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14 July 2014

Dear Sirs

**Transparency & Trust: Government response**  
**Section 4: Opaque corporate control through irresponsible ‘front’ directors**

We welcome the opportunity to comment on the proposals set out in the Government response to the consultation on Transparency & Trust. As you know, the Institute of Chartered Secretaries and Administrators (ICSA) is the professional body that qualifies Chartered Secretaries. We would like to comment on the proposals set out at the end of section 4: Opaque corporate control through irresponsible ‘front’ directors. Company secretaries have a key role by working with their companies’ boards and have a good understanding of the issues around directors’ duties and shadow directors.

**1. Section 4: Opaque corporate control through irresponsible ‘front’ directors**

We have no concerns over the first three proposals set out under ‘Summary Government Response’. We support improving the awareness of directors’ duties, and would recommend increasing awareness for *all* directors. We have no objections to directors being contacted to inform them of their duties, and suggest it might be useful for directors’ duties to be included on form AP01 so that directors confirm their understanding before appointment. We also have no objection to the proposal that individual directors be contacted to ensure they have understood their duties, and we



support the proposal that the court takes account of breaches of any legislation, including breach of directors' duties, when considering disqualification or other action against a director.

However, we have serious concerns over the proposal to extend the reach of directors' duties to those who control a single director. We outlined our concerns at our meeting in June 2014 and set these out below.

## **2. Increasing the reach of legal accountability to cover those who control a single director and considering extending the directors' general statutory duties to those who control directors**

Our concerns fall into two areas:

### **2.1 The board decision making process and the collective responsibility of the board**

The concept of a shadow director involves a person being treated as a director by the board although not appointed as such, ie "a person in accordance with whose directions or instructions the directors of the company are accustomed to act"<sup>1</sup>. This is someone known to the board and they know they are acting on his/her instructions. Changing the definition of a shadow director to include someone who controls an *individual* director is a concern because the board may not be aware of the existence of this third party with a controlling influence over a single director. If this third party is to be treated as a shadow director in the way proposed, the result would be that:

- a) the board would not have knowledge of all of its directors (appointed or shadow directors); and therefore
- b) the board would not have knowledge of all the people involved in its decision making process.

Under the current definition of a shadow director, the individual in question is known to the board. The other directors are able to discuss issues with the shadow director and understand their reasons for promoting a certain decision or course of action. Boards need to hear the views of all individual directors and discuss issues adequately. It has long been established that the board as a whole has collective responsibility for its actions. If board decisions are based partly on the views of an unknown third party with whom the board has no contact, this breaks the sovereignty of the directors' decision making process and the collective responsibility of the board. These are fundamental principles relating to the role of a director and a basic concept of company law.

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<sup>1</sup> s251 Companies Act 2006



## 2.2 Transmission of liability to unknown third party

Although general duties apply to shadow directors<sup>2</sup>, we agree that it would have been helpful if the Companies Act 2006 had made this explicit and would support any future changes to Companies Act 2006 to this effect.

However, we have concerns that the proposed change to the definition of a shadow director appears to suggest a ‘front’ director’s liability should be ‘transferred’ to a third person standing behind them. Directors appointed to the board have to be responsible for their own actions. If a director is acting on the instructions of a third party and is trying to persuade a board to make decisions that are to the benefit of a third party, then the ‘front’ director would breach his or her duties in several ways: the director will not be exercising independent judgement; will not be avoiding conflicts of interest; not exercising reasonable care, skill and diligence; and, it is unlikely they will be acting in the interests of the company. The duty to avoid conflicts of interest is particularly relevant as the Companies Act 2006 states “*A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company*”<sup>3</sup>. It goes on to say that “*this duty is not infringed*<sup>4</sup>...*if the matter has been authorised by the directors*”<sup>5</sup>. The duty to avoid conflicts of interest in these circumstances is managed within companies by directors disclosing to the board all such situations before the situation arises (such as before appointment to another directorship) and the board then has the opportunity not to authorise the conflict of interest and can take any other action it considers appropriate.

If liability is ‘transferred’ to an unknown third party this could cause a number of difficulties. This third party’s name will not appear on the public record as a director or officer of the company. Individuals dealing with the company, such as creditors, can only take action against the company and its directors, not third parties. This is another fundamental principle of company law. It is also unclear where liability for actions would lie if a ‘front’ director simply resigned, or the third party stepped away. A third party could not be held responsible and, as the other directors were unaware of the existence of the third party, it is difficult to see how the company or the other directors could be held liable or take action themselves.

A further concern is that this proposal may provide an appointed ‘front’ director with an opportunity to avoid responsibility by claiming he or she was forced to act on the

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<sup>2</sup> where, and to the extent that, the corresponding common law rules or equitable principles so apply. s170(5) Companies Act 2006

<sup>3</sup> s175(1)

<sup>4</sup> s175(4)

<sup>5</sup> s175(4)(b)



wishes of the third party. If 'front' directors were able to avoid liability, this would undermine the duties of directors generally.

If, however, it were possible to impose a new duty on a third party who controls a 'front' director to make them jointly liable for breaches of directors duties, without using the concept of a shadow director, we would support such an initiative.

### **2.3 Possible ways forward**

As mentioned above, we support proposals to increase the awareness of directors' duties, particularly if this was done before or at the time of appointment. It would also be helpful to emphasise the obligation on directors to disclose to the board any situations that may give rise to a direct or indirect interest that conflicts with the company, before the situation arises. We would also support increased enforcement and penalties in the event of breach. However, we do not think that company law is the appropriate vehicle for addressing the behaviour of a third party controlling the actions of a 'front' director.

We do not think there are inadequacies in the existing law but we do think that the application of existing liability and enforcement could be improved. The concept of a shadow director is well understood but this is very different from this idea of a third party influencing a single director. Also the duty of directors to act in the best interests of the company has been clearly understood, accepted and managed for a long time; well before codification of directors' duties in the Companies Act 2006. However, disqualification of directors is not a common occurrence and it is usually as a result of criminal activity or fraud.

In our view it would be a mistake to try to extend the concept of a shadow director to a third party controlling an individual director and thereby to attach directors' duties to that third party. We think greater awareness of directors' duties and increased cases of enforcement, coupled with serious consequences, would deter people from taking directorships as a 'front' for others, thereby mitigating the influence of a third party. A robust approach to enforcement and increased penalties for breach of directors' duties, including financial penalties, would strengthen the existing law and act as a powerful deterrent to potential 'front' directors.

Finally, we would also highlight that, in the circumstances of a 'front' director acting on the instructions of a third party, once the board became aware of the situation the other directors would have a duty to take action (on behalf of the company) against the 'front' director and the third party for fraud against the company. Greater awareness of this should also prove a deterrence to potential 'front' directors.



We hope you find our comments helpful and would be happy to expand on any of these points should you wish to discuss them further.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Peter Swabey', written in a cursive style.

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