De facto directors

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L.Q.R. 162 THE facts of *Revenue and Customs Commissioners v Holland* [2010] UKSC 51; [2010] 1 W.L.R 2793 (*Paycheck*) lent themselves to a reassertion of Chancery orthodoxy on the subject of de facto directors. The majority of the Supreme Court largely obliged, finding that the eponymous Mr Holland was not a de facto director. To be one, he had to have opted into the role. The minority's position was that it was enough if he *in fact* directed the company's activities.

The case involved an old-fashioned breach of trust; in particular, the breach of trust that arises when company directors pay, or recommend the payment of, dividends when there are not profits to meet them. The form of action brought by the Revenue on the company's behalf to deal with this wrong was also a 19th century one, in its current guise of s.212 of the Insolvency Act 1986. Liability on directors for a breach of trust of this sort is traditionally strict (or, at least, no quarter is given to fiduciaries in comprehending the scope of their duties). This was a point on which Lord Hope of Craighead, one of the majority, agreed with the minority, although he did not need to rule on it since he had already concluded ***L.Q.R. 163*** that Mr Holland was not a director, de facto or de jure (Lord Collins of Mapesbury and Lord Saville did not address this issue). The justification for this strict liability is that directors, like express trustees, voluntarily assume the role and the duties that go with it (see in relation to fiduciaries in general, *Dubai Aluminium Co Ltd v Salaam* [2002] UKHL 48; [2003] 2 A.C. 366 at [138] and the Rt Hon. Sir Peter Millett, "Restitution and Constructive Trusts" (1998) 114 L.Q.R. 399 at 404-405). These are the things that underscore, it is respectfully suggested, the error in the minority's willingness to *impose* the status of director on the defendant in this case. Only a utilitarian calculus would leave cases of strict liability to be embraced by a broad and undiscriminating concept of de facto status.

It is true that there is some discretion within s.212 of the 1986 Act and in s.1157 of the Companies Act 2006 (s.727 of the Companies Act 1985 at the time of *Paycheck*) to relieve from this strict liability, but, in the absence of clear evidence that the legislature intended to alter the original concept of the de facto director, there has been insufficient to abrogate the common law's requirement that the relevant individual have willingly taken the office upon himself.

Two other things should be borne in mind. First, where an individual *knows* that dividends are not lawfully payable, but procures their payment by the directors, he or she is apt to be liable for dishonestly assisting a breach of trust. De facto status is not needed there. Secondly, even where the individual is unaware that dividends cannot lawfully be paid, but carelessly procures their payment by the de jure directors, he or she may well be liable in negligence to those directors. If the directors are not good for judgment, recourse in their insolvency might then be had on their rights against the negligent procurer. The costs of litigating up a chain of obligations can be a frustration, but it must be recalled that negligence of this sort cannot with integrity be brought within the principle in *Donoghue v Stevenson* [1932] A.C. 562 HL; liability for this type of carelessness is again based on the director's assumption of responsibility. In the present context, these liability chains respect the fact that the company, usually acting through its shareholders, will have willingly appointed a second company to be a director and, like any principal, must be taken to have been satisfied with the resulting arrangements. Attempts to entice courts into leapfrogging the links in such chains have become a bane of modern private law.

With that background, more detail to *Paycheck* can now be given. The Paycheck group of companies, which comprised some 42 incorporated businesses, was established by Mr Holland (and his wife) to provide logistical and taxation services to small business operators, mainly in the information technology sector. One assumes that these individuals preferred to concentrate on exercising their IT skills than deal with the bureaucratic requirements of running a business. The income of the individual businesses was in all cases beneath the threshold for the payment of the higher rate of corporation tax, and it was important that Mr Holland's scheme did not jeopardise that basic position. An element of tax minimisation was also part of the scheme, so that the operator of each business was paid by the relevant company a salary near the national minimum wage, with the rest of his income coming from a regular diet of dividend payments.

The problem was that there was a flaw in the tax planning of the structure adopted, which meant that the income of the group became aggregated for tax ***L.Q.R. 164** purposes. This had the consequence that the higher rate of corporation tax was payable, producing a tax shortfall across the period, and across the group, of approximately £3.5 million. In order, however, to appreciate the potential reach of the Revenue's argument, one can see from the judgments in the Court of Appeal that the figure for which Mr Holland was prima facie liable (with any escape routes being uncertain) was something like £13 million, being the total amount of dividends paid. The Revenue pulled its punches on this sum. It seems too that, with relatively minor adjustments, the scheme could all along have been operated without falling foul of the revenue statute. The Revenue was the sole creditor of the trading companies.

If Mr Holland's tax advice had been flawed, he had been well advised not to be a de jure director of any of the trading companies. Instead, two service companies were established to act, respectively, as sole director and secretary to each trading company. Mr Holland and his wife were the de jure directors of those service companies. The services that were provided to the trading companies were relatively mechanical, and one of Mr Holland's principal tasks was to cause the service companies, as directors, routinely to make declarations by the trading companies of the dividends at issue in the proceedings.

The Supreme Court, affirming the Court of Appeal (reversing the trial judge), held that all the tasks that Mr Holland performed were ones performed solely as director of the service companies, and the fact that he was the only human involved in the process was not enough to make him de facto director of the trading companies. The interposition of the service companies between him and the trading companies could not be short-circuited by that route.

It is possible to discern three key strands to the reasoning of the majority. One is found in the judgment of Lord Hope, the other two in that of Lord Collins. Lord Hope (at [41]) expressly adopted the reasoning of Rimer L.J. in the Court of Appeal, which was that the relevant act (namely, the payment of a dividend) was one "directed by the corporate director, not one directed by the latter company's individual board members." This was said to result from a system of company law that recognises the difference between a company and its directors. The first of Lord Collins' reasons was that (at [54])

"for almost 150 years de facto directors in English law were persons who had been appointed as directors, but whose appointment was defective, or had come to an end, but who acted or continued to act as directors."

A striking judicial extension of the concept had begun, he said, with *Re Lo-Line Electric Motors Ltd* [1988] Ch. 477 Ch D, but that extension applied only in particular contexts and should not be generalised, at least to cases of breach of fiduciary duty. The second reason Lord Collins gave (at [93]) was that the role of director, whether de jure or de facto, is one that is *assumed* by the director. The key issue is not what the individual does but whether there is an assumption of responsibility by him or her to act as director (at [53] and [96]).

It is respectfully submitted that it is the last of these reasons that is the most satisfactory. Since Lord Hope agreed with the reasoning of Lord Collins, and Lord Saville concurred with both judgments, the centre of gravity, technically, lies with Lord Collins' judgment. The weaknesses in the formula of Lord Hope, it is ***L.Q.R. 165** suggested, are these. First, it is not necessary to deny that Mr Holland paid, or directed the payment of, the dividends. The relevant acts were his all right, but in law they were also to be attributed to his principal, and it was only his principal on whom the law had placed the obligation not to pay them. Secondly, the formula might be taken to imply that something turns on the fact that the de jure director was a company. As a matter of principle, it would have made no difference in *Paycheck* had the de jure director been a human who, upon appointment, had openly stated that he or she intended to absent himself or herself, leaving all decisions to Mr Holland, as agent. Such an individual need have no more financial wherewithal than a company. Equity might prima facie treat such a wholesale delegation by a fiduciary as itself a dereliction of duty, but that conclusion would not transfer liability to the delegate. Moreover, equity's rule is subject to contract, as are the governance rules provided for by the Companies (Model Articles) Regulations 2008 (as with Table A of the 1985 Act, applicable in *Paycheck*). Other jurisdictions both preclude companies from being directors and forbid directors from delegating decisions as to the declaration of dividends (see, e.g. Companies Act 1993 (NZ)). Of course, the 2006 Act (s.155) now requires that UK companies also have at least one natural person as a director.

The problem with Lord Collins' precedent-based line of reasoning is that it does not furnish a rationale. Faulty appointment and post-termination lingering need not be the only explanations for de facto directorship. Plain usurpation is another. One can also expect aberrations in a precedent-based argument, since counsel or the judge will not always grasp the principles. *R. v Lawson* [1905] 1 K.B. 541, for example, does seem to contain some dicta favouring a fact-based test for de facto status, although Lord Alverstone C.J. and Darling J. are not highly regarded and neither was a Chancery judge. On the other hand, the sea-change after 1988 to which Lord Collins referred is rather murky. Although Lord Walker of Gestingthorpe read the dictum otherwise, Browne-Wilkinson V.-C. in *Re Lo-Line Electric Motors Ltd,* above, did refer to any candidate for de facto status having "assumed" the role, which is consistent with an intention-based test. And Millett J. in *Re Hydrodan (Corby) Ltd (In Liquidation)* [1994] 2 B.C.L.C. 180 Ch D at 182 stated (emphasis added):

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

The more principled test, therefore, is the one based on an assumption of responsibility. Lord Collins' reasoning, as has been foreshadowed, conforms to a wider generalisation. Agents are not normally directly liable for the obligations that their principals take upon themselves, whether at equity or common law. The reach in equity of this principle is usually illustrated by *Bath v Standard Land Co* [1911] 1 Ch. 618 CA, and it is somewhat surprising that this case did not figure at all in the judgments, since it contains a number of dicta that are highly pertinent to *Paycheck* and it was relied upon by counsel for the respondent. It may be, however, that even the majority judges had qualms about aspects of the case. While it has stood for 100 years, it is worth saying a little about it here (subsequent case history can be found in *Gregson v HAE Trustees Ltd* [2008] EWHC 1006 (Ch); [2009] 1 All E.R. (Comm) 457; but cf. *Markel International Insurance Co Ltd v* ****L.Q.R. 166*** *Surety Guarantee Consultants Ltd* [2008] EWHC 1135 (Comm); [2009] Lloyd's Rep. I.R. 77 at [225]; affirmed on other points [2009] EWCA Civ 790).

The defendant company had been appointed managing agent for the claimant landowner. In managing the estates, its directors awarded to four of their number paying tasks in differing capacities as solicitor, auctioneer, accountant and pit manager. The claimant challenged the resulting payments. He weakened, probably doomed, his case by seeking to deny the sub-agents any remuneration at all, on the basis of an asserted principle that remuneration is inconsistent with fiduciary office unless expressly approved by the head principal. There is no such principle. While trustees and directors are not entitled to remuneration in their capacities as such without express approval, rights to remuneration can be implied for other types of fiduciary, including for the variety of professional featuring in the *Bath* case. It was arguable, however, that the actual contracts of retainer were voidable at the principal's behest for conflict of interest on the part of the head agent known to the sub-agents; fiduciary obligations, of the standard prophylactic type, might have been implied in favour of the principal. Both Cozens-Hardy M.R. and Buckley L.J., nonetheless, spoke in terms that precluded rescission on terms, or even accountability for any profit after allowance for a quantum meruit. Nor did they deny to the defendant the right to include the payments as deductions in its accounts with the claimant. But their Lordships did leave open the question of other remedies as between the claimant and the defendant.

Whatever reservations one might have about some aspects of *Bath,* the following dictum of the Master of Rolls is of persuasive relevance to *Paycheck,* a case not involving a conflict of interest nor untoward profiting (at 625-626):

"Directors stand in a fiduciary relation to the company, but not to a stranger with whom the company is dealing. It is of course true that a company acts through its directors. But that does not involve the proposition that if a breach of trust is committed by a company, acting through its board, a beneficiary can maintain any action against the directors in respect of such breach of trust. Of course I except the case where trust property can be followed into the hands of a director, or of any stranger with notice. No such point arises here."

One must note, however, that *Bath* was also a split decision. Indeed, there are aspects of the dissenting judgment of Fletcher-Moulton L.J. that resonate with the dissenting judgments of Lord Walker and Lord Clarke of Stone-cum-Ebony in *Paycheck.* The Lord Justice favoured a fact-centred basis for intervention, and was much exercised by the position of companies as intermediate fiduciaries: there is, he said, no mind interposed between the directors of the fiduciary company and the beneficiaries of the company's duties; the directors are the company's brain and hands.

There are, though, two aspects of the dissenting reasons in *Paycheck* that did not figure in Fletcher-Moulton L.J.'s judgment. First, in deference to the fact that the legislature has condoned the use of incorporated directors, both Lord Walker and Lord Clarke confined their test of the de facto director to someone who does the sorts of things that directors do "on his own initiative", rather than "simply as part of a process of collective decision-making" by the board. We can call this the ***L.Q.R. 167** "sole actor" test. Secondly, both dissenters considered that the decision in *Standard Chartered Bank v Pakistan National Shipping Corp (No.2)* [2002] UKHL 43; [2003] 1 A.C. 959 supported a direct liability being placed on Mr Holland.

Only these latter points call for further response. The *Standard Chartered* case was concerned with a duty, one not to deceive, which applies to us all. The very significance of the case lies in its conclusion that the defendant's liability had nothing to do with his being a director. The duty not to pay dividends except out of profits, in contrast, is not one imposed on the world, but one that the statute imposes only on the company, and its directors. Put another way, the defendant in *Standard Chartered* was trying to avoid a liability he would otherwise have had on the basis that he *was* a director, whereas Mr Holland was doing his best to *deny* he was a director, because the obligation in question applied only to directors. *Standard Chartered* cannot assist with determining whether someone *is* a director, nor does it add anything once one *has* determined that someone is a director.

Then, the sole-actor test for determining de facto status is not an adequate substitute for an intention-based test. For one thing, it simply induces safety in numbers. Secondly, it cannot surmount the hurdle needed to justify the strictness of some obligations imposed on directors. The tasks that have been performed might be accepted as evidence of an assumption of the role of director, but they cannot provide a substitute for it. Lord Collins was right to hold the ground, although, surprisingly, he seems (at [96]) to have conceded a role for a fact-based test in other contexts.[1]

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Footnotes

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