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Duties owed by shadow directors: Closing in on the puppet masters?

Simon Witney*

Introduction

British company law has long recognised that those who issue instructions to the directors of a company, and therefore wield “real influence”¹ over that company’s affairs, should bear some level of responsibility for corporate actions, even though they have not themselves been appointed to the board². Various (and sometimes misleadingly³) described by judges as figures who “lurk in the shadows”, as “puppet masters” in control of puppet directors, or as those in control of the “cat’s paw”, these “shadow directors” (as the law has designated them) have been called to account for their actions. However, although there are a number of specific company and insolvency law statutory provisions that apply to shadow directors⁴, the precise extent of their obligations and liabilities has never been clearly delineated. Indeed, following the 2005 decision of Lewison J in *Ultraframe v Fielding*⁵, it was not even clear whether directors’ general fiduciary duties to their companies could ever be owed by shadow directors, unless they voluntarily submitted to them (which they would seem unlikely to do). To some extent, the wrong turn taken by the common law in that case was put right in 2013 by Newey J, who gave judgement in *Vivendi v Richards*⁶, and argued that Lewison had understated the position; but, taken together, these two first instance decisions cannot be said to have left the law in a clear and satisfactory state.

In June 2013, the UK government hosted a G8 summit in Lough Erne, and put “trust and transparency” and the abuse of corporate structures at the heart of the agenda. After signing a joint declaration on the misuse of companies⁷, which included commitments to ensure that companies know who “owns and controls them” and to place that information in the hands of law enforcement agencies, it set about re-examining UK law in this area.

Following an initial review, the Department for Business, Innovation & Skills (BIS) made a number of specific proposals in the summer of 2013. These included changes to UK company law rules to deal with the perceived (and related) problem of “nominee directors” – those who act as directors of UK companies but who are themselves controlled by another person. After a period of consultation, during which those proposals were modified, law reforms were included in the Small Business, Enterprise and Employment Act 2015 (“the 2015 Act”)⁸, and became effective on 26 May 2015. These eventual reforms adjusted the basis on which directors’ duties are to be applied to shadow directors.

In this article, I first summarise the existing state of the law on shadow directors, and then trace the course of the reform now included in the 2015 Act. I consider the government’s expressed intention in making the change that it has and argue, in the final part, that the relatively modest change leaves the legal position far from clear and may unhelpfully constrain further development of the law. There was no clear explanation

* PhD candidate, London School of Economics. I am grateful to David Kershaw, Carsten Gerner-Beuerle and anonymous reviewers for helpful comments on an earlier draft. Any remaining errors and omissions are my own. The author assisted the British Private Equity and Venture Capital Association in responding to various consultations and participating in discussions with government relating to the Small Business, Enterprise and Employment Bill.

¹ *Secretary of State for Trade and Industry v Deverell* [2001] Ch. 340 per Morritt LJ at [33] on page 353.

² The current statutory definition originates from section 3 of the Companies (Particulars as to Directors) Act 1917, although it was not then given the epithet “shadow director”.

³ See comments of Morritt LJ in *Secretary of State for Trade and Industry v Deverell* [2001] Ch. 340 at [36] on page 354-5.

⁴ See, for example, section 214 Insolvency Act 1986, and section 182 Companies Act 2006 (as modified by section 187).

⁵ *Ultraframe and others v Fielding and others* [2005] EWHC 1638 (Ch).

⁶ [2013] EWHC 3006 (Ch).

⁷ “Common principles on misuse of companies and legal arrangements”, June 2013 (<https://www.gov.uk/government/publications/common-principles-on-misuse-of-companies-and-legal-arrangements>)

⁸ The Small Business, Enterprise and Employment Act received Royal Assent on 26 March 2015. The Act also includes a number of other important changes that are also designed to enhance transparency and trust, including the establishment of public register of “persons with significant control” of a UK company, the abolition of bearer shares, and the prohibition (subject to certain exceptions) of corporate directorships. These changes are outside the scope of this article.

from the government as to how this change was intended to modify the common law, and there does not seem to have been sufficient regard to the potentially negative behavioural effects that the change could have. The common law is neither improved nor clarified by the reform, and it is possible that unintended and undesirable consequences will follow, as lenders and significant shareholders re-evaluate the extent to which the law may hold them accountable if they inadvertently become shadow directors.

The existing law

The statutory test, as interpreted by the courts

A cursory analysis of the definition of a shadow director, as now laid out in section 251 of the Companies Act 2006 and elaborated by various cases, reveals that it is actually quite hard for a person to become a shadow director. The relevant definition is as follows: "In the Companies Acts '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".

According to this definition, it is not enough that the directors seek advice from a non-director; they must act in accordance with their "directions or instructions". Nor is it enough that they do this just once, or even occasionally; the directors must be "accustomed" to acting in accordance with these directions or instructions. Section 251(2) goes on to say that giving "advice in a professional capacity" puts the relevant professional outside the scope of the definition, and it has long been clear that having control of a single director, or even several directors, is insufficient: the putative shadow director must be able to determine the company's actions, which means they must be in control of all, or at least a "governing majority", of the actual directors⁹. For these reasons, although a bank or controlling shareholder might be concerned about the potential liability imposed by these rules, it will be relatively rare for a well-advised non-director, even one with "strong influence", to find that they are held to have inherited duties because they are a shadow director. In *Ultraframe v Fielding*¹⁰, Lewison J refers to cases in which the question of whether a lender had become a shadow director had been considered, but had in each case been rejected. He refers, for example, to comments of Judge Baker QC in *Re PTZFM Ltd*¹¹, who says that it is significant that the lenders were "acting in defence of their own interests" and that "the directors of the company were quite free to take the offer or leave it". Lewison J himself says that lenders are entitled to impose conditions on their support to a company without becoming shadow directors, and the same would presumably be true for significant shareholders.

The extent of the duties owed

As well as making it clear that it is hard to be a shadow director, the court in *Ultraframe* also threw doubt on the extent of the duties owed by a shadow director, even once a person is held to have met the relevant statutory test. In a widely-criticised part of his judgement¹², Lewison J, relying chiefly on principles of equity, said that there must be evidence of a direct relationship of "trust and confidence" between the shadow director and the company in order for general fiduciary obligations to be imposed on her¹³. Citing the trusts law cases of *Bristol & West BS v Mothew*¹⁴ and *Arklow Investments Ltd v Maclean*¹⁵, and quoting from Snell's Equity, Lewison J was "not persuaded that the mere fact that a person falls within the statutory definition of 'shadow director' is enough to impose upon him the same fiduciary duties to the relevant

⁹ See comments of Harman J in *Re Unisoft Group Ltd (No. 3)* [1994] 1 BCLC 609 at 620, and Hart J in *Lord v Sinai Securities Ltd* [2004] EWHC 1764 (Ch), both of which were cited with approval by Lewison J in *Ultraframe*.

¹⁰ [2005] EWHC 1638 (Ch).

¹¹ [1995] 2 BCLC 354.

¹² See, for example, D. Prentice and J. Payne, "Directors' Fiduciary Duties" (2006) 122 LQR 558 and P. Davies & S. Worthington, "Gower & Davies: Principles of Modern Company Law", (9th edn), 2012, Sweet & Maxwell at 16-15. See also, however, K. Idensohn, "The Regulation of Shadow Directors" [2010] 22 SA Merc LJ 326 (especially section 3.2 at page 332) for an examination of the reasons why the English courts have been reluctant to impose fiduciary duties on shadow directors.

¹³ [2005] EWHC 1638 (Ch) at [1286].

¹⁴ [1998] Ch 1.

¹⁵ [2000] 1 WLR 594.

company as are owed by a *de jure* or *de facto* director¹⁶. He argued that in the one decided case in which a shadow director was said to owe fiduciary duties, *Yukong Line v Rendsberg*¹⁷, the director in question could more accurately be described as a *de facto* director. Lewison J asserted that an assumption of an “obligation of loyalty to the company” was needed on the part of the putative fiduciary, which he did not discern in the case before him.

In fact, after the more convincing judgement of Newey J in *Vivendi v Richards*¹⁸, the law was already moving away from such a demanding requirement. In that 2013 case, Newey J argued that, if there is a need to show assumption of responsibility by a shadow director, then acceptance and use of corporate powers must imply such an assumption of responsibility. After referring to a Law Commission report¹⁹, which had endorsed the approach of Toulson J in the *Yukong Line* case²⁰, the judge quoted extensively from the judgement in *Ultraframe* and referred to the academic criticisms of his conclusion. Newey J accepted that there was widespread support in the authorities for the proposition that “fiduciary duties stem from undertakings or the assumption of responsibility”, but he asserted that the test of whether there had been such an undertaking or assumption was an objective one, and was not based on what the alleged fiduciary subjectively intended. Newey J also maintained that “the taking on of a role or position must be capable of implying an undertaking/assumption of responsibility”, so that a person who agrees to become a trustee must also be taken to have agreed to accept the duties which accompany that position. In the case of a shadow director, the judge said that – taking account of the authorities, legislative intent, public policy and the important role that a shadow director can have, and has assumed to have, in relation to a company’s affairs – she will “at least” owe duties in relation to the directions or instructions which she gives, and these would “normally” include a duty of “good faith (or loyalty)”. In Newey J’s view, *Ultraframe* “understates the extent to which shadow directors owe fiduciary duties”.

So, although the legal position was not clear and settled, there were signs that the common law would in future take a tougher stance than had been evident in the sparse prior authority.

The Companies Act 2006

The 2006 Act, which came after the *Ultraframe* decision but several years before *Vivendi*, had done relatively little to change the rules relating to shadow directors, merely repeating with inconsequential amendments the definition that was previously in the Companies Act 1985, and specifically applying certain provisions of the Act to shadow directors as well as to *de jure* and *de facto* directors.

As is well known, the 2006 Act also amended and codified the “general duties” of directors, and Parliament expressly decided to preserve the common law’s ability to determine the extent to which those duties should apply to shadow directors. To that end, section 170(5) of the 2006 Act says: “The general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles so apply”. Moreover, it is clear that Parliament, and those who drafted the 2006 Act, were well aware of the decision in *Ultraframe* when they enacted section 170(5). That decision, among others, was referred to in the debates, and the government acknowledged that the law was unclear. However, a decision was taken then to “allow the common law and equitable principles to develop”, rather than to “jump in and try to impose a view”²¹.

Nevertheless, despite that clear policy decision taken in 2006 and the subsequent judgement of Newey J in *Vivendi*, when reviewing the state of the law on shadow directors more recently, the government found it to

¹⁶ [2005] EWHC 1638 (Ch) at [1284].

¹⁷ *Yukong Line Ltd of Korea v Rendsburg Investments Corporation of Liberia and Others (No 2)* [1998] 1 WLR 294.

¹⁸ [2013] EWHC 3006 (Ch), at [133] to [145].

¹⁹ *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties*, Law Commission, CP153, para 17.15.

²⁰ See fn 17 above.

²¹ See comments of the Solicitor General, Hansard, Standing Committee D, Thursday 6 July 2006 (afternoon), column 525.

be lacking. In the next section, I will trace the course of the law reform process which led to changes being enacted in 2015.

The reform process

The UK government's 2013 discussion paper

In July 2013, just one month after a joint declaration made at the G8 summit in Lough Erne²² included commitments to bear down on legal structures designed to hide wrongdoing, BIS issued a discussion paper entitled *Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business*²³. That document included various proposals to make it easier to hold those actually in control of a company to account, but it is notable that there were no proposals relating to shadow directors. Instead, there was a section on “nominee directors”, a phrase that was intended to include *de jure* directors who are appointed by those who want to “use a company to facilitate criminal activity”, whereby the nominee “follows the directions of the person who is really controlling the company (i.e. the beneficial owner)”. It was acknowledged that nominee directors could be appointed for legitimate commercial reasons (particularly in groups of companies), but the paper referred to two reports that had highlighted the use of “nominee directors” by those engaged in “criminal activities such as tax evasion and money laundering”²⁴.

Inspired by FATF recommendations²⁵, the government asked respondents whether they would favour a public register of “nominee directors”, and/or greater efforts to educate directors as to the legal position (which, it was said, does not absolve the “nominee” from her duties to the company even if she has agreed to act in accordance with the instructions of another). More tentatively, the government asked for views on whether it should be made an offence for a director to “divest themselves of the power to run the company”²⁶.

The April 2014 response

The respondents to the 2013 discussion paper did not, in general, support the specific suggestions to establish a register of “nominee directors”, nor to make it an offence to divest powers, and in its April 2014 response to the consultation, the government revised its proposals²⁷. The government maintained that there was strong support for dealing with the problem of “front directors” (which was the terminology it now preferred to use, instead of “nominee directors”), but in different ways to those initially suggested. Several respondents had argued that it was already unlawful for directors to divest themselves of power²⁸, while others pointed out that there would be significant problems in defining when the duty to disclose would arise²⁹. Instead, some respondents suggested³⁰ that the government could look again at the definition of “shadow director” and, in particular, could consider whether it should be possible to be a shadow director if only one director was in the control of the putative shadow director – rather than “the directors” (as required

²² “Common principles on misuse of companies and legal arrangements”, June 2013 (<https://www.gov.uk/government/publications/common-principles-on-misuse-of-companies-and-legal-arrangements>)

²³ BIS/13/959.

²⁴ The reports referred to were World Bank, “Puppet Masters: how the corrupt use legal structures to hide stolen assets and what to do about it”, 2011 (<http://star.worldbank.org/star/publication/puppet-masters>), and Global Witness, “Grave Secrecy”, 2012 (<http://www.globalwitness.org/library/grave-secrecy>)

²⁵ The FATF (Financial Action Task Force) Recommendations, February 2012 (http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf).

²⁶ See the Executive Summary of the July 2013 discussion paper at paragraphs 30–33 and Section 4 at pages 46–49.

²⁷ BIS, “Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business – Government response”, April 2014 (BIS/14/672), in particular paragraphs 191–202 at pages 49–51.

²⁸ See, for example, the response of the Law Society of England and Wales at paragraph 31, which refers to a “significant body of case law” and specifically cites *Re Neath Rugby Ltd (No. 2)*, *Hawkes v Cuddy* [2009] 2 BCLC 427; response of the Institute of Chartered Accountants of England and Wales (ICAEW) at paragraph 74; and the response of the City of London Law Society at paragraph 31. All non-confidential responses are available at <https://www.gov.uk/government/consultations/company-ownership-transparency-and-trust-discussion-paper>.

²⁹ BIS/14/672, paragraph 181, which quotes from the response of the ICAEW.

³⁰ See, for example, the response of the Law Society of England and Wales at paragraph 33 and the response of ICAEW at paragraph 75.

by section 251 of the Companies Act 2006) or at least a “governing majority” of them (as section 251 was interpreted by Lewison J in *Ultraframe*). This suggestion was only made tentatively: it was acknowledged by those making it that such a change could interfere with legitimate commercial practices (including in relation to joint ventures and private-equity type arrangements), and that further consideration was required before proceeding.

The government’s amended proposals included procedures to be established at Companies House to facilitate better education of newly-appointed directors, better and more accessible information about directors’ duties, and expanding the matters to be taken into account by the court in deciding whether to disqualify a director under the Company Directors Disqualification Act 1986³¹. In addition, BIS invited views on the suggestion made by some respondents to change the definition of shadow director, and said that it was also considering whether to make it clear that the “general statutory duties of directors [apply] to shadow directors”.

The draft legislation and the “capability” wording

When the draft legislation was published in mid-2014, it became clear that the government (having consulted with various stakeholders) had decided not to proceed with the suggestion to change the definition of “shadow director” so that it would cover the situation in which a person was only instructing one director, as had been suggested by some respondents³². Changes were instead proposed to the Company Directors Disqualification Act to make it possible for the courts to disqualify a person from acting as a director if they had given instructions or directions to a director (called “the main transgressor”) in relation to behaviour which was itself the reason for a disqualification order that had been made against the main transgressor³³. However, clauses were also included to implement the second suggestion: to amend the Companies Act to make it clear that the general duties of directors will apply to shadow directors “where and to the extent they are capable of so applying”³⁴. Apparently aware, however, that such a blanket application of duties might not be appropriate, the draft legislation also included (in what is now section 89(2) of the 2015 Act) a power for the Secretary of State to make regulations about “the application of the general duties of directors to shadow directors”. These regulations could adapt the general duties as they apply to shadow directors, and could specify that certain duties will not apply at all.

Objections to this proposed wording were raised in Grand Committee in the House of Lords, and an amendment was tabled which would have replaced the phrase “where and to the extent they are capable of so applying” with “to the extent it is reasonable, just and equitable for any such general duty to apply”. The intention was to give greater flexibility to the courts in determining whether and to what extent particular duties should apply to shadow directors, given that there might be circumstances in which, although capable of applying, it might be unreasonable to make a shadow director subject to the full scope of a particular duty³⁵. In effect, it seems likely that this would have confirmed the approach that was adopted by Newey J in *Vivendi*, and would have made little difference to the existing law, other than to confirm the new course that the common law was charting after the wrong turn it had taken in *Ultraframe*.

The government seemed sympathetic to this concern, and recognised that it was important not to put shadow directors “in a worse position than directors”³⁶, but declined to alter the wording of the Act. Instead, the government made an amendment to the Act’s Explanatory Notes to clarify their intention in using the wording of “capability” in section 89. They explained that the “change in default position is neither intended

³¹ These proposals were taken forward in Section 101 and Section 105 respectively of the 2015 Act.

³² In fact, section 90 of the 2015 Act does make some other changes to the definition of “shadow director”, which are designed to ensure that those giving instructions or directions pursuant to a power contained in legislation do not become shadow directors, and nor can Ministers of the Crown become shadow directors by virtue of guidance or advice issued by them.

³³ These provisions are now found in Section 105 of the 2015 Act, which inserts a new Section 8ZA into the Company Directors Disqualification Act 1986.

³⁴ This wording, which is now included in section 89 of the 2015 Act, amends section 170 of the 2006 Act by replacing section 170(5).

³⁵ Hansard, Grand Committee, Monday 19 January 2015, column GC337-339.

³⁶ See comments of Baroness Neville-Rolfe, Hansard, Grand Committee, Monday 19 January 2015, column GC338-339.

to preclude the courts from looking at the application of the duties on a case by case basis, nor from drawing on existing case law in any given case³⁷.

Whether the courts will interpret the section in the way in which the government intends remains to be seen. It would be possible for the courts to have regard to the comments made by the government³⁸ during the Parliamentary debates if they were of the view that the wording of what is now section 170(5) of the 2006 Act was “ambiguous or obscure” or its literal meaning “leads to an absurdity”, under the rule set out in *Pepper v Hart*³⁹. In addition, it is clear that Explanatory Notes to a *Bill*, which are available while Parliament is debating the relevant provisions, are admissible as evidence of the mischief that Parliament was seeking to address⁴⁰. However, it is notable that the amendment to the Notes referred to above was only included in the Explanatory Notes to the *Act*, which were published after the Bill had been debated in Parliament. It is therefore not clear whether the additional wording could be used by the courts as evidence of the will of Parliament⁴¹; and in any event, neither the statements⁴¹ by the government nor the additional sentence added to the Notes provides clear guidance that the duties will not apply where that would create compliance difficulties or where compliance would not be appropriate (as opposed to impossible).

The new approach to shadow director duties

The 2015 Act effectively reverses one aspect of the decision of Lewison J in *Ultraframe*, in which he argued that fiduciary duties could not be imposed on someone without a deliberate assumption of responsibility. However, instead of building on the formulation of the law as set out by Newey J in *Vivendi*, who had significant reservations about that aspect of *Ultraframe*, it seems to move it further towards the automatic application of the general duties to shadow directors.

Newey J had taken the view that the subjective intention of the shadow director was not relevant in determining whether they were a fiduciary, but that “[assuming] to act in relation to the company’s affairs” would “typically” be a sufficient reason to impose fiduciary duties “in relation *at least to the directions or instructions that he gives to the de jure directors*”. This is a significantly more qualified position than that which is now imposed by the amended version of Section 170(5), which is neither restricted to certain of the general duties, nor specifically limited to the “directions or instructions” which render the person concerned a shadow director.

Furthermore, although the government’s Explanatory Notes are no doubt right to suggest that the “capability” wording of the Act still contemplates that the question is considered “on a case by case basis”, the assertion that prior case law remains relevant is questionable. It is true that Section 170(4) says that regard shall be had to common law rules and equitable principles in “interpreting and applying” the general duties, and it is at least arguable that this specifically allows the court to consider the case law when deciding which duties should apply to shadow directors and to what extent. However, given that it is also clear that the new statutory provision seeks to modify the common law (and the language of “capability” is not used in the cases), the common law is likely to be of limited assistance. It would have been open to Parliament to adopt

³⁷ Explanatory Notes to the Small Business, Enterprise and Employment Act 2015, paragraph 603.

³⁸ Baroness Neville-Rolfe was a Parliamentary Under-Secretary at the Department for Business, Innovation & Skills and was therefore speaking on behalf of the government.

³⁹ [1993] A.C. 593, per Lord Browne-Wilkinson at page 631. However, see A. Kavanage, “*Pepper v Hart* and matters of constitutional principle” ([2005] 121 Law Quarterly Review 98) for a discussion of the objections to, and the limited scope for, using statements made in Parliament as a guide to statutory interpretation, in particular following the decision of the House of Lords in *Wilson v Secretary of State for Trade and Industry* [2003] 3 W.L.R. 568. Kavanage argues (at p.114) that the reasoning in *Wilson* requires us to read the decision in *Pepper v Hart* “in a narrow and qualified way”.

⁴⁰ See comments of Lord Steyn in *R v Chief Constable of South Yorkshire Police ex parte LS and Marper* [2004] HL UKHL

39: “Explanatory Notes are not endorsed by Parliament. On the other hand, in so far as they cast light on the setting of a statute, and the mischief at which it is aimed, they are admissible in aid of construction of the statute. After all, they may potentially contain much more immediate and valuable material than other aids regularly used by the courts, such as Law Commission Reports, Government Committee reports, Green Papers, and so forth”.

⁴¹ For a discussion on this point, see D. Kershaw, “The Rule in *Foss v Harbottle* is Dead: Long Live the Rule in *Foss v Harbottle*”, (2015) J.B.L., Issue 3, 274 at 294 *et seq.* Kershaw argues that, as a matter of principle, comments made after enactment cannot be taken as evidence of the will of Parliament, citing comments made by Lord Hamilton, the Lord President, in *Imperial Tobacco Ltd v Lord Advocate* [2012] CSIH 9 at [13].

the formulation used by Newey J if they had wished to codify the position he laid out in that case, but Parliament did not do that and chose a different formulation: it has chosen a more rigid approach. The extent of that extra rigidity may not become clear for many years, when the new formulation is tested in the courts, but in the meantime it will have an impact on behaviour.

The government's policy intention may seem clear: to make it plain to those who actually control UK companies that they should regard themselves as being subject to the same (extensive) duties as the *de jure* directors. It remains hard to pass the test for being a shadow director – requiring actual and repeated control of decisions – and no doubt the government's view is that those who satisfy the criteria should be held to exacting standards. It might be thought that, if there are any behavioural implications, they would surely be desirable ones: to encourage putative shadow directors to behave more responsibly and honestly, or to join the board of the company and explicitly submit to duties. However, in the next section I argue that the consequences may not be quite as intended, and could constrain behaviours that would be commercially or socially desirable.

Problems arising from the new approach

The main problem with the new approach stems from the fact that the scope of the duties owed by directors, as with fiduciaries more generally, has always been defined by the courts by reference to the specific circumstances of the case. That is most obviously true in the case of the duty to avoid conflicts of interest, now codified as regards "situational" conflicts in section 175 of the 2006 Act.

The duty to avoid conflicts

The *potential* scope of the section 175 duty is clearly very broad, especially in light of the wording used in the Act (which includes both potential and actual, and direct and indirect, conflicts) and the decision of the Court of Appeal in *Bhullar v Bhullar*⁴². In that case, and in *Industrial Development Consultants Ltd v Cooley*⁴³, it was held that a director was under an obligation to offer a "corporate opportunity" to his company even though it was discovered "in his spare time", and not only while acting in his capacity as a director. Given that the scope of this duty not to divert corporate opportunities is unbounded by the ability of the company to take up the opportunity⁴⁴, and might also not be restricted by the scope of the company's existing business⁴⁵, it is capable of applying to a very wide range of situations.

However, there are a variety of reasons why the duty to avoid conflicts of interest is not as onerous as the potential scope of the duty might imply.

First, when assessing the scope of the duty as it applies to any particular *de jure* director, the courts have always stressed that the question is not whether, and to what extent, the duty is *capable* of applying; instead they have insisted that the rule has to be applied flexibly and with reference to the circumstances. For example, in *Bhullar v Bhullar*⁴⁶, Jonathan Parker LJ, drawing heavily on the approach of Lord Upjohn in *Boardman v Phipps*⁴⁷, says that "flexibility of application is of the essence of the rule", and the question is whether the "fiduciary's exploitation of the opportunity is such as to attract the application of the rule". The test is not one of capability of application, but of whether application is appropriate.

⁴² [2003] EWCA Civ 424. Decisions which pre-date the 2006 Act remain relevant to an understanding of the general duties because Section 170(4) says that "regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties".

⁴³ [1972] 2 All ER 162.

⁴⁴ Companies Act s.175(2), which says that "it is immaterial whether the company could take advantage of the property, information or opportunity".

⁴⁵ This was the view of the Court of Appeal in *Re Allied Business and Financial Consultants; O'Donnell v Shanahan* [2009] 2 BCLC 666 when considering the pre-2006 Act law. Some commentators have argued that Section 175(4)(a) leaves room for the courts to re-apply some business line restrictions when applying the duty to avoid conflicts, but this is far from clear. For a fuller discussion see D. Kershaw, *Company Law and Materials*, (2nd edn) 2012, Oxford University Press, at page 573.

⁴⁶ [2003] EWCA Civ 424 at [28].

⁴⁷ [1967] 2 A.C. 46.

Secondly, the 2006 Act quite clearly contemplates that directors might have section 175 conflicts, but that these could be authorised by the board⁴⁸. So, if a director wishes to take on a directorship in another company which could possibly put them in a position of conflict with the company, they are free to seek the consent of the independent directors. Similarly, if a director comes across a corporate opportunity that they wish to pursue on their own account (or for the account of another company), they may disclose it to the board and seek approval to do so. It is not entirely clear whether a shadow director would be able to make use of the same procedure, since that would depend upon a court taking the view that the authorisation procedure in section 175(4) of the 2006 Act is also available to a shadow director (which might perhaps be odd because, on the one hand, that procedure requires that the directors who approve the conflict are independent, whilst to be a shadow director to whom the relevant duty applies a person must be in a position to instruct the board as to how to vote). But even if this statutory procedure were available, it seems rather unlikely that a shadow director would, in practice, seek to use this procedure because they would probably not self-identify as a shadow director.

Further, and perhaps more importantly, the Articles of Association of many private companies will include detailed conflict of interest management provisions which will apply to the *de jure* directors, and sometimes to specific *de jure* directors (such as those nominated by a significant shareholder). These will, for example, often allow a director to have interests in, or be a director of, another company, or to disclose confidential information to a third party (such as an appointing shareholder). Such provisions are valid pursuant to Section 232(4) and Section 180(4)(b) of the 2006 Act⁴⁹, but would usually not be available to shadow directors⁵⁰. In practice, therefore, a shadow director might very well be in a worse position than a *de jure* director as regards management of conflicts of interest – a position that the government said that it did not intend.

The different role of a shadow director

The problem for a shadow director to whom the 175 duty is capable of applying is exacerbated by the fact that the role and responsibility of a shadow director cannot be equated with that of a *de jure* director, or indeed a person who is classified as a *de facto* director because she “assumes to act” as, and “claims and purports to be”, a director⁵¹. There are important differences between these types of director on the one hand and a shadow director on the other, which should have a bearing on the extent of their legal duties, and these differences would have been taken into account by the common law in defining their scope.

To begin with, it is clear that a person does not have to have been involved in, and therefore to have accepted any responsibility for, all aspects of a company’s business in order to be subsequently found to have been a shadow director. In *Secretary of State for Trade and Industry v Deverell*⁵², Morritt LJ said: “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”. In many cases it is very likely that a “shadow director” would not be involved in the range of matters that one would expect the board to oversee, and might very well not assume to act beyond a very specific area. It is also not likely that the person concerned would self-identify as a

⁴⁸ Companies Act s.175(4), (5) and (6).

⁴⁹ Section 232(4) shields provisions in a company’s Articles which deal with conflicts of interest from the prohibition on exemptions from duty to the extent that they were lawful before the 2006 Act, while Section 180(4)(b) says that “where the company’s articles contain provisions for dealing with conflicts of interest, [the general duties] are not infringed by anything done (or omitted) by the directors, or any of them, in accordance with those provisions”. The meaning of these provisions are not entirely clear (see, for example, P. Davies & S. Worthington, “Gower & Davies: Principles of Modern Company Law”, (9th edn), 2012, Sweet & Maxwell at 16-201, but it seems that provisions such as those previously included in Table A would be protected by them.

⁵⁰ See, for example, the BVCA Standard Form Articles of Association, available at <http://www.bvca.co.uk/ResearchPublications/Publications/StandardIndustryDocuments/Modeldocumentsforearlystageinvestments.aspx>, (accessed 30 March 2015) which include specific conflict of interest management provisions at Article 31, including some which only apply to “Investor Directors” as defined, and which would not therefore apply to a shadow director.

⁵¹ *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 at 183 per Millet J.

⁵² [2001] Ch. 340 at [33] on page 353. See also *In re Kaytech International plc* [1999] BCC 390 at 402, where similar comments were made by Robert Walker LJ.

shadow director, and would therefore not be aware that duties could extend well beyond the matters with which she concerns herself.

Moreover, the test used to determine whether someone is a shadow director is an objective one, and the shadow director's actions might subsequently be characterised as "directions or instructions" even if that is not what they are intended to be, or understood as such by the person giving them. Such a view of law is evident from several cases, and in *Deverell*, for example, Morritt LJ says that there is no need for either the giver or receiver of directions or instructions to have understood them as such.

It is therefore well established that a person may become a shadow director without having assumed responsibility for the full range of the board's functions, and without knowing or intending to inherit wide-ranging responsibilities. It remains true that the test is not an easy one to pass, but to apply the fullest extent of a director's duties to a person who does qualify, without acknowledging the flexibility of application that the court has always sought to retain, would impose unworkable restrictions on the outside activities of a shadow director. The 2015 Act seems to constrain the court's ability to mitigate that harshness.

Behavioural consequences

It might still be objected that, even if the law is harsh for a shadow director, the behavioural consequences would be welfare-enhancing, encouraging loyalty and care from those who are involved in directing the corporate affairs of the company. However, the common law could have done that more appropriately by applying duties flexibly and appropriately, and all that was needed from the law-makers (if anything was needed at all) was confirmation that assumption of fiduciary duties can be implied from the assumption of responsibility that leads to a finding that a person is a shadow director.

Imposing instead an unworkable and unnecessary restriction on the outside activities of a putative shadow director does not enhance the law's ability to hold such people to account in appropriate cases, but it could cause other outsiders to engage in inappropriately defensive behaviour. If it is not possible to manage the risk of breaching a duty once one is held to be a shadow director, outsiders – many of whom are likely to be risk averse – will take steps to reduce even further the likelihood of becoming one. Real world actors, most notably lenders and significant shareholders in private companies, are usually aware of the risk that certain behaviours, such as intervening in the management of the company in the event of a loan default, give rise to a risk of shadow directorship⁵³ – but may be prepared to accept that risk if it imposes a manageable set of duties with which they are able to comply. On the other hand, they might prefer instead not to intervene, or perhaps to intervene in other ways (for example, by recalling the loan), if the duties are unreasonably wide or unclear and therefore difficult to manage.

A common situation in which the theoretical risk of a shadow directorship arises is when a significant shareholder (or, more often, its representative) in a closely-held company engages with the board, or perhaps appoints an "observer" to oversee the board's deliberations, during a time when a major strategic event is being discussed, or when the company is facing financial distress. The shareholder's input is likely to be welcomed by the board, and may be very helpful to the directors at a time when they face challenges which are not within their "comfort zone". Such interaction might help the directors to reach optimal decisions, and might also give the shareholder the reassurance that it needs to extend further financial support to the company. Such an investor will probably opt not to accept the full responsibility of a seat on the board, which would in any event be inappropriate, given that they will see their role as limited to oversight and, perhaps, advice on specific questions, or as a transmission mechanism for the views of the shareholder. Such professional shareholders, whose reputation for probity is more important to them than any one financial commitment, will (often on the basis of legal advice) accept the risk that they might be subsequently identified as a shadow director if they can assess the nature and scope of the duties that would apply to them. If those duties are reasonable – for example, restricted to actions which they take when

⁵³ See, for example, K Reece Thomas and C L Ryan, *The Law & Practice of Shareholders' Agreements*, 2014 (4th edn), Lexis Nexis, where it is said that: "The relevance of the law on shadow directors for those investing in joint ventures or management buy-outs cannot be overemphasised".

acting as a shadow director, rather than impinging on their other, outside interests and activities – the risk is manageable and the duties relatively straightforward to comply with. If, on the other hand, they are advised that the scope of the relevant duties is unclear and potentially far-reaching, they might instead prefer to withdraw from the discussions. In deciding how to behave, they would have to bear in mind that profits from opportunities pursued by a director in breach of the duty to avoid conflicts can be disgorged by the court, which means that the downside of an adverse outcome could be very significant.

Any legal advice that such a shareholder receives would, of course, make it clear that mere oversight, or even advice and opinions given to the board, would not satisfy the statutory “shadow director” test. However, an adviser would also have to point out that the question as to whether the shareholder had been a shadow director would be a question of fact, to be determined by the court usually many years after the event; it might then be hard for the shareholder to establish what went on around the boardroom table, what was said by the shareholder, and how it was interpreted by the other directors. And if the rest of the board, perhaps anxious to shift blame for the subsequent events away from themselves, describe how – being acutely aware both that the shareholder had the right to remove them from office, and that it was represented by a professional with deep and relevant experience – they merely sought and acted upon instructions during this difficult time, that might paint a plausible picture which it is hard for the putative shadow director to disprove.

So, although the test is a tough one, a shareholder (or indeed lender) who does take an active interest in the company at a time of strategic change or financial distress will not be able to rule out the risk that they will later be found to have met that test. That being the case, they must be able to determine that the extent of the duties by which they were (unintentionally) bound is reasonable, and those duties allow them to continue with outside (perhaps conflicting) interests. If they cannot become comfortable that the risk that they face is manageable, the alternative – particularly if they are risk averse – may be to withdraw support, experiential or financial or both, with negative consequences for the firm and its other stakeholders. Importantly, whether or not their assessment of the risk is correct, the negative consequences will follow. A change to the law which makes that assessment more difficult than it was, and which might well extend the scope to unmanageable levels, is therefore unhelpful.

In making the change that it has, it does not appear that the government has analysed the potentially negative consequences of any such defensive practice, nor does it seem likely to have intended them.

A possible solution?

My view is that replacement of section 170(5) with an alternative which effectively confirmed the approach of Newey J, and which made it clear that shadow directors could inherit duties, whether fiduciary or otherwise, where it was “reasonable, just and equitable” for them to apply (the wording suggested in the amendment tabled during Grand Committee⁵⁴), would have been a helpful clarification. Without materially changing the common law, it would have put beyond doubt that the approach adopted in *Ultraframe* was too lenient. However, it has been argued that using the language of capability could tie the hands of the court to an unhelpful extent in developing the law further and might, in turn, encourage unintended defensive behaviour.

There is a potential solution. As mentioned above, the 2015 Act permits the government to make regulations which specify that certain duties do not apply to shadow directors, or which adapt the general duties as they apply to shadow directors⁵⁵. There is currently no indication that BIS intends to bring forward regulations under this power, although in a letter to The Lord Flight and Lord Leigh of Hurley the Minister did commit to “keep a close eye on how the courts interpret this wording” and to “adapt the duties, if needed, in light of developments”⁵⁶. It does therefore remain possible that the government will in future decide to make use of

⁵⁴ See fn 35 above.

⁵⁵ Section 89(2) of the 2015 Act.

⁵⁶ Letter to The Lord Flight and Lord Leigh of Hurley from Baroness Neville-Rolfe DBE CMG, Minister for Intellectual Property, Parliamentary Under-Secretary-of-State, dated 5 February 2015, available in the Library of the House of Commons and the Library of the House of Lords.

their power to limit the applicability of the general duties in a way that is more appropriate to the circumstances of a particular case, and that does not simply assume that a shadow director can be treated in the same way as a *de jure* or *de facto* director for this purpose.