

Corporate & Commercial

Beware of the Risk of Being Liable as a De Facto Director

In the recent English case of Smithton v Naggar and others [2014] EWCA Civ 939, the English Court of Appeal clarified the factors it will consider when determining whether a person is a de facto director.

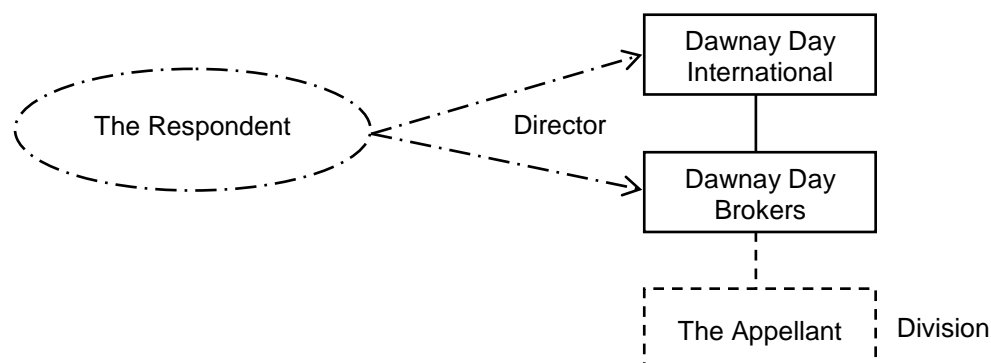
Background

The Companies Ordinance (Cap. 622) provides that director includes any person occupying the position of director by whatever name called. In other words, if a person performs duties or does acts which are considered directorial in nature, that person may have assumed the responsibility and legal liability as a director without any valid appointment or any appointment at all and become a de facto director. As the English Companies Act 2006 defines director in the same way, it is possible that Hong Kong Courts will rely on the guidance set out by the English Court of Appeal (the “**Court**”) in Smithton v Naggar and others [2014] EWCA Civ 939 in future.

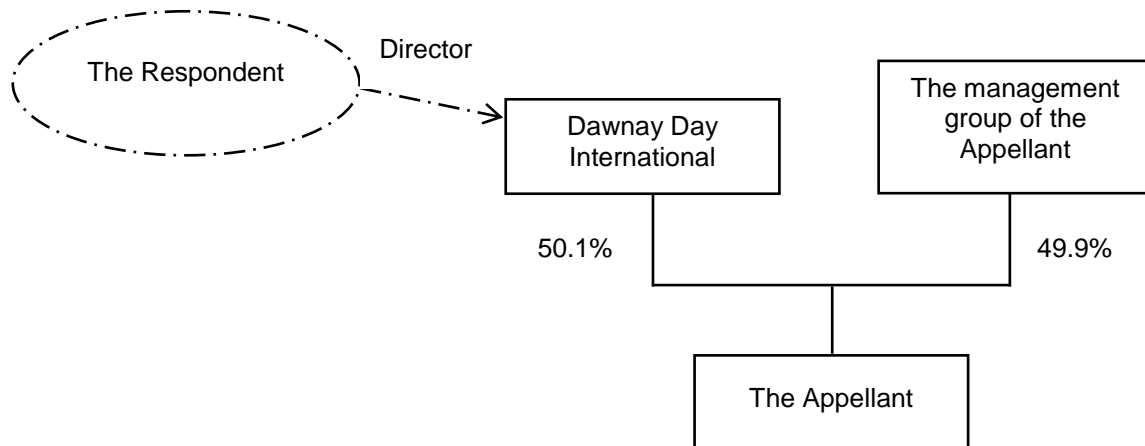
This article will focus on the guidance set out by the Court.

Background to the case

In the present appeal, the Appellant was Smithton Limited (the “**Appellant**”), a company formerly known as (i) Dawnay Day Capital Markets and (ii) Hobart Capital Markets Ltd shortly after the collapse of its former holding company, the Dawnay Day Group. The Respondent was Mr. Naggar, a director of the Appellant’s former holding company (the “**Respondent**”). The Dawnay Day Group reorganised its corporate structure in the period between 2007 and 2008 as shown in the following graphs:



Graph 1: Before incorporation of the Appellant in October 2007



Graph 2: After incorporation of the Appellant under a joint venture agreement in October 2007

As a result of the corporate reorganisation, the Appellant had been operated under a joint venture agreement between Dawnay Day International and the management group of the Appellant since October 2007. The Appellant had been in a broking business which specialised in setting up Contracts for Differences. In February 2007, the Respondent concluded that shares in a company were undervalued and the Appellant began writing Contracts for Differences for the shares on behalf of its clients, many of whom were connected persons to the Respondent. In April to June 2008, Dawnay Day International began to suffer cash-flow problems and in July 2008 it collapsed. The Appellant continued to carry on business after the collapse of Dawnay Day International and is now renamed Smithton Limited.

The Appellant sued for damages for losses which it incurred in consequence of transactions with clients introduced to it through the Respondent on the ground that while the Respondent was not a duly appointed director of the Appellant, he was a de facto of it. The trial judge ruled in favor of the Respondent that he was not a de facto director.

What makes a person a de facto director

The Court acknowledged that *HMRC v Holland* [2010] 1 WLR 2793 was the leading authority in this area and that there was no one definitive test for a de facto director. The Court acknowledged that a person may be de facto director even if there was no invalid appointment. The Court must determine in what capacity the “director” was acting. In general, the Court will look at the corporate governance system to decide whether one was part of the system of the company and whether one assumed the status and function of a director so as to make him or her responsible as if he or she were a director.

The Court also clarified the factors it will consider when determining whether a person is a de facto director. The Court will look at all the circumstances because this is a question of fact and degree, and examine, among other things:

1. the company's corporate governance system so as to decide in relation to the company's business whether the person's acts were directorial in nature;
2. whether the person assumed the status and function of a director so as to make him or her responsible as if he or she were a director;
3. what the director actually did and not any job title actually given to the director;.
4. whether the company considered the person to be a director and held him or her out as such;
5. whether third parties considered that the person was a director; and
6. in what capacity the director was acting in respect of the subsidiary if the person is a director of the holding company.

When examining the factors the Court will:

1. take an objective approach and irrespective of the person's motivation or belief;
2. look at the cumulative effect of the activities relied on and the role of de facto director need not extend over the whole range of a company's activities; and
3. consider acts outside the period when the person is said to have been a de facto director because they may throw light on whether he or she was one in the relevant period.

The Court made clear that:

1. a de facto director does not avoid liability by showing that he or she in good faith thought he or she was not acting as a director;
2. in the usual case, it would not include a purely negative role of giving or receiving permission for some business activity; and
3. the fact that a person is consulted about directorial decisions or his approval does not in general make him a director because he is not making the decision.

Decision

The Court dismissed the appeal and ruled that there was no basis for setting aside the trial judge's conclusion that the Respondent had been involved with the Appellant's affairs but this was in his capacity as a director of Dawnay Day International or some other capacity than that of director of the Appellant.

The reasons for the decision include:

1. the evidence suggested that the Respondent was acting as the chairman of Dawnay Day International, the Appellant's former holding company;
2. there was nothing that went beyond the involvement normally expected of someone combining the roles of major client and chairman of the majority shareholder; and
3. there was no evidence that the Appellant's board were accustomed to complying with the Respondent's instructions.

Implication

Where someone is a director of a holding company which is its subsidiary's corporate shareholder, provided that his or her behaviours are wholly within the ambit of his or her duties and responsibilities as a director of the corporate shareholder/ holding company, his or her acts would not make him or her a de facto director of that subsidiary.

Groups of companies, directors and those who may fall within the definition of de facto director of a holding company should consider whether the directors of the holding company form an integral part of the subsidiary's corporate governance and would be exposed to being deemed de facto directors.

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Important: The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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