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(published February 2010) and is reproduced here with the kind permission of
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De Facto Directors, Corporate Directors and Lifting the Veil:
Holland v Revenue and Customs Commissioners [2009] 2 BCLC 309

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Introduction

Allowing a company to operate with corporate directors raises the question of how the sanctions against an errant director can be properly applied. The Companies Act 2006, by s.155(1), now requires a company to have at least one director who is a natural person. The 1985 Act allowed a company to have a corporate director and did not prevent such a corporate director being the sole director. In the Court of Appeal decision in *Holland*, the Revenue and Customs Commissioners (“HMRC”) sought to use the de facto director argument to establish the liability of the natural directors of a corporate director to the subject company. This argument, in turn, engaged the legal principle of separate legal personality and the restricted policy grounds for piercing the corporate veil.

Background

In 1997, H and his wife set up Paycheck Services Ltd which, in return for a fee, administered the business and tax affairs of contractors working mainly in IT. Each contractor became an employee of the company and was allotted a non-voting share; the company paid corporation tax at the small companies’ rate (18–20 per cent) rather than higher rate (30–33 per cent) and the bulk of the income received by the contractors was by way of dividend. As the company’s profits grew, H was advised to adopt a new corporate structure to retain the lower tax rate. Under a complex new structure, H and his wife held 50 per cent of the issued shares in and were directors of a new Paycheck Services Ltd, which in turn held 100 per cent of the issued shares in Paycheck (Directors Services) Ltd (“Directors”) and Paycheck (Secretarial Services) Ltd (“Secretarial”). The latter two companies acted as sole director and secretary of 42 “composite” companies distinguished only by a number (e.g. Paycheck Services 3 Ltd). The composite companies had one voting “A” share held by Paycheck Services Trustee Ltd (itself directed and owned by H and his wife) for the benefit of 50 non-voting “B” shareholders who were all employees of the composite companies. The aim was to give the individual employees/shareholders of the composite companies the tax advantage (paying tax at the small companies rate) they would have enjoyed if they had set up their own company, along with the administrative support provided by Directors and Secretarial. The composite companies contracted out the services of the employees and out of the income received they paid a fee for the services of Directors and Secretarial, a salary usually limited to the minimum wage, tax and National Insurance contributions (“NICs”) and finally (after making a provision for corporation tax at the small companies’ rate), a dividend.

However, as Rimer L.J. noted at [16], there was “a flaw in the structure that was not spotted when it was established”. That flaw arose out of the “associated company” provisions in the Income and Corporation Taxes Act 1988, which frequently catches tax avoidance schemes; in essence Paycheck Services Trustee Ltd’s control of the composite companies meant that they were associated and, therefore, their collective profits had to be aggregated (although his advisers had anticipated this association, they had not realised that H’s role as settlor of the trusts would create a separate association). As the aggregated profits fell under the higher tax rate there had been an underpayment of corporation tax, which would make some or all of the composite companies insolvent. H was advised to set up a new corporate structure (no details are provided in the judgments) to which the employees were transferred and the old composite companies went into administration owing £3.5m unpaid corporation tax.

This detailed background is necessary to understand what happened next. HMRC, as creditors, brought summary proceedings under s.212 of the Insolvency Act 1986 against H and his wife to reimburse the composite companies the unpaid tax on the basis that, as de facto directors of those companies, they had breached their duty to the companies by causing them to declare unlawful dividends since they had insufficient distributable profits due to the outstanding liability to higher rate tax. While accepting that he was the human agent behind all that Directors did in its capacity as director of the composite companies, H argued that the acts so procured were the acts of the corporate director and not of its human agent and that to hold otherwise was to ignore the separate legal identity of the corporate director on one hand and its human directors on the other. HMRC's response was that to find that H was not a de facto director would fundamentally undermine the corporate regulatory regime and the public protection which it was intended to achieve.

The law

Under the heading "Summary remedy against delinquent directors, liquidators, etc", s.212(1) of the Insolvency Act 1986 applies if, in the course of the winding up of a company, it appears that a person who is or has been an officer of the company (which includes a de facto director) "has misapplied or retained, or become accountable for, any money or other property of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company". In those circumstances and "on the application of the official receiver or the liquidator, or of any creditor or contributory" the court may order that person to, "repay, restore or account for the money or property or any part of it, with interest at such rate as the court thinks just" or "to contribute such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty as the court thinks just".

Salomon v A Salomon & Co Ltd [1897] A.C. 22 is the source of the principle of a company's legal personality separate from the legal personality of its directors. In *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180, Millet J. said at [183] that a de facto director was, "one who claims to act and purports to act as a director, although not validly appointed as such" and at [184]:

"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 *Re Kaytech International Ltd* [1999] 2 BCLC 351 Walker L.J. said at [424] that:

"the crucial issue is whether the individual in question has assumed the status and function of a company director so as to make himself responsible under the [Company Directors Disqualification Act 1986] as if he were a de jure director".

Decisions at first instance (Mark Cawson QC) and in the Court of Appeal (Ward, Rimer and Elias L.JJ.)

At first instance ([2008] 2 BCLC 613) the deputy judge at [176]–[177] held that H was a de facto director of the composite companies because, as a director of Directors, he had:

"clearly caused it to act in such a way as would have caused the latter to be treated as a de facto director were it not already a de jure director . . . As a matter of fact [H] . . . did . . . direct the affairs of the composite companies and assume the functions of a director albeit not holding himself out as such. Whether he strictly purported to do so on his own account or as agent for [Directors] is . . . beside the point."

That issue, however, turned out to be exactly the point on which the Court of Appeal found that he had erred.

Rimer L.J., who gave the leading judgment, said at [65] that:

"we were not shown . . . any authority in which someone who acted as a director of the sole corporate director of a company was, merely by so acting, regarded also as a de facto director of the subject company."

He then asked why a director of a de jure corporate director, by acting as such, should become a de facto director of the subject company when it was constitutionally permissible for a company to have

another company on its board. He added at [67] that such a director will only be regarded as a director of the subject company if “he steps outside the confines of his role as a member of the board of the corporate director and acts directly in relation to the affairs of the subject company.” There was no suggestion that H had done so.

In response to HMRC’s argument that the regulatory process would be undermined, Rimer L.J. said that while he had some sympathy he was bound by the applicable principles rather than by what the policy might be: “If there is such a policy need, then it is for the legislature to meet it.” Section 155(1) of the 2006 Act, by requiring a personal director, seems to plug that gap.

Elias L.J. agreed. “I do not see how the directors of a corporate director, acting purely in that capacity, can by virtue of that fact alone be constituted de facto directors of the company of which the corporation is the sole director.” (at [115]). He added that in any event H was not a de facto director since he had not purported to act as a director of the composite companies: if anything he would have been a shadow director “exercising influence in fact but concealing that influence behind the cloak of the corporate director of the composite companies.” ([117]). However, his position as director of Directors was insufficient to make him a shadow director.

Conclusion

The judge at first instance had clearly taken his eye off the ball of separate legal personality which is only departed from in extreme circumstances. Promoters of schemes similar to that created by H will be well advised to note the requirement that the director of the corporate director should not step outside his role as director of the corporate directors’ board so as to link him directly with the subject company.