from a prescriptive approach to the identification of de facto and shadow directors and to a focus on the question of who has "real influence" on the corporate affairs of the company in all the circumstances.

**THE AUSTRALIAN DECISION OF BUZZLE**

Buzzle had formed through the merger of six retailers of Apple computer products (the Resellers). Buzzle acquired the stock and businesses of the Resellers and the Resellers took shares in Buzzle’s holding company.

Each of the Resellers had previously entered into Reseller Agreements with Apple pursuant to which the Reseller purchased stock on credit. Each Reseller had also given a charge over its assets to Apple, consequently the Resellers required Apple’s consent to transfer their assets to Buzzle. The Resellers also needed Apple’s agreement to enter into a Reseller Agreement with Buzzle. Apple consented to the merger, entered into a Reseller Agreement with Buzzle, and took a charge over...
Buzzle’s assets. The business failed, however, and Buzzle went into liquidation.

The liquidators of Buzzle alleged that: Buzzle was insolvent after 1 January 2001; from 1 January 2001 Apple and its finance director (Mr L) were shadow directors of Buzzle; Apple and Mr L were shadow directors at a time when the company was trading while insolvent, so they were liable for insolvent trading.

The court held (at first instance and on appeal) that Apple and Mr L were not shadow directors.

To prove that Apple and Mr L were shadow directors of Buzzle, the plaintiffs needed to show that the directors of Buzzle were “accustomed to act” on their instructions or wishes. However, this was not established on the facts.

Firstly, insofar as Apple exerted commercial pressure prior to the merger, it did so vis-a-vis directors of the Resellers, not the directors of Buzzle. The relevant individuals only became directors of Buzzle after the merger.

Moreover, a person or company is not a shadow director merely because that person imposes conditions on his commercial dealings.

GUIDANCE FROM THE BUZZLE CASE
The directions or instructions must relate to “director matters”
It is the directors collectively in the exercise of their powers of management who must be accustomed to act on the instructions of the putative shadow director for the definition to be satisfied; it is not sufficient that executives who are not directors may be accustomed to act on the putative shadow director’s instructions. The instructions must relate to “director matters”. The rationale for this approach is that the directions should relate to “the company” if the person or body is to be found to be a shadow director. These observations in relation to executives are consistent with English law but this point has not been made as expressly by the English courts.

The Board can still exercise a level of discretion
While the court generally adopted the analysis of Millett J in Hydrodan as to what was required to establish that a person was a shadow director, it emphasised that the influence of a shadow director need not be exercised over the whole of the company’s corporate activities (as per the court’s approach in Deverell). Accordingly, there is “no inconsistency with a person being a shadow director, and on the other hand the board exercising some discretion or judgment in areas in respect of which the shadow director does not give instructions or express a wish”. This appears to be a new gloss on the Millett J test.

“In accordance with” requires a causal link
There must be a causal connection between the putative shadow director giving the instruction and the directors acting on it.

In Buzzle, there were many matters about which Apple or Mr L expressed a preference which the board were going to do in any event (e.g. preparing financial reports, collecting debts) so in relation to these matters, the board was not acting “in accordance with” Apple’s instructions or wishes and there was no causal connection.

This significant point about causation has not been made expressly in the English authorities although it appears consistent with them.

It is sufficient if a governing majority of directors are “accustomed to act”
The court confirmed that the directors who must be accustomed to act in accordance with the shadow director’s instructions or wishes need not be all of the directors. It is sufficient that a governing majority is accustomed to act on the shadow director’s instructions or wishes. Further, “the instructions or wishes need not be communicated directly...to all or a governing majority of the directors” (Buzzle [2010] at 307), a point which has not yet been made in the English authorities.

Generally, mere “commercial pressure” is not enough but it depends on the facts
A person is not a shadow director “merely because that party imposes conditions on his or her commercial dealings with the company with which the directors feel obliged to comply” (Buzzle [2010] at 242; [2011] at 191). Unless “something more” intrudes, the directors are expected to exercise their own judgment as to whether it is in the company’s interests to comply with the terms upon which the third party insists.

However, the court emphasised that each case turns on its facts. Young JA stated: “one must approach this subject with an eye to the ultimate question and not rely overmuch on one line statements” (Buzzle [2011] at 205). The court highlighted the importance of evaluating the putative shadow director’s real influence.

CONCLUSION
English law on identification of shadow directors remains unsettled, particularly in light of the Supreme Court’s decision in Re Paycheck. Whether Millett J’s test in Hydrodan will continue to be the cornerstone for identifying a shadow director remains to be seen.

Nonetheless, the Australian decision of Buzzle provides useful guidance on how to apply Millett J’s test. Many of the principles outlined in Buzzle derive from the English authorities. In particular, the general principle that creditors are entitled to protect their own interests without necessarily becoming shadow directors is not new.

However, the court’s decision that there must be a causal connection between the instruction or wish of the shadow director and the action taken by the directors, and that the board can exercise a certain level of independent judgment without that being inconsistent with the presence of a shadow director are significant pronouncements. It will be interesting to follow whether (and if so, to what extent) the English courts apply the principles adopted in Buzzle in future cases.

1 See definition of director in a s 9, Corporations Act 2001 (Cth).
2 See Griffin, Stephen, “Confusion surrounding the characteristics, identification and liability of a shadow director” Insolv. Int. 2011, 24(3), 44-47.