SLAUGHTER AND MAY

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Corporate directors and *de facto* directorship – the Supreme Court requires "something more"

INTRODUCTION

In the case of *Holland v The Commissioners for Her Majesty's Revenue and Customs; Paycheck Services 3 Ltd, Re [2010] UKSC 51 ("**Holland**")* the Supreme Court finally had the opportunity to consider when a director of a corporate director can be considered a *de facto* director of the subject company. The path to clarification was arguably not without its obstacles and the opinions of the panel raise questions about the protection of creditors in such structures and more generally.

THE FACTS

The corporate structure

Mr and Mrs Holland had set up a scheme with the intention that contractors could benefit from certain tax advantages without the administrative burden of having to set up and run their own companies. They held the shares in, and were the only directors of, a holding company which held the shares in two intermediate companies that they also owned and directed. Those intermediate companies acted as the sole director and secretary of 42 trading companies. Each of the trading companies had a single voting "A" share and 50 non-voting shares. The "A" shares were held by another of Mr and Mrs Holland's companies on trust for the benefit of the contractors who were the employees of the trading companies and also held the non-voting shares. The trading companies paid a fee to the intermediate companies for administrative services and paid a salary to the contractors. Dividends were also paid to each contractor on a regular (and largely automated) basis after provision had been made for the payment of corporation tax.

The tax liability

The intention was that the companies would only be liable to pay corporation tax at the small companies' rate and the provisions were made on that basis. However, Mr Holland had been advised that this might be challenged and, some time after the structure had been set up, HMRC concluded that the companies were actually liable to pay higher rate corporation tax. As a result, when the dividends were paid to the contractors there were insufficient distributable reserves to pay HMRC (the companies' only creditor). A settlement could not be reached and the companies were placed into administration and later liquidation.

The application

HMRC applied to court under section 212 of the Insolvency Act 1986 (the "**IA 86**") alleging that Mr and Mrs Holland were liable for misfeasance and breach of duty, because they had caused the trading companies to pay dividends to their shareholders when there were insufficient distributable reserves to pay creditors, and that they should be ordered to contribute to the assets of the insolvent companies by way of compensation.

THE DECISION

The key question: was Mr Holland a de facto director?

There were a number of issues to be decided by the court, including whether liability for procuring the payment of unlawful dividends is strict, what the remedy should be for such a breach of fiduciary duty and the extent of the court's powers to grant relief. However, the crux of the matter was that, to succeed in its claims, it was necessary for HMRC to show that Mr and Mrs Holland were *de facto* directors of the trading companies and thus owed duties to those companies. The case against Mrs Holland was dismissed at first instance and HMRC did not appeal that decision. However, the deputy judge found that Mr Holland was a *de facto* director of each of the trading companies and that he had, at times, been guilty of misfeasance. The Court of Appeal disagreed and the case went on to be considered by the Supreme Court where a majority of three upheld the Court of Appeal's decision. The divisive nature of the issue is apparent from the dissenting opinions of Lords Walker and Clarke and the fact that, although Lords Hope, Saville and Collins all concluded that Mr Holland was not a *de facto* director of the trading companies, they each arrived at this decision by different means.

De facto directorship: lacking definition

There is no statutory definition of *de facto* directorship and this case is significant because it gave the Supreme Court the opportunity to consider and provide guidance on the concept, particularly in the context of corporate directorship. Such guidance is essential because the statutory definition of "director", found in section 250 of the Companies Act 2006, includes *de facto* directors and so the general duties that apply to *de jure* directors also apply to them. It was not disputed that *de facto* directors fall within section 212 IA 86 and so can be liable for misfeasance and breach of duty.

The authorities: no simple and reliable test

The court considered a number of earlier cases concerning *de facto* directorship, dating from 1840. These feature heavily in the judgments of Lords Hope and Collins but the panel was conscious of the limitations of the older authorities and noted that: the circumstances vary widely from case to case; the concept of *de facto* directorship was developed by the courts largely at a time when the concept of corporate directorship did not exist; and until recently *de facto* directorship applied only to those who had been appointed as directors but whose appointment was defective or had expired. Therefore it was difficult to identify a simple and reliable test for determining whether a person in Mr Holland's position was acting as a *de facto* director (given that he had never been appointed as a director of the trading companies but was the sole *de jure* director of their corporate director). Lord Hope asserted that the only generalisation that could be made was that all the relevant factors must be taken into account. However, he and Lord Collins went on to provide more detailed (but somewhat contrasting) guidance.

A question of fact: Hydrodam and the requirement for something "more"

The case that received the most attention was *Re Hydrodam (Corby) Ltd [1994] 2 BCLC 180 ("**Hydrodam**")* It was referred to in the opinions of all of the members of the panel except Lord Saville (whose judgment was considerably briefer than the others). All agreed that the law had moved on since the judgment of Millett J (as he then was), particularly that in order to be a *de facto* director it was no longer necessary for the individual in question to have held himself out as a director. Some aspects of the *Hydrodam* decision were upheld; Lord Hope felt that it was necessary to examine the facts and consider what Mr Holland had actually done; he focused on Millett J's suggestion that:

"*Attendance at board meetings and voting, with others, may in certain limited circumstances expose a director to personal liability to the company of which he is a director or its creditors. But it does not, without more, constitute him a director of any company of which his company is a director.*"

In Lord Hope's opinion, Mr Holland had not fulfilled this requirement for "something more" because he had done no more than discharge his duties as the director of the corporate director of the trading companies:

"*So long as the relevant acts are done by the individual entirely within the ambit of the discharge of his duties and responsibilities as a director of the corporate director, it is to that capacity that his acts must be attributed.*"

He concluded that Mr Holland was not a *de facto* director of the trading companies and more generally that the mere fact of acting as a director of a corporate director will not be enough for that individual to become a *de facto* director of the subject company.

The dissenting judges were keen to distinguish *Hydrodam* (a case in which there were a number of directors on the board) from the case in question – taking the view that being a *de facto* director is determined by what an individual does on his own initiative. Lord Walker was happy to adopt the requirement for "something more", the pertinent question for him was: did the individual do something more than participate in a collective decision? Mr Holland was, *inter alia,* the guiding spirit of the whole empire, the only active director of the corporate director and the original holder of all the voting shares, he alone took the decision that the trading companies should continue to trade and to pay dividends without providing for higher-rate corporation tax – if that did not amount to "something more" then Lord Walker found it hard to imagine circumstances that would do so.

A question of law and principle: piercing the corporate veil?

Lord Collins did not agree that it was necessary to look at what Mr Holland did and to ascertain whether this was the "more" of which Millett J spoke. To him the question was one of principle and law: can fiduciary duties be imposed, in relation to a company whose sole director is a corporate director, on a director of that corporate director when all of his relevant acts were done as a director of the corporate director and can be attributed in law solely to the activities of the corporate director? He seems to have been concerned about judicial transgression and was keen not to extend the concept of *de facto* directorship beyond the confines that had already been established – describing the extension of *de facto* directorship from defective appointment to persons who had never been appointed but had simply taken part in the management of the company, as "*judicial innovation*". He noted that, as a result of this extension, it is necessary to decide which management functions are the sole responsibility of directors to establish whether an individual is a *de facto* director. In the absence of statutory guidance he turned to a number of tests proposed in earlier cases and concluded that the question was: whether Mr Holland was part of the corporate governing structure of the trading companies and whether he assumed a role in those companies that imposed on him the fiduciary duties of a director.

When considering this question, Lord Collins drew attention to the need to consider the effect of acts that are carried out by a director of a corporate director in that capacity. The three judges who concluded that Mr Holland was not a *de facto* director emphasised that he was at all times acting in his capacity as a director of the corporate director. They placed a great deal of emphasis on the importance of the principle of separate legal personality (as Millett J had done in *Hydrodam*) and felt that allowing HMRC to succeed in its claim to obtain compensation from Mr Holland in respect of dividends paid by the trading companies, would involve looking through the intermediate companies, which they were reluctant to do. Lord Saville's brief judgment sums up this view:

"*… the appellant's case necessarily involves substantial inroads into the long established principle that although a company is an artificial entity and can only act through natural persons, it is to be treated as a legal personality separate and distinct from its directors and members.*

It is the case that Mr Holland was the guiding mind behind the sole corporate director of the composite companies. He was the natural person who decided that the composite companies should pay the dividends in question. But he did

so in the course of directing the corporate director, not by acting or purporting to act as a director of the composite companies. In my judgment, it does not follow from the fact that Mr Holland caused the corporate director to make decisions in relation to the composite companies that he was accordingly a de facto director of the composite companies. To suggest that he was is to ignore or bypass the separate legal personality of the corporate director and instead to treat Mr Holland as though he, rather than the corporate director, was the legal personality running the composite companies."

The majority were reluctant to pierce the corporate veil because the distinction between a company and its directors is a fundamental feature of English corporate law but also because they felt that to overlook this distinction, in these circumstances, would create too much uncertainty for any individual acting as a director of a corporate director.

While the two dissenting judges agreed that Mr Holland's acts had all been carried out in his capacity as a director of the corporate director, they attached importance to what Mr Holland actually did, rather than the capacity in which he did it, when deciding whether he was a *de facto* director. In the eyes of Lord Clarke, the decision to continue trading and paying dividends was a decision that was made "*wearing a number of hats at the same time*" and it was entirely possible for an individual to act both as a *de jure* director of a corporate director and as a *de facto* director of the subject company.

The protection of creditors

Lord Walker opened his dissenting opinion by voicing concern that the decision of the majority in this case will make it easier for other individuals to use artificial corporate structures to avoid being held responsible to an insolvent company's unsecured creditors. In reaching the conclusion that Mr Holland was not a *de facto* director, Lords Hope and Collins were not oblivious to this concern but they took the view that, regardless of how unpalatable it may be for a structure to exist where a company is directed by a sole corporate director, it was entirely lawful at the time in question and Mr Holland could not be criticised for it.

Lord Collins suggested that the policy reasons for making someone in Mr Holland's position liable as a *de facto* director may not be as powerful now as they were before the implementation of the Companies Act 2006 – a reference to section 155(1), which provides that a company must have at least one director who is a natural person. As well as recognising the greater protection that the provision offers, the majority also saw it as further evidence that their conclusions were correct: such a provision was "*hardly necessary if the natural person or persons who were the guiding minds behind the corporate director's decisions relating to the company were ipso facto to be treated as de facto directors of the company*". Lord Collins cited a white paper on company law reform, issued by the Department of Trade and Industry in 2005 (CM 6456), which explained that the purpose of the provision was to ensure that every company would have at least one individual who could, if necessary, be held to account for a company's actions. He also noted that the legislature could have gone further and prohibited corporate directors altogether – as is the case in many other jurisdictions including Australia, Canada and New York and Delaware in the US. Interestingly, none of the judges mentioned that the Government had, in an earlier paper on modernising company law (CM 5553-I), proposed a total prohibition on corporate directorships (with the protection of creditors in mind).

Although it was not central to the case, shadow directorship was considered at each hearing and the Supreme Court made some interesting observations in this regard. Early in his judgment Lord Hope explained that HMRC had not asserted that Mr Holland was a shadow director and noted that shadow directors can be liable for wrongful trading under section 214 IA 86. He went on to state unequivocally (albeit *obiter*) that shadow directors are not liable under section 212 IA 86 because, unlike section 214, section 212 does not provide for this. Lord Collins expressed the same view with equal conviction. Therefore, a claim for misfeasance or breach of duty under section 212 can be brought against a *de facto* director but not against a shadow director and a claim for wrongful trading

can be brought against a *de facto* director or a shadow director. In this context, it is interesting to note the view expressed by a number of the judges in this case, that although shadow directorship is defined by statute and *de facto* directorship is not and the courts have in the past found the concepts to be mutually exclusive, the distinction between the two has been eroded and they have much in common.

CONCLUSION

The decision is of more than purely academic interest even though it is no longer permissible for a company to be managed by a sole corporate director: similar structures that existed in the recent past may be investigated by creditors, liquidators or administrators; corporate directors continue to exist; and, more generally, the judgment provides a useful overview of the development of the concept of *de facto* directorship and includes some interesting observations about shadow directorship and how far the courts are able to go to protect the interests of creditors.

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