Shadow Directors - Myth or Reality

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It is generally presumed that the business of corporate entities is controlled and transacted by their Board of directors, which occupies a fiduciary position and acts as a trustee of the stakeholders. As a result, the directors of the board are expected to diligently discharge their duties. The Board as such comprise of Directors with defined, contractual or otherwise by statute, authority responsibility relationship.

Whereas, In case of Managing Directors or Whole time Directors, however, the scope of duties and of course the authority, is more as they act in their dual capacity of being directors as well as employees with substantial powers over the affairs of a Company.

Independent Directors, on the other hand, are those whose directorship constitutes their only connection with the Company. Professionals from various spheres are inducted as independent Director in the Board as advisors for issues related to their field and are ordinarily paid fees to attend Board or Committee meetings. They can ensure only supervisory guidance and not effective stewardship for corporate business as they are
inducted for ensuring the compliance with corporate governance norms. Such directors, as a result of legislative responsibility, have free access to information required to accomplish their role in monitoring and controlling the activities of the company/ies.

However, there exists another category of Directors in the corporate sector that escapes the implications of law and derives undue benefits/advantages by avoiding various provisions and limiting the transactional nexus/vested interest qua the capacity of a Director of a Company.

Considering such eventualities, the Companies Act has taken care of such individuals, who stay away from the formal Board, yet retain complete control over the affairs of the company. Such directors are circumstantially categorised under the Companies Act 1956, as “Person in accordance with whose instructions the board is accustomed to act” and can also be deemed to be Director of a Company. However, in commercial parlance such a person/s is defined as a “Shadow Director”.

The term has been elaborately defined in Secretary of State for Trade and Industry V Deverell {2001 CLC 905 Court of Appeal} as follows:

a) The purpose of the legislation was to identify those (other than professional advisers) with real influence in the company's corporate affairs, but this influence did not have to be over the whole field of its corporate activities.

b) Whether a communication, by words or conduct, was to be classified as a "direction or instruction" had to be objectively ascertained by the court in light of all the evidence.

c) It would not be necessary to show the subservient roles of the properly appointed directors.

A Shadow Director is an “officer” within the definition of the terms in Section 2 (30) of the Companies Act 1956 as it includes, "any person in accordance with whose directions or instructions the Board of directors or any one or more of the Directors is or are accustomed to act". Even the Companies Bill 2012 acknowledges the same vide clause 2(60).
The Companies Act 1956 deals with such Shadow Directors under various sections. A few of these have been summarised below:

· Section 5(e) wherein, meaning of “officer who is in default” includes any person in accordance with whose directions or instructions the Board of directors of the company is accustomed to act.

· Section 162(2) provides penalty for failure to file annual return in accordance with Sections 159, 160 and 161, where the expressions “officer” and “director” include any person in accordance with whose directions or instructions the Board of directors of the company is accustomed to act.

· Section 239 (1) (c) which deals with powers of the inspectors to investigate into affairs of a body corporate which is or whose Board is accustomed to act in accordance with the directions or instructions of any Director of the company under investigation. **Similar provision in CL 219 (c) of the Companies Bill 2012.**

· Section 295(1)(e) where if loans are made to any body corporate, whose Board is accustomed to act in accordance with the directions or instructions of the directors, or of any director, of the lending company would require prior Central Government approval. **Equivalent to CL 185(e) of the Companies Bill 2012.**

· Section 303(1) explanation (1) wherein details of any person in accordance with whose directions or instructions the Board of directors of a company is accustomed to act is required to be entered in the Register of directors.

· Section 305(2) wherein every Director, including a Deemed Director of the company, on his appointment or relinquishment of office in any other body corporate, is required to intimate within twenty days of such event.

· Section 307(10)(a) wherein details of Directors shareholdings needs to be maintained including holdings by any person in accordance with whose directions or instructions the Board of directors of a company is accustomed to act.
· Section 308 wherein every Director of a company and every person deemed to be a Director of the company by virtue of sub-section (10) of Section 307, is required to give notice to the company of such matters relating to him as may be necessary to maintain details of their shareholdings.

**Status of a Shadow Director**

Specific proof is required to establish that the Board is accustomed to act in accordance with the instructions, directions and advice of a person who is termed as Deemed Director or is a Shadow Director. Though the issue is debatable, yet, the following parameters can be applied to determine the actual status of the person exercising the control.

· **Continuity** - Whether there is a pattern of acting in accordance with the directions of the parent company / alleged Shadow Director. In this regard, a one-off event will usually be insufficient.

· **Intention** - The alleged Shadow Director intends to control the members of the board of the subsidiary. In this regard, it has been noted that “the Shadow Director must be, in effect, the puppet master controlling the actions of the board. The directors must be the 'cat's paw' of the Shadow Director” Re Unisoft Group Ltd (No 3) [1994] BCLC 609 per Harman J at 620. However, it need not be established that actual instructions or directions were issued to the Board of directors.

· **Majority to follow** - Even though there has been some commentary supporting the need for all directors to be accustomed to act, the case of Re Lo-Line Electric Motors Ltd [1988] 2All ER 692 suggested that “the board” must act in accordance with the instructions. This implies the requirement of a simple majority of directors to be so accustomed. Further the same has been reinforced in Kuwait Asia Bank v National Mutual Life Nominees Ltd [1990] 3 All ER 404 where it was held that a minority of directors accustomed to act in accordance with a person's instructions or wishes will be insufficient to form a shadow directorship.

· **Direct involvement in taking decision/s and not merely in an advisory role** - The definition of Shadow Director is designed to encompass all those who have a decision
making role within the corporation. The post is not intended to cover those who merely offer advice, suggestions on particular issues. Likewise, advice given by a person in his professional capacity or as a result of a business relationship with the directors, members of the board, will not make him liable to fall within the definition of Shadow Director.

The Companies Act 1956 vide Section 7, excludes a professional according to whose directions or instructions the Board of directors of a company is accustomed to act, by reason only that the Board acts on advice given by him in a professional capacity and not beyond.

**Risks for Bankers, Accountants or Lawyers participating in revival schemes**

Accountants or Lawyers with expertise in insolvency often review a corporation's financial affairs and operations to aid the recovery of failing businesses at the request of creditors.

A unique example of the above scenario between advice on the one hand and effective directions and instructions on the other is provided by Re Tasbian (No.3) [1992] BCC 358. In this case, a Chartered Accountant was appointed to an ailing retail business (Tasbian) by a finance company (Castle). As Tasbian had never traded at a profit, the accountant was appointed to get the company “on track” to produce profits which he was ultimately unable to achieve. However, during his appointment, the accountant had taken over effective control of Tasbian as he had required all the company’s cheques to be countersigned by himself, had bargained with external entities on Tasbian’s behalf, negotiated an informal moratorium with Tasbian’s trade creditors and so on. Consequently, he was not merely providing advice but was exercising decision-making powers and control on behalf of Tasbian.

In addition, the accountant had acted beyond his professional role by engaging in nefarious conduct through a tax avoidance scheme designed for Tasbian. This unprofessional conduct indicated that he was not covered by the “professional” advice exemption. As a result, the
accountant was held to be a “Director” of Tasbian's and subject to disqualification among other sanctions.

**Holding Companies Directors can also be treated as Shadow Directors**

This possibility will be of particular concern to holding companies with subsidiaries in financial difficulty. Once again, in times of economic difficulty a holding company is likely to exercise management discretion for general decision-making powers in relation to the affairs of its subsidiary. If the board of the subsidiary simply accepts these decisions without independent analysis, the holding companies director is likely to be a Shadow Director.

However, the specific criteria for determining the liability were stated by Millett J [(1994) 2 BCLC 180 at p. 184]

- Parent company board acting collectively should not be liable for directing a subsidiary's directors, because in doing so the board is exercising the parent company's discretion. The parent company will though be liable.

- A parent company Director who personally communicates a direction of the parent company to subsidiary's Director should not be liable, because in doing so he exercises no discretion of his own.

- A parent company Director or who has been given authority to direct a subsidiary's directors may be liable, in so far as he has discretion as to what directions to give. The position should be the same where the authority has been given to a committee of the parent Company's Directors.

**Benefits Derived by Shadow Directors**

Shadow Directors also stand to benefit in many ways other than exercising control. One such misuse is by way of receiving loans from an entity. The scenario is governed vide Section 295(1) (e) of the Companies Act, 1956. An illustration of this aspect can be drawn from a departmental clarification (departments file no .7(20)-CL-VI/61), wherein a loan was made by Refinance Corporation for Industry Limited to State Bank of India wherein, the Managing
Director, Manager etc were accustomed to act in accordance with directions and instructions of its Chairman who was a Director in Refinance Corporation.

The Ministry of law opined that the Managing Director or Manager of State Bank of India, being the borrower who acted in accordance with the directions of its Chairman, can be held to attract the provisions of Section 295 (1) (e) and that any loan granted to State Bank by Refinance Corporation would require previous approval of the Central Government.

**Are Shadow Directors required to file Form 32?**

Section 303(1) envisages the maintenance of register of directors' inter-alia, including details of those person/s in accordance with whose directions the board acts. This refers to details of a Shadow Director or Deemed Director. However, secretarial prudence would prompt us to include details of those Directors in the 303 register for whom FORM 32 has been filed. This then implies that we must file FORM 32 for deemed directors and if so, how do we infer that the person is a Deemed Director, as no decisive criteria has been defined in the relevant existing statutes so far.

**Definition of Director in the Concept paper on Company Law**

No definition of Shadow Director has been provided. However, regulation 2(22) of Concept paper defines “Deemed Director” as a person in accordance with whose directions or instructions the Board of directors of a company is accustomed to act, which by way of liberal interpretation can be said to include a Shadow Director.

**Definition of Shadow Director in JJ Irani report on Company Law**

The Expert Committee report on Company Law under the Chairmanship of Dr. Jamshed J. Irani, dated 31st May 2005, has referred to “Shadow Directors” in clause 36.1. It advocated for a framework that requires disclosure of director's background, education, training and qualifications, as well as relationships with managers and shareholders. However, no definition has been provided.

*AS 18, Related Party Disclosures*
Accounting Standard 18 also recognises the concept by including persons in accordance with whose directions or instructions the Board of directors of the company is accustomed to act, to be included in the definition of key managerial personnel.

Companies Bill 2012 however does not define either a Shadow Director or a Deemed Director.

What duties does a shadow director owe to the company?

From the moment that it can be established that a majority of the directors are accustomed to act in accordance with the alleged Shadow Director’s instructions, he will owe certain duties to the company. (Ultraframe (UK) Ltd v Fielding [2005 EWHC 1638](ch)

- The duties owed by a Shadow Director do not apply retrospectively back to the time that the Directors began to act in accordance with his instructions.

- A Shadow Director who does not directly deal with the company’s assets does not owe the company any formal fiduciary duties; e.g., he has no de jure duty to act in the best interests of the company or to not make a profit from his position.

- A Shadow Director must declare his interest in any contract or proposed contract with the company at a board meeting.

- A Shadow Director must disclose his interests in any shares or debentures of the company.

- Restrictions on many financial and property-related transactions between a Shadow Director (and any person connected with a Shadow Director), and the company of which the person or company is a Shadow Director;

Implications for Directors and Shareholders

- Directors should review the decision-making process of the board on a regular basis, in particular the functions and responsibilities of senior managers, to ensure that they are not acting in accordance with the directions or instructions of non-directors.
• Shareholders, of parent companies as well, who have the right to appoint one or more directors to the board of a company should review their working practices in respect of those who represent their interests on the board in question to ensure that they do not exert so much influence that they fall within the definition of a Shadow director.

The rationale for the concept of “Shadow Director” is to prevent the evasion of obligations/liabilities by persons who control the company but choose to remain in the shadow. If the majority of the directors of the company persistently act in accordance with the directions or instructions of a person, the company will implement such directions or instructions. Hence, there seems to be little logic in allowing the person to be excluded from the definition of “Shadow Director” or “Director” merely because a single or a minority of the directors are not accustomed to act in accordance with his directions or instructions when the majority is doing so.

CONCLUSION

The object of emphasizing the requirement of some Directive on Shadow Director(s) is nothing but to put those to accountability, who, because of certain practical issue which have not been dealt with in/by the statue, have resorted to various escape routes to avoid their responsibilities especially towards the stakeholders of an entity. It must, nevertheless, be appreciated that it is virtually impossible to address all practical business issues while writing a regulation. It is, however, expected that an ethical compliance of the statute in its true spirit and objective be assumed/ensured by the citizens of a State.

This would befittingly address the need of the hour i.e. better transparency and the investor’s confidence.

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