ADDING FORM TO THE SHADOW

Nick Stanbury FCA FCII FInstD

What is a shadow director?

The "shadow director" is a relatively new creature of statute, first seeing the light of day (if that be the correct term) in section 63 of Companies Act 1980 and currently appearing in the same terms in section 741 of the Companies Act 1985 and section 22(5) of the Company Directors Disqualification Act 1986, section 251 of the Insolvency Act 1986 and section 207(1) of the Financial Services Act 1986. The definition states that:

> "In relation to a company, 'shadow director' means a person in accordance with whose directions or instructions the directors of the company are accustomed to act. However, a person is not deemed to be a shadow director by reason only that the directors act on advice given by him in a professional capacity."

Other provisions make it clear that a holding company is not *ipso facto* to be regarded as a shadow director of its subsidiary.

The concept of the shadow director is that of a person who, whilst not himself an appointed director, so influences a company's board as to make him liable as a true director if certain action taken within the company over which he exerted his influence subsequently backfires. Such liability includes that for "wrongful trading", for ignoring employees' interests and for various failings relating to matters in which directors have a personal interest. One may perhaps picture the shadow director as someone who deliberately distances himself from the company's public persona, for whatever commercial or personal reason, but is in a position to influence the board, whether invited or not, because of his particular connection with the company. The reclusive but forceful major shareholder could thrust himself and his views at the board in a manner which they may be unable totally to resist, whilst by contrast the experienced businessman entirely independent of the company could be intentionally consulted by the board on a particular matter, particularly if the company has a sudden financial or other problem. Both such individuals would be potential shadow directors but the common picture of an individual lurking in the shadows, with its implication of some sinister intention, is scarcely true of the latter however well it might describe the former.

In passing, it is perhaps helpful to contrast the shadow director, who is clearly not an active, visible member of the everyday company management, with the *de facto* (constructive) director. The latter, despite his lack of effective appointment, generally gives the impression of being a fully-fledged director and behaves accordingly; indeed, he (and perhaps his colleagues) may fully believe that he is one. Their intentions and conduct are perhaps very different but they may both assume the personal liability of the properly appointed (*de jure*) director.

The qualifications within the definition above are important; there must be "directions or instructions" (as opposed to, for example, comment, suggestion or simple advice, including especially advice given "in a professional capacity"), whilst some degree of regularity or at least repetition is implied by the need for the directors to be "accustomed to act" on the shadow director's input. It will thus be apparent that the *bona fide* independent professional advisor should not find himself liable as a shadow director (as long as he sticks to giving *advice* only. On the other hand, what of non-professional advice and how often and in what manner does someone have to exert real influence before its effect can no longer be ignored in judging the actions of the board? More on these conundrums anon.

The disqualification sanction

So, setting aside the hallmarks of the shadow director, an individual who is shown to have acted in that capacity will be liable for the consequences of his acts just as if he was a *de jure* director. One of the sanctions to which a director will be subject, if his conduct is of a certain type, is that of disqualification, as provided in the Company Directors Disqualification Act 1986 ("CDDA"). Disqualification proceedings are civil, not criminal, and the civil standard of proof therefore applies, albeit that the more grave an allegation, the harder it will be to prove. As Sir Nicholas Browne-Wilkinson V-C said in a notable disqualification action (*Re Lo-Line Electric Motors Ltd* [1988] Ch 477, 489):

> "The primary purpose ... is not to punish the individual but to protect the public against the future conduct of companies by persons whose past records as directors ... have shown them to be a danger to creditors and others. Therefore, the power is not fundamentally penal. But if the power to disqualify is exercised, disqualification does involve a substantial interference with the freedom of the individual. It follows that the rights of the individual must be fully protected."

The essence of this statement makes it clear that the definition of "shadow director" is not to be strictly construed merely because CDDA has a quasi-penal effect, a point reinforced by the inclusion of the same definition in the other legislation mentioned above. This was one of the conclusions of the Court of Appeal in *Secretary of State for Trade and Industry v Deverell and Another* (*The Times*, 21 January 2000), in which two individuals were held to be shadow directors of a company in insolvent liquidation and thus liable to disqualification (together with three of the *de jure* directors) under section 6 of CDDA upon the application of the Secretary of State in the light of the liquidator's report.

In *Deverell*, the judge at first instance had determined that shadow directorship could not be established where the individual had provided merely "advice" (rather than the defined "directions or instructions") and that the board being "accustomed to act" on an individual's input meant not only a pattern of such input but also that it

was accepted and acted upon with little or no independent judgement on the part of the board. The Court of Appeal (Morritt LJ) considered that both these tests were too strictly set and that the essence of shadow directorship should be the establishment of influence:

- in at least the corporate governance of the company (but not necessarily over all its activities);
- rendered as any form of "guidance" (which would not exclude non-professional "advice" as an alternative to the more specific "directions or instructions");
- upon which the board was accustomed to act but without necessarily surrendering its authority or discretion.

The insurance implications

Deverell has thus usefully given a clearer form to the shadow director with the probability that more individuals will now be found to have acted in that capacity and therefore, if liable as directors, potentially to be claimants under whatever liability or other insurance may be in place for the protection of a company's directors and other officers. Directors and officers liability insurance ("D&O") is the most obvious such cover (its *raison d'être* is to indemnify the personal liability of such persons) and most D&O currently available impliedly if not expressly embraces shadow directors. Indeed, the tenor of D&O, rightly, is that if an individual is held to have incurred an insured personal liability whilst acting in any capacity of director or officer, he will be indemnified accordingly. It is no more necessary to define the various categories of director or officer than to name the particular incumbents individually; those who were, are or will become holders of such an office, whether by accident or design, may call upon the policy if and when they need it.

Although D&O will provide indemnity for most damages and costs flowing from a director's "wrongful act", it is important to remember that an action for disqualification does not involve any insured loss beyond the costs of the director's representation. He will not be entitled to any compensation for suffering disqualification, however potentially damaging it may prove to be, given the probability that his ability to earn a living may be significantly impaired whilst he is prevented from acting as a director or manager of a company.

One should not however ignore, for example, general liability, professional indemnity ("PI") or legal expenses insurances, all of which commonly include elements of personal cover for directors (and ordinary employees) when they face liability or other loss whilst acting in that capacity, quite possibly as joint tortfeasors with the company.

The distinction and interface between D&O and PI calls for special attention, for these reasons:

- PI is strictly only cover for liability arising from the negligent provision of professional advice or other professional services. A director's duty to his company or to a third party is not a "professional" duty within the ambit of PI, even though directorship is gradually becoming recognised as a profession, as evidenced by the "chartered director" qualification now offered by the Institute of Directors. D&O is the cover that should respond to a claim for directors' liability.

- The professionally-qualified director who provides his professional services to his company independently of his general duties as a director (as would for example the solicitor who does legal work through his practice for a company of which he is a director) will remain liable as a professional for his negligence and that negligence should be covered by PI as it is almost always a specific exclusion under D&O.

- The independent professional, such as a management consultant or "company doctor", will not become a shadow director whilst his advice remains both independent and professional, as outlined above. He thus remains within the normal scope of PI. But, if he crosses the thin dividing line exemplified in *Deverell* and his "advice" becomes in reality "directions or instructions" upon which "the directors of the company are accustomed to act", he has likely become a shadow director and will lose the protection of his PI. In these circumstances, he must hope that there is D&O in place; perhaps he should "advise" the board to effect it when he is first engaged, just in case.

It can't happen to me ...

Deverell and other cases concerning shadow directorship only hint at how the last scenario can arise in practice, with potentially embarrassing if not damaging consequences for the individual concerned, but it is not difficult to envisage such a situation occurring. When a company has a problem and the board calls in outside help, the consultant will typically analyse the situation and offer his diagnosis to the board together with general advice on the possible courses of action open to them. So far, so good, but the task will probably not end there and the consultant may well be asked to keep at least a watching brief as the board starts to put matters right, if not to intervene if there is any hitch.

It is not difficult to picture the possible progression from there: the consultant has his sleeves rolled-up alongside a busy bunch of directors and they are increasingly reliant upon his close "guidance" (the term used in *Deverell*) such that he begins to become a full member of the team and to say "you must" and "we will" rather than "I advise" or "I suggest". The directors, if they have true faith in the expert whom they have engaged and paid, will almost certainly jump when he tells them to jump and go on doing so until the problem is solved. At that point, the consultant has

probably, and unconsciously, become a shadow director, something he may later have good reason to regret.

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Nick Stanbury, FCA, FCII, FIMTD, Insurance Consultant