This article was first published in Greens Business Law Bulletin, Issue 139 (published December 2015) and is reproduced here with the kind permission of W. Green, the Law Publishers

****

Informal directors, holding companies and "hat" identification: *Smithton Ltd v Naggar* [2015] 2 B.C.L.C. 22

Andrew Bowen *QC*

Introduction

Questions of whether an individual was a de facto or shadow director usually arise when liquidators or government bodies are attempting to recoup an insolvent company's loses from a person who, while not a de jure director, appeared to have exercised real influence in the company's "corporate governance". Although a holding company does not become a shadow director of its subsidiary merely because it directs the subsidiary's business, a director of that holding company can in principle become an informal director of its subsidiary where that director can be proved to have assumed the role or responsibilities of a director. However, *Smithton*, a decision of the Court of Appeal (Arden LJ with whom Elias and Tomlinson LJJ agreed), illustrates the difficulty of doing so when faced with the holding company's separate legal personality. The decision rejected an appeal from Rose J ([2014] 1 B.C.L.C. 602) dismissing an action claiming that the defendant N was an informal director.

Facts

N, described as a "deal" person, was the chairman of DDI, the holding company of the claimant. Prior to its incorporation the claimant had been run as a division of a subsidiary company of DDI by a merchant banking management team which then "spun it off" as a separate corporate joint venture between DDI and the management team. The JV provided that DDI had just over 50 per cent of the shares, the rest owned by the management team, who were also the directors along with DDI-appointed directors.

Although N was not a director of the claimant, nothing of significance was discussed or decided at board meetings and N and one of the management team directors took the important decisions, acting effectively as partners in the business outside of formal board meetings.

The claimant's business was writing "contracts for difference" (CfDs); clients entered into a contract with the provider with reference to a particular number of shares at a particular price; if the share price was higher when the contract closed, the provider paid the client the value of that uplift and if the price was lower the client paid the value of the deficit; if the share price moved against the client the claimant could make a margin call to increase its security. The claimant entered into two CfDs with two clients who were connected companies of N. When the shares lost value the claimant made a margin call but the clients defaulted on the calls and went into insolvency. The claimant sought to recover its loss from N on the basis that he had breached his duties as a de facto or shadow director in that the CfDs with the connected companies involved a conflict of interest between his duty to the claimant and his interest in the holder of the CfD. The issue of conflict of interest was not addressed since the judge at first instance found that N was not an informal director. At the trial N did not dispute that he had performed directorial acts but ran his defence on the basis of "hat" identification, i.e. that he had multiple roles and that he had acted in a different capacity at all times from that of a director of the claimant.

The law

Section 155(1) of the Companies Act 2006 (the 2006 Act) requires that a company must have at least one director who is a natural person, to ensure that every company has at least one individual who can be held accountable for the company's actions. Section 250 of the 2006 Act provides that "director" includes "any person occupying the position of director, by whatever name called”, in other words, a director in fact. Section 251(1) of the 2006 Act defines “shadow director” as a “‘person in accordance with whose directions or instructions the directors of the company are accustomed to act”, subject to s.251(2) that 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”.

Section 251(3) prevents holding companies from becoming shadow directors of subsidiaries by providing that a

> “body corporate is not to be regarded as a shadow director of any of its subsidiary companies … by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions”.

The distinction between a de facto and a shadow director is not crystal clear; in the Supreme Court decision in *Re Paycheck Services 3 Ltd* [2010] 1 W.L.R. 2793 Lord Collins observed that the distinction between de facto and shadow directors had become eroded but what they had in common was that an individual, not a de jure director, is exercising real influence (otherwise than as a professional adviser) in the corporate governance of the company [91]. He added that, to be a de facto director, the person had to be part of the corporate governing structure and to have assumed a role in the company sufficient to impose on him a fiduciary duty [93]. Lord Walker at [110] said that the concepts of de facto and shadow directors were not fundamentally different and to be regarded as mutually exclusive categories; there was no conceptual difficulty in concluding that a person could be both simultaneously. For him the test was undertaking functions in relation to the company which could properly be discharged only by a director [111]. However, the fact that they are distinguished in the 2006 Act is significant. In *McKillen v Misland (Cyprus) Investments Ltd* [2012] EWHC 521 (Ch), averments of sporadic involvement in the shape of giving instructions or guidance were held incapable of amounting to an assumption of the role or responsibilities of a de facto director but relevant on the issue of a shadow director.

In *Re Paycheck* the defendant had been the director of the corporate director of a number of trading companies Lord Hope held that, as long as the relevant acts done by the defendant were entirely within the ambit of the discharge of his duties as a director of the corporate director, it was to that capacity that his acts had to be attributed [42]. Lord Collins held that it did not follow from the fact that the defendant was taking all the relevant decisions that he was part of the corporate governance of the trading companies [96]. In *Smithton* Arden LJ referred to this as a “subtle difference of expression” [75]. Where the individual is not wearing another directorial hat it is easier for the court to infer that his actions must be as an informal director (*Re Mumtaz Properties Ltd* [2012] 2 B.C.L.C. 109).

First Instance and Court of Appeal

The tactical difficulty for the claimant was N’s position as a director of the holding group which could explain his involvement in the affairs of the subsidiary (as it had in *Re Paycheck Services 3 Ltd*). The claimant argued that the DDI-nominated directors had simply acted as nominees of N, that he exerted day-to-day control over the claimant and took decisions on important aspects of its business, and that he had instructed the claimant to enter into the CfDs with his connected persons. Rose J ([2014] 1 B.C.L.C. 602) rejected these allegations on the basis that the DDI-nominated directors naturally sought group support for their decisions from N as chairman of the holding company, that the instances of N’s involvement in the day-to-day management of the claimant were readily explicable on the basis of his role as chairman and that he had only given instructions to enter into the CfDs as representative of the connected persons (the judge had also found that the CfDs were not voidable as “substantial property transactions” in terms of s.190 of the 2006 Act). The judge analysed N’s role by reference to “hat” identification; he had a hat for each office he held and the issue was which hat he was wearing in relation to the actions alleged to be carried out as either de facto or shadow director. Her conclusion was that nothing which N did went beyond the involvement one would expect from a person who combined the roles of major client and chairman of the majority shareholder.

On appeal the claimant argued that the judge erred in principle in her approach to "hat" identification by finding that N could not be a de facto director if the acts relied on could also be done wearing the hat of director of DDI rather than determining in which capacity an act was actually done. While accepting that there had to be a cogent reason to attribute an act to a person as a de facto director if there were other capacities in which he could have lawfully acted, the claimant argued that that burden was discharged by showing that N performed acts which the director of the company would normally do.

Arden LJ listed the practical points which made a person a de facto director; the question was whether he has assumed responsibility to act as a director. To answer that question the court might have to determine in what capacity the director was acting and what he actually did in the context of the corporate governance structure to decide in relation to the company's business whether the director's acts were directorial in nature viewed objectively, with relevant factors including whether the company and third parties considered him to be a director, with the fact that a person was consulted about directorial decisions not of itself making him a director because he was not making the decision. She concluded that whether a director was a de facto or shadow director was a question of fact and degree [33–45].

Although N had accepted that he had performed directorial acts and important decisions were not discussed at board meetings, Arden LJ emphasised that the company structure had been exhaustively laid out in the JV agreement that carefully delineated the balance of power and the limits of discretion between management and shareholders; the fact that N did not become a director under the JV was a deliberate decision of which the other directors were aware. In her view the claimant's challenge depended on downplaying the significance of the JV agreement and was in reality a disagreement with her findings in fact about the capacity in which N acted which disclosed no error in law [77].

On the issue of whether N was a shadow director Arden LJ simply said that the judge's finding that N was not a de facto director because he was protecting his or other's interests in some other capacity would also preclude him being a shadow director [90].

Conclusion

The facts of *Smithton* were unusual in that the judge was strongly influenced by the JV agreement as contradicting the claimant's case that N's actions had to be seen as made in his capacity as its informal director. Even where there is no shareholders' agreement, *Re Paycheck* illustrates the difficulties of overcoming an individual's capacity as director of a holding company in order to establish his status as an informal director of a subsidiary. Unless there are no other hats that the individual can claim to have been wearing while being involved in the company's affairs, those difficulties are probably overwhelming.