LIFTING THE VEIL OF INCORPORATION AND THE ESTABLISHMENT OF SHADOW DIRECTORSHIP

...a comparative analysis of legal practices regarding shareholder liability in the United Kingdom, Denmark and Iceland.

Master's degree thesis by Hjalti Thor Gudmundsson

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FOREWORD

My interest in the subject of shareholder liability arose in relation with the international financial crisis, where shareholders have repeatedly avoided liability by hiding behind the corporate veil. Due to the lack of statutory provisions and judicial practices in Iceland, I found it interesting to analyse and compare the establishment of personal liability upon shareholders in the United Kingdom, Denmark and Iceland. It is my wish that my work sheds light on the position of shareholders and the situations that can render them liable beyond their limited liability.

This literary work is a result of a 6 month writing period, which has been very interesting and informative, as well as demanding at times. Finishing my thesis leaves me with a bittersweet feeling as it marks the end of my Master’s studies as well as an exciting beginning of my career as a lawyer.

I want to thank my beloved fiancée, Harpa Mjöll Ingadóttir, for supporting and tolerating me when I was close to losing my mind over the writings. I also must thank my dear grandfather, Magnús Pétursson, who has given me endless support and numerous useful comments. He has shown incredible dedication to my work and for that I am very grateful.

Copenhagen, March 23rd, 2010

[Signature]

Hjalti Þór Gudmundsson
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PART 1 – INTRODUCTION

1.1 GENERAL REVIEW

1.1.1 Scope of the thesis

The shareholders form the top organ of a limited liability company and they execute their powers in a shareholder meeting, by directing the company’s management. The management of a limited company is responsible for the company’s affairs and consequently every decision executed within the company. The management is obliged to be loyal to the company and make decisions in the best interests of the company as a whole, i.e. guarding the interests of every stakeholder involved in the affairs of the company. Therefore, the management serves an important role and owes onerous duties towards the limited company, whose members can be held liable for breach of their duties. The shareholders, however, are not entitled to interfere with the management of the company. They are only the owners of the company, and the main rule is that they are not liable for any claims against the company which exceed their contribution of capital or their commitment to invest in the company.

Despite the fact that shareholders have limited liability, there are various circumstances which can cause the shareholders’ limited liability to disappear and personal liability can be imposed upon them instead. This is often because the shareholders do not respect the fundamental elements of the corporate form. Moreover, they tend to influence the management of a limited company and try to interfere with its business affairs. Thus, a shareholder can act as a director, by giving the members of the management instructions on how to run the company. He may be eager to influence the decisions taken by the management in order to grant himself a beneficial advantage, and consequently for the detriment of an individual member of the entity or the company as a whole. Thus, this raises the question of the shareholders’ liability when interfering excessively with the management of the company. Under specific circumstances, a shareholder may lose the protection provided by the principle of shareholders’ limited liability, and risk being liable and entitled to the onerous duties of the company’s management. It is therefore important to determine the situations where shareholders will risk being designated as directors of a company, by virtue of the control
they exercise over the management, and be held liable as the regular directors of the limited company.

In the following analysis, the position of shareholders is analysed and a light will be shed on circumstances where a shareholder can be held liable, beyond the limitation of liability which is provided for shareholders of limited companies by the law. The situations in which shareholders do not respect the elements of the limited company form, and where they act as directors are examined and answers will be provided to the main questions of the analysis: Which situations can render shareholders personally liable, and how are these situations determined? The discussion focuses on situations where the limited liability is set aside and where shadow directorship can be established. These instances are given a thorough analysis and examples are provided in order to clarify the answers to the main questions. Furthermore, a comparative analysis is provided of the legal systems and of how the jurisdictions in the UK, Denmark and Iceland have coped with these matters.

1.1.2 Objectives and background

In his book, Johnson (2010, p. 3) claims that lack of historical and economic understanding of how markets have been constructed results in surprise and fury when markets fail to produce in an orderly fashion and as anticipated. In truth, we have been there before he says; the historical evidence is disturbingly familiar. Despite the fact that economists and practitioners have analysed market relationships and developed market instruments and strategies during the last two centuries, a struggle with unpredictable capital markets has been the main problem of financial crises throughout the past centuries. The recent crisis in 2008-, which has caused a detrimental impact on the world economic system, is no exception. It revealed great weaknesses of the world’s economic system and has proven that the capital markets are still very fragile and can be very unpredictable. Legal statutes play an important role in stabilising the market and sustaining its predictability. Many claim that imperfect and badly formed legal statutes were the main reason for the market meltdown, and amendments of legal statutes have been proposed worldwide to prevent such a market meltdown in the future (Johnson 2010, p. 3). Considering one aspect of the discussion, the liability of shareholders within limited companies has caught the attention of the author, along with the tendency among them to act as shadow directors. In some cases, shareholders’ role as shadow directors seems to have been an important factor in the decision-making process in many limited companies in the antecedents of the recent crisis, where the interests of the company have been disregarded and revealed companies more vulnerable to the financial distress than expected. It is
therefore of great importance to consider how the liability of shareholders can be expanded in order to cover situations where the shareholders are revealed to have exercised effective control within limited companies.

Due to the author’s Icelandic heritage, it is interesting to analyse how shareholders can become liable beyond their statutory limited liability. The practice of establishing personal liability upon shareholders is vaguely established in the Icelandic jurisdiction, and it is therefore uncertain how courts will cope with the matter in future judgements. Thus, situations where limited liability is set aside and where shadow directorships can be established are of utmost interest in order to analyse and examine how these issues are dealt with in the neighbouring jurisdictions of the UK and Denmark. The procedure varies between the jurisdictions though, whereas the Danish jurisdiction has very limited experience within the field, and the British jurisdiction consists of a vast judicial practice of imposing personal liability upon shareholders, both by lifting the veil of incorporation and establishing shadow directorship. Neither the Danish nor the Icelandic law comprises statutory provisions regarding such practice, which in turn is left for the courts to elaborate on. The lack of statutory provisions in the Icelandic and the Danish jurisdictions, as well as a limited number of judicial examples within the field, brings uncertainty into the question of how the Nordic courts will cope with the matter and which requirements the courts present in order to establish personal liability upon persons in these situations. Legal actions are already being processed in the jurisdictions where courts will have to provide and establish clear tests regarding the matter. Therefore, it is necessary to provide an analysis of situations where shareholders can be held liable beyond the statutory limitation of liability, in order to foresee the possible results from such legal proceedings against the shareholders of limited companies.

1.1.3 Methodology and limitations of the scope

In this thesis, the author seeks to examine and analyse the liability of shareholders and the law of shadow directorships. In order to do so, the position of shareholders is examined in the jurisdictions in question, and light is shed on situations which can lead to increased liability upon the shareholders of the company. Furthermore, the concept of shadow directorship is analysed and the characteristics that define a person as a shadow director are presented. Duties and liabilities of directors are presented briefly; although a thorough analysis and comparison of the directors’ duties
between the jurisdictions is left out of the discussion.\textsuperscript{1} However, the thesis does consider the general duties and obligations associated with shadow directorships and the circumstances in which a shadow director may be liable to compensate the company or its individual members. The discussion is limited to shareholders’ liability within limited companies and the potential liability of corporate advisers, financiers, creditors and other controlling entities as shadow directors is only discussed to a limited extent.\textsuperscript{2}

Thus, the purpose of the thesis is to analyse the position of shareholders within limited companies and situations in which liability can be extended beyond the statutory limitation of liability, the manner in which this can be carried out and the requirements for such determination. Due to the vague practice in Denmark and, particularly, in Iceland, the analysis will focus on presenting examples and methods used in the UK, where the field has been explored and developed by courts to a significant extent. The discussion covers an analysis of relevant legal statutes, preparation work and court rulings relating to the issue, with the sole purpose of presenting shareholder liability and the various situations in which their liability can be extended.

Due to the fact that new companies acts have been enforced in the UK and in Denmark, the author finds it interesting to analyse the procedure of those jurisdictions, how the new statutes have handled the issues of lifting the veil of incorporation and establishing shadow director liability, and how courts have coped with the issue. The jurisdictions’ different legal methods of solving these issues encourage the author to look for the successful measures used, in the hope of being able to provide suggestions of amendments to a new or revised companies act in Iceland. Furthermore, it is the author’s wish that the analysis sheds light on shadow directors in general in the jurisdictions of the UK, Denmark and Iceland, and that the concept becomes clearer and easier to determine in relation to shareholders acting as shadow directors.

1.1.4 Overview

First, a brief overview is given on the legal systems applied by the jurisdictions in question, where the governance models applied are presented. A light is shed on the corporate governance debate and the governing law which the following discussion is based on. In Part 2, the limited company is presented where the historical notes, incorporation and the effects of establishing a limited company

\textsuperscript{1} Such an analysis and comparison is very comprehensive and would be sufficient for a separate discussion.

\textsuperscript{2} The concepts of ‘lender liability’ and other third party liability in general are also left out of the discussion as it would suffice for a separate discussion.
are introduced. The nature and mechanisms of limited companies are explained and the role of shareholders and other members of the company are considered. Secondly, shareholder liability and the situations where a shareholder can risk incurring increased liability are presented. These involve various situations in which the fundamental characteristics of a limited company are set aside and the shareholders are prevented from hiding behind the corporate veil. Another important situation is analysed in Part 3, which reveals that too much interference with the company’s affairs can impose the status of director upon a shareholder, though under limited circumstances. Thus, a brief overview of the position of directors is provided, and the different types of directors are considered. Accordingly, the concept of shadow directorship is presented by analysing their determination, characteristics and the consequences of being designated as one. The question of when shareholders can be assumed to have acted as shadow directors is discussed and examples are provided from the law on shadow director liability. Legal statutes and court rulings form the main substance of this part of the work. The conclusion in Part 4 provides a summary of the discussion regarding shareholder liability and the situations which can render a shareholder personally liable for his actions. Thought is given to the practice of such situations and to how this might benefit the Nordic countries, in particular the Icelandic jurisdiction. Suggestions of amendments to any future changes of the Icelandic statute will be provided, with the aim of eliminating the abuse of powers of controlling share- or stakeholders who usually escape personal liability for their harmful acts.

1.2 The legal systems

1.2.1 In general

The majority of the world’s jurisdictions can be divided into three main groups: the Anglo-American group, the Napoleonic group and the Roman-Germanic group. The three jurisdictions of the UK, Denmark and Iceland do not belong to the same group, and it is therefore necessary to give a brief overview of the legal systems applied in the jurisdictions.

3 Historically, the laws of the groups derive from a few countries in Western Europe; Britain, France and Germany, where from the jurisdictions of the groups inherit their legal forms and procedures (Wood 2008, pp. 15-16).
The legal system in the UK stands out from the other two, seeing as it is considered a part of the Anglo-American common law system, while the legal system of the Nordic countries is considered part of the Roman-Germanic civil law jurisdictions. However, the system comprised by the Nordic countries is in fact different from the civil law system and is connected to the common law system in many respects. The main difference between the legal system in the UK and the system represented by the Nordic countries is reflected in the importance of precedents within the common law system of the UK as opposed to the codification of legislation in the civil law system applied by the Nordic jurisdictions. Despite the fundamental difference in the legislative procedure of the legal systems applied by the jurisdictions in question, the governance of companies is similar in many respects. Thus, the system applied by the Nordic jurisdictions is a specific legal system, situated somewhere in between the two (Wood 2008, p. 33).

1.2.2 Governance models

In order to provide an easily understandable discussion of shareholder liability and shadow directorship, it is necessary to give a brief introduction to the governance models that the jurisdictions in question apply. Most jurisdictions either apply the one-tier system or the two-tier system. However, the Nordic countries apply a model which seems to combine features from both systems.

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4 The Nordic countries usually consist of Denmark, Norway, Sweden, Finland and Iceland, and the associated territories. In the following discussion, the term will be used to refer to Iceland and Denmark, either as the Nordic countries or the Nordic jurisdictions.

5 Common law system or Anglo-American legal system is in a widespread use, particularly in the United Kingdom, the United States, Australia and the many other nations that trace their legal heritage to the UK as former colonies of the British Empire. The system’s distinct feature is its development of legislation through customs and decisions of courts, rather than through legal statutes. The importance of judicial precedents is dominating in the legal system since it binds future decisions of courts. It is based on the principle of stare decisis, where similar cases in similar occasions must be decided according to consistent principled rules so that they will reach similar results. Civil law system is contrasted with common law and its heritance derives from the ancient Roman law. The primary characteristic of civil law is the written form or the codification of the legal principles into a collection, serving as the primary source of law. The principle of civil law is to provide all citizens with an accessible and written collection of the laws which apply to them, and which courts must follow and on which they shall base their decision. Contrary to common law, courts are unbound by precedent and do not serve the purpose of determining the law, which purpose is of the national legislators.


6 A common feature of the Nordic jurisdictions is that they share the same legal traditions. Their legislation is therefore very similar and is often harmonized. Due to the similarity of many legal areas in the Nordic jurisdictions, one country’s provisions or case-law can often influence decisions of courts or legal advisors in other Nordic jurisdictions (Hansen 2003, pp. 9-10).
1.2.2.1 The one-tier model – the UK

The governance of most limited companies in the common law jurisdictions is based on the one-tier system, where only one single management organ is in control of the supervision powers and all the executive powers within the company. Thus, the board of directors undertakes both management and supervisory functions and, therefore, it can consist of both executive directors and non-executive directors. The normal procedure is that the board grants a part of its powers to others and, therefore, it appoints executive managers to be in charge of the day-to-day management of the company.

The shareholders exercise their powers at the general meeting which used to be considered the highest authority within the company in the UK. Through the last century, court decisions have changed this viewpoint and confirmed that the shareholders shall not interfere with the management of the company, as this responsibility belongs to the board of directors. Thus, the managerial powers of the general meeting only allow for laying down guidelines for the board of directors to follow in the future management of the company (ex ante approach), but the general meeting cannot interfere with decisions already taken by the board (ex post approach). Besides being able to give directions to the board of directors, the shareholders are provided with widespread powers to influence and discipline the exercise of management powers by the board of directors, in particular by electing and removing members of the board of directors with a simple majority voting. Consequently, the members of the board in British companies can be subject to shareholder influence to a significant extent and, therefore, the British model is considered shareholder oriented (Hansen 2003, pp. 70-72).

1.2.2.2 The two-tier model – Germany

Germany can be viewed as a paradigm for the two-tier system applied in most civil law jurisdictions. The German model consists of three company organs within limited companies: the management organ (Vorstand), the supervisory organ (Aufsichtsrat) and the general meeting. The model is characterised by a high level of independence for the management organ and a clear separation of control and management (Hansen 2003, p. 59).

7 Non-executive directors are people who are not involved in the daily management of the company, also called outside directors.

8 This view was expressed by the decision of the Court of Appeal in Automatic Self-Cleansing Filters v. Cunninghame [1906] 2 Ch. 34, and backed up by the decision of the Court of Appeal in Shaw & Sons (Salford) v. Shaw [1935] 2 KB 113, which rejected the idea that the general meeting had management powers to interfere or change arrangements made by the management (Hansen 2003, p. 70).
The management board has the residual powers for making decisions and executing them. Besides managing the company’s affairs, the management board sets forward long term goals and guidelines. The supervisory organ, on the other hand, consists of either shareholder representatives or labour representatives, and it exercises control over the company by appointing and dismissing members of the management organ. Thus, the supervisory organ is left only with the role of monitoring the management organ.  

German company law demonstrates its desire to protect the company’s capital and this is reflected in the two-tier model structure, whereas the shareholders have very limited influence on the company’s management. Various measures are undertaken within the model to ensure the independence of the management organ from the shareholders. Moreover, German company law favours employee representation, which further limits the influence of the general meeting and prevents a dominant shareholder to exercise controlling influence (Hansen 2003, p. 59). Thus, the two-tier model is assumed to be stakeholder oriented.

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9 The distinction between the power of executive directors and non-executive directors in the British one-tier model is mirrored in the German model. The role of the management board is identical to that of the executive directors, and the role of the supervisory board is identical to that of the non-executive directors.

10 To avoid supervisors’ direct influence over the management, and to ensure the independence of the management, members of the management are appointed by the supervisory organ for a period of 5 years and dismissal of a member must be justified by a material failure of duty. Moreover, a prohibition against double mandates strengthens the distinction between the two organs’ powers, (The prohibition is laid against persons serving positions in or being members of the both company organs, cf. AktG § 105(1)).

11 Hansen (2003, pp. 66-67) states that according to the recent development taking place in the field of company law in Germany, this view appears to be retreating and it gives the indication of an increased movement towards a shareholder-oriented approach in the field of German company law.
1.2.2.3 The dual executive system – the Nordic countries

The Nordic governance model is different from both the two-tier model applied in Germany and the one-tier model in the UK. The Nordic countries share a corporate governance model which divides the executive powers into two separate organs: the board of directors and the board of the management. At first, the model seems to be like the two-tier model applied in Germany, consisting of three company organs with separate functions. However, both of the boards in the Nordic model are in control of executive powers and, therefore, it is called the dual executive system.¹²

The Nordic model consists of a strict hierarchy between the company’s three organs, which is similar to the structure applied in the UK. The shareholders exercise their powers at the general meeting which is considered the company’s highest authority. However, the shareholders can normally only exercise their powers through the management of the company, since only the management organs can represent the company in relation to third parties (Hansen 2003, p. 74). In

¹² The origins of the model derive from the one-tier system in the UK, consisting of two company organs; the general meeting and the board of directors. Due to the double mandate issue (cf. footnote 11) and interference of the board in the management, the law in the UK made it possible to set up: either a representative committee to serve as a separate supervisory organ, or an executive committee in case the board of directors had purely a supervisory role. The dual executive system developed from the UK model by making the executive committee as a legally required company organ. This was first required in the reform of the Danish Companies Act in 1930 and now it is required in all Nordic public companies (Hansen 2003, p. 72).
Nordic company law is based on the majority principle, thus the general meeting can decide to give directions to the board of directors based on a simple majority of the shareholders. The board is then able to give directions to the board of management with consent of the equivalent majority of its members. The consequence of the hierarchical structure is that the management powers are effectively placed in the general meeting which can easily interfere with the management of the company by giving instructions to the directors via the meeting. Thus, as is also the situation in the one-tier model, the management powers can easily be in the hands of a dominating shareholder (Hansen 2003, pp. 139-140).

The board of management usually consists of appointed executive managers and it is responsible for the day-to-day management of the company. The senior organ, the board of directors, is responsible for all major decisions within the company as well as for the management board.\footnote{Employee representation is considered important in the Nordic countries, since the board of directors has the overall management powers. The Icelandic statute is the only jurisdiction of the Nordic countries that does not provide such a measure (Hansen 2003, p. 75).} Therefore, the role of the board of directors is not only supervisory, as in the German model, it also exercises powers and has responsibilities, including the right to hire and dismiss the employed executive managers and give them directions as regards the management of the company. Thus, the executive managers of the junior organ serve as agents for the directors of the senior organ; their powers are limited and subject to the directions from the board of directors. Thus, they can bind the company, without being directly liable, if they act according to their powers as agents and their authority in the day-to-day management of the company. Considering all of the aforementioned, the Nordic model is in fact very similar to the one-tier model applied in the UK, comprising a division of the executive powers between the two company organs (Hansen 2003, pp. 72-73).

\subsection*{1.2.3 The corporate governance debate}\footnote{Thomsen (2008, p. 15) defines corporate governance ‘as the control and direction of companies by ownership, boards, incentives, company law, and other mechanisms.’ Thus, it is the method by which companies are run, directed and controlled in a very broad respect. It covers every managerial issue that takes place within the company; the relationships between directors, shareholders and other stakeholders. Measures have been taken in the international field to influence companies and provide them with directions in certain codes, which focus on the companies’ governance and imply suggestions of the best practice of the relations within them.}

A limited company is a legal fiction and cannot act without natural persons making the decisions and executing them on the company’s behalf. Those natural persons are considered members of a company organ, either of a single person organ or a collective body of two or more natural
persons. The natural person will inevitably act in a dual relationship, both as a private person and as a member of the company organ. When fulfilling his duty as a member of the organ, this dual function can cause conflicts of interests between that person’s private interests and the company’s interests. Therefore, rules of governance of companies are important to avoid such conflicts of interests and ensure the effective management of the company which benefits the company and its shareholders (Girvin et al. 2010, p. 401).

The separation between ownership and management is considered the basic problem of corporate governance and is referred to as the agency problem. The basic notion is that the shareholders hire executives to exercise the management powers of the company. Thus, the members of the management act as agents of the shareholders, being the principals. Corporate governance deals with the problem of ensuring that managers will manage the company with the principals’ best interest in mind (Thomsen 2008, p. 17). To solve this problem, the establishment of boards is viewed as a simple and straightforward solution where the directors of the board take on obligations and liabilities towards the company, whereas they authorise all major decisions within the company and monitor the work of the executive managers (Thomsen 2008, p. 18). Thus, the board of directors serves the most important role within limited companies and thereby undertakes onerous duties towards the company, while personal liability may follow in case of breach of such duties.

1.2.4 Governing law

The British jurisdiction has recently adopted a new companies act that reformed the British company law and restated the greater part of the enactments relating to companies in the UK by replacing the former companies act from 1985. The new United Kingdom’s Companies Act from 2006 (hereinafter referred to as UKCA) was applied after a long and difficult development, due to

Legal persons can be represented as a member of the organ by natural persons (Girvin et al. 2010, p. 401).

Beyond the statutory and case law principles, which govern the management of companies, non-legal principles have been established, in the form of codes, to provide directions and good practices for the ways in which companies should be operated, in order to prevent the recurrence of the unfortunate events. A number of influential events and scandals have led to further cooperation in the field of corporate governance, whereas the famous scandals of Enron and WorldCom in the U.S. in the late nineties are perfect examples and possibly the main motives for the discussion of corporate governance at the time (Girvin et al. 2010, p. 401).

The discussion of corporate governance began with the 1992 Cadbury Report (Financial Aspects of Corporate Governance), and the main emphasis of the discussion was the need to control the power of directors (Girvin et al. 2010, p. 401). Indeed, the directors are the ones with the actual management power within the company, seeing as they represent the company and have the power to execute the company’s business affairs.

The United Kingdom’s Companies Act, 2006 c. 46. The Act was fully in force as from October 1, 2009.
its very comprehensive and complex nature. The UKCA contains provisions regulating companies registered in the UK, both public and private limited companies. Due to the representation of the common law system and also to the fact that British company law is characterised by a high degree of self-regulation, the new act is to a large extent only considered declaratory for the legal principles already established by the courts (Hansen 2003, pp. 68-69).

In Denmark, limited companies are governed by the recently applied Danish Companies Act 470/2009 (hereinafter referred to as DKCA). The new act combines two of the former companies acts into a single act, regulating both public and private companies, just as the one applied in the UK. One of the most important factors implemented in the DKCA is the possibility of companies being able to choose which governance system suits their corporation best: the British one-tier system, the Nordic dual executive system or the German two-tier system. This must be assumed to be a step towards further harmonisation in the field of company law. The governance model applied in an international corporation is no longer an obstacle for it to be established within the Danish jurisdiction. Therefore, this must be assumed to generate a more efficient market environment, as this encourages companies to consider establishing themselves within the jurisdiction.

The Icelandic Companies Act (hereinafter referred to as ISCA) was applied in 1995. After the financial crisis hit the Icelandic economy, legal advisors and politicians have discussed the proposal of a reform of the act in order to strengthen the rules for the directors, capital preservation within limited companies etc. This is deemed necessary in the light of the previous events which have revealed weaknesses of the legislation.

References to provisions of the aforementioned legal statutes will be presented in a general way in the following discussion in order to prevent confusion and make it easier for the reader to

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19 The act consists of approximately 1,300 provisions.
20 Lov nr. 470 af 12. juni 2009 om aktie- og anpartsselskaber (selskabsloven). The Act as not entered completely into force yet. Due to technical problems relating to reforms of official IT and registration systems, the Act will come into force in steps. The first part already entered into force on the dates of March 1st and May 1st 2010. The second part has recently entered into force on March 1st, 2011, and the final part is expected to follow shortly after.
21 This is different from what is applied in the other Nordic jurisdictions and will likely be exemplary for them to follow in the near future.
22 Section 111 of the DKCA allows for limited companies to choose between the two governance structures. However, the two-tier system presented in the new Act has been made more hierarchical than the German model. The supervisory board can hire the members of the management board and may discretionally fire them (Hansen 2010, p. 89).
23 The Icelandic Public Companies Act 2/1995 (Lög um hlutafélög, nr. 2 frá 30. janúar 1995). Statutory provisions are split into two acts, one regulating public limited companies and the other regulating private limited companies. This does not have any significant importance for the following discussion as there are similar provisions that apply to members of the limited companies, their establishment and conduct. The difference lies to a significant part in formality requirements.
understand. References will be made by adding the phrase *section* or the letter *s* in front of each section’s number. The number of sub-paragraphs, if there are any, will be placed in brackets immediately following each section’s number.24

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24 Thus, the reference ‘s. 6(2)’ in the text constitutes reference to section 6 and sub-paragraph 2 of the legal statute applicable.
PART 2 - LIABILITY WITHIN LIMITED COMPANIES

2.1 **In general**

The question of liability within a limited company often arises when serious financial difficulties occur and insolvency proceedings take place. Normally, when companies are struggling in their business or have become insolvent, the creditors file their claims against the company as they request to start insolvency proceedings and seek to recover their claims from the company’s assets. Inevitably, claimants will not receive full payment of their claims, since the debtor is already experiencing financial difficulties and is unable to fulfil his obligations in time.

The main rule under insolvency proceedings is to guard the principle of equality of all the company’s creditors. Thus, it must be ensured that payments from the company’s funds and assets to all the creditors are on equal footing, in proportion to their claims and according to the *priority ladder of creditors*.\(^25\) However, when financial difficulties are ahead, or even when the company has already become insolvent, equality is often disregarded by the members of the company, and the risk of assets vanishing from the business becomes evident. The members of the management are therefore at risk of incurring personal liability for acts which are of a nature that might benefit one stakeholder and harm the company as a whole. The foregoing acts of the management are examined upon insolvency in order to determine whether harmful acts have been carried out while the company was insolvent. If so, the creditors will want to recover their claims from those responsible for the harmful acts: the persons who controlled the business affairs of the company at the given time (Ohrenstein 2009, p. 1). Thus, compensational claims for damages can be filed against the members of the company if they carried out acts in the antecedents of the financial difficulties, which have resulted in a breach of their duties.

The main candidates for personal liability for harmful acts against the company are the lawfully appointed members of the management, as they have onerous obligations to fulfil towards the company (Wood 2008, p. 65). However, in certain circumstances others can be held liable, on the grounds that they were in fact in control of the business affairs of the company at the time of the detrimental acts. Thus, judicial practice has developed in order to determine the real controllers behind the decisions of a company, which has often led to the designation of dominating

\(^{25}\) On insolvency, creditors are classified in relation to the priority of their claims, as some creditors have priority position while others are secondary creditors etc.
shareholders, parent companies or other closely connected persons, as being the actual controlling force behind the decision-making procedure of the company, and consequently imposed liability upon them. As will be revealed in the following discussion, the rationale of the law and judicial practices is indeed to impose liability upon those who are in possession of control over the company’s affairs.

2.2 INCORPORATION OF A LIMITED COMPANY

2.2.1 General notes on limited companies

Modern company law began to take shape following the revolutionary change in Europe’s governance systems in the late 18th century, switching from reactionary views and state supervision to market liberation. Following from that fact, it is assumed that corporate capitalism was created in the Victorian era,26 from which limited companies, shares, stock markets and even moral codes derive (Johnson 2010, foreword). These market instruments, which still underpin the structure of modern capitalism, were the result of a slow progress of historical conjunctures that took place in the Victorian reign. The most important of these inventions was the joint-stock limited liability company which was highly disputed in the beginning of the 19th century. However, by the end of the 19th century it had become the primary form of business organisations in Britain (Johnson 2010, pp. 2-3).

The main decisive legislations favouring the limited liability company form and altering the distribution of risk in business affairs were the legal statutes that entered into force in the UK in 1855 and 1856.27 The enactment of the former act represented a substantial shift from the previous obdurate view of demanding full responsibility of those who invested in business ventures, to the endorsement of other systems of liability (McQueen 2009, p. 313).28 Therefore, from the beginning

26 The Victorian era of the United Kingdom was the period of Queen Victoria’s reign from June 1837 until her death on the 22nd of January 1901, which is characterised by long period of prosperity for the British people.
27 Liability limited to shares in registered companies was introduced by the 1855 Limited Liability Act. The 1856 Joint Stock Companies Act which presented the two important documents of the limited company; the memorandum of association and the articles of association. The memorandum of association mainly concerns the incorporation of the company and is intended to inform the public and potential investors about the company. The articles of association is the most important document of the company, as it lays down the constitution of the company and the rights and obligations of those who participate in its affairs (Hansen 2003, pp. 222-223).
28 More importantly, the statute represented a significant change in incorporation of companies, allowing for incorporation to be available as a right to all who applied. Before the enactment of the statute, only a few chosen ones could incorporate a company, by obtaining a Royal Charter or Private Act of Parliament.
of the Victorian era, the UK switched status from being the most restricted country in Europe, as regards registering companies, to the most reluctant one by the end of the 19\textsuperscript{th} century (Girvin et al. 2010, p. 8).

Nordic company law followed shortly after and developed the limited company in the 19\textsuperscript{th} century under the influence of central Europe and the British development. The Nordic countries share a high degree of uniformity in their legislation since much of the development of their laws has taken place within a Nordic framework. The regulation of company law is no exception, and the first generation of Nordic companies acts was born as a result of cooperation within the framework in 1875 on the regulation of limited liability companies (Hansen 2003, p. 21). Furthermore, with the establishment of the European Union company law has been harmonised with a framework of rules regulating the field. Therefore, the companies acts in the jurisdictions in question share a similar structure, although technical issues may differ from one jurisdiction to another.

2.2.2 The company's members

2.2.2.1 Position of the shareholders
The shareholders form the general meeting which is the highest company organ in the hierarchy ladder of powers within limited companies in the jurisdictions in question. The general meeting is almost omnipotent, which means that it can decide on nearly all matters laid down before the meeting (Hansen 2003, p. 81). The hierarchical structure of a limited company places the management powers with the general meeting, whose decisions are executed by the shareholders by majority voting.\textsuperscript{29} The most important managerial powers of the meeting are to appoint and dismiss members of the board of directors at its discretion, amend the articles of association and give instructions to the board of directors on monitoring the company. Thus, the shareholders are ensured decisive influence over the board of directors by the majority principle.\textsuperscript{30,31} However, the company can only be represented by its management, through whom the shareholders must exercise their management powers.

\textsuperscript{29} The main rule is that shareholders control the company with a majority voting and the rule is supported with the fact that it is considered natural to have the financial liability corresponding to the decision-making powers within the company (Stefánsson 2003, p. 295).

\textsuperscript{30} The influence of the general meeting in the decision-making procedure of a limited company is ensured by the right of the meeting to appoint the majority of members to the board, which in turn makes its decisions by a majority vote.

\textsuperscript{31} Compared to the German model where shareholders are not entitled to influence the management, this would be problematic (Hansen 2003, p. 139).
The main obligation shareholders have towards the company is to provide the capital they have subscribed for. They are also entitled to act in the company’s best interest and to use their management powers legitimately at the general meeting (Girvin et al. 2010, p. 4). Thus, they must guard the legitimacy of the decisions made at the general meeting. Moreover, the powers of the general meeting are limited in a few instances.\textsuperscript{32} The limitation is provided by connecting the powers of the meeting to decisions of the board of directors, which is responsible for running the company and guarding its interests.\textsuperscript{33} The aim of the limitation of powers is mainly to avoid conflicts of interests between the shareholders and the company’s creditors, and to protect the company as a whole by ensuring its existence and its ability to meet its obligations (Tison et al. 2009, p. 174). A shareholder risks becoming liable, if he or chooses to exercise the rights that derive from his shares, either deliberately or through gross negligence, and the conducted act is revealed to be harmful towards the company as a whole.\textsuperscript{34}

\subsection*{2.2.2.2 Directors as agents}

Despite the fact that the shareholders form the highest company organ, the shareholders’ superiority is only in respect of governance, since the general meeting can only execute its powers through the management, and only when lawfully convened (Hansen 2003, p. 127). Thus, the company cannot be represented by the shareholders, neither individually nor collectively. A management organ, consisting of natural persons, is therefore needed to represent the company and control the company’s business affairs. The persons, via who a company acts and via who the company’s business is carried out and controlled, are the company’s directors. They are elected by the shareholders at the general meeting to run the company in its best interests and for the benefit of the company as a whole.

The members of the management are entitled to represent the company and can enter into obligations on its behalf.\textsuperscript{35} Considering the supervisory powers and the overall management powers of the board of directors, the directors form the company’s most powerful organ and, therefore, they

\begin{itemize}
\item The managerial powers retained are among others, the right to alter the memorandum of association or the articles of association, increase or reduction of the share capital, and the right to petition for a voluntary winding up of the company etc.
\item These particularly include decisions that involve the protection of the company’s funds, such as paying out dividends or reducing its share capital.
\item The shareholders can be liable for any loss or damages they incur or cause the company, other shareholders or third parties when exercising their powers or abusing their powers at the general meeting (Hansen 2003, p. 97).
\item The right to act on behalf of the company can however be restricted by the articles of association. This is assumed to be a preventive measure against the members of the management abusing their rights and incurring unwarranted obligations for the company (Hansen 2003, p. 129).
\end{itemize}
have onerous obligations towards the company. Thus, the standard of culpability is therefore stricter towards the members of the management than towards the shareholders.36

Contrary to wholly owned businesses or partnerships, neither the owners nor the directors of limited companies are directly responsible for decisions and actions of the business. The company itself is responsible, seeing as it is a separate legal person. Thus, the directors only act as fiduciaries37 or agents on behalf of the company.38 Therefore, they cannot be held personally liable while executing decisions on behalf of the company, provided that they act in the course of their employment or within their scope of authority as agents.

The general duties of directors are laid down in the companies acts of the jurisdictions.39 The directors of a limited company owe their duties to the company itself and not, for example, to the shareholders of the company. As Girvin et al. asserts (2010, p. 321), the company is therefore confirmed to have the proper rights to claims against directors in breach of the general duties. Thus, a director is first and foremost required to guard the interests and legitimacy of the company itself when voting on decisions at the board meetings, and each director must act within his employment and authority.40

2.2.3 The separate legal person

A limited company can either be public or private,41 and it may be formed by one or more natural or legal persons.42 Once a limited company is incorporated, it has the characteristic of being referred to

36 While shareholders can only be liable for acts conducted through gross negligence or deliberate acts of their behalf, the members of the management may become liable for acts conducted through simple negligence.
37 Fiduciaries are those who are entrusted to manage the property of others so that there is an expectation of trust and confidence.
38 The agents have fiduciary duty towards their principal, they shall promote the interests of the corporation in the best possible way and shall by all means not enter into any engagements ‘in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect.’ [(1854) 1 Macq. 461 at 471] (Girvin et al. 2010, p. 371).
39 In Britain, a new statutory code of directors’ general duties was introduced by the UKCA in 2006, which until then had only been elaborated on in judicial practice. The code is titled ‘General Duties of Directors’ and is contained in Part 10, Chapter 2 of the UKCA. The chapter comprises of 12 articles, of which the main principles are included in section 171 through section 177. The principles of directors’ general duties in the Nordic jurisdictions are laid down in chapter IX in the ISCA and in s.115-118 of the DKCA.
40 A director must act in accordance with what he believes to be in the best interests of the company as a whole, and ensure no conflicts between his duties and his personal interests. Thus, statutory provisions forbid the directors from conducting the affairs of the company in a manner which is unfairly prejudicial to its members. UKCA art. 994, IS 76(1) og DK 127(1).
41 A private limited company can either be limited by guarantee, whereas its members agree to pay a fixed amount in the event of the company’s liquidation, or it is limited by shares consisting of shareholders with limited liability. A public limited company is a limited company that has permission to offer its registered securities for sale to the general
as a separate legal person: a person who is separate and distinct from its members. Thus, it is a legal entity, regarded to enjoy the same legal status as applies to other natural persons, having its own legal rights and obligations, for instance being able to enter into agreements, own land and property, participate in legal proceedings, employ workers and so forth (Hansen 2003, pp. 27-28). However, a limited company is not recognised as an independent legal person until it is registered. Requirements for registered companies to disclose information of their business are laid down in the companies acts and are regarded as the price companies pay for the veil of incorporation (Girvin et al. 2010, pp. 5-6).

The principle of corporate personality was laid down by the House of Lords in the landmark case of Salomon v. Salomon & Co where the court declared that ‘once a company is incorporated, it must be treated like any other independent person, and the motives of those who promoted it are irrelevant.’ Despite the fact that the company in this case only consisted of a single shareholder, the company was confirmed as a separate legal person in its acts, and not as Salomon’s agent. The court supported its arguments that if the company was not a separate legal person, it could never be considered an agent. As a consequence, the case of Salomon v. Salomon is often referred to when courts find it necessary to demonstrate the importance of upholding the corporate personality in order to preserving the limited company form.

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42 Although, under Icelandic law, there is a requirement that there shall be at least two promoters of the company when incorporating a public limited company ISCA s.3(2).
43 Until registered, the company can neither acquire rights nor duties, and, therefore, it has no legal capacity. The effects of registration are laid down in ISCA s.15(1), DKCA s.41(1), UKCA s.16.
44 The case of Salomon v. Salomon & Co., Limited, [1897] A C.22. The case was brought before the court where it was ruled that the company was an agent of Mr. Salomon and thus he was deemed liable as a principal for the debts incurred in the business. The disappointing result was appealed to the House of Lords where the company was deemed neither an agent of Mr. Salomon, nor was he contrary to the spirit of the law, thus he was not liable for the debts the company had incurred. It was further noted in the case that:

*Either the limited company was a legal entity or it was not. If it was, the business belonged to it, and not to Mr. Salomon. If it was not, there was no person and nothing to be an agent at all; and it is impossible to say at the same time that there is a company and there is not... the liability does not arise simply from the fact that he holds nearly all the shares in the company. A man may do that and yet be under no such liability as Mr. Aron Salomon has come under. His liability rests on the purpose for which he formed the company and on the way he formed it, and on the use which he made of it...* (Johnson 2010, p. 153-159).
45 Ibid.
46 Ibid. It was noted in the case that the corporate personality was to be upheld, even if one individual held almost all the shares and debentures in a company. Lord MacNaughten noted:

“The company is at law a different person altogether from the subscribers to the Memorandum and, although it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or the trustee for them. Nor are subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act [i.e. Companies Act 1862].”
The concept of the company’s corporate personality leads to a complete separation of the company and its members, a separation between ownership and control. Thus, the company is liable for any claims filed against it. Therefore, the shareholders are not the owners of the company itself since they only serve the purpose of financing the company by providing capital in return for shares. They are the owners of their shares and can only exercise their ownership rights by voting at the general meeting, or simply by selling or disposing of their shares. Thus, the ownership rights of the company are in fact in the hands of the management of the company in terms of possession, control and disposition of its assets (Johnson 2010, pp. 161-162). Consequently, the members of the management have onerous duties towards the company and can be held personally liable for any misconduct. The shareholders are, however, granted with limitation as regards their liability and they cannot be compelled to pay the company’s outstanding debts, which exceed the amount they originally invested or committed to invest in the company. This principle of limited liability is a natural consequence from the aforementioned principle of corporate personality, and the connection between the two principles was illustrated in the case of Salomon v. Salomon & Co. Ltd. The two are considered the fundamental basis of the veil of incorporation.

2.2.4 Limited liability

2.2.4.1 Historical perspective

The concept of limited liability has developed during the last centuries, evolving from legal procedures in the UK. The beginning of the statutory concept in the UK was when the so-called 1720 Bubble Act was repealed in 1825 and the Crown was empowered to decide to which extent the members of companies should be personally liable for the companies’ debts (Girvin et al. 2010, p. 8). Until the act was repealed, shareholders faced unlimited personal liability, and this had placed restrictions on many important investments within the society (Johnson 2010, p. 142). Nevertheless,

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47 The principle is the main difference between companies and partnerships and is regarded as a fundamental principle of general company law (Ohrenstein 2009, p. 1).
48 The Case of Salomon v. Salomon & Co., Limited, [1897] A C.22. As the company was considered being a separate legal person, and not an agent of Salomon, limited liability was granted to Salomon from the company’s obligations, as was intended when he set up the business under the Companies Act 1862. Cf. footnotes #44-46.
49 The corporate veil may be considered to be a screen which upon incorporation separates the limited company itself from those behind the company. Thus, the ‘corporate veil’ emphasises the concept of the company as a separate and independent legal person, which is liable for its conduct. Thus, on insolvency, personal liability cannot be imposed upon others than the company, unless a member of the company has conducted in harmful acts or breached his duties towards the company (Wood 2008, p. 65).
50 The Bubble Act 1720 (6 Geo I, c 18) forbade all joint-stock companies which were not authorized by Royal Charter. It was similar to the registration process of limited companies nowadays and was the only way to form an incorporated entity.
over time, lawyers invented a variety of devices to constrain personal liability which were recognised by courts. Thus, a quasi-limited liability regime was already recognised by courts before the abolishment of the act (Johnson 2010, p. 148). The Chartered Companies Act 1837 developed the concept further by providing registration requirements to the persons in question. As mentioned earlier, liability limited to shares in registered companies was introduced by the Limited Liability Act 1855 and followed by the Joint Stock Companies Act 1856 presenting the memorandum of association and the articles of association. The two acts were repealed and combined in the Companies Act 1862 which simultaneously established the limited liability by guarantee (Girvin et al. 2010, p. 8).

At that time, the concept of limited liability was highly debated, and many were certain that it would liberate and stimulate the nation’s economic system by inducing widespread economic and moral degeneration (Johnson 2010, p. 137). Robert Lowe, a British politician and by many referred to as the father of modern company law, viewed the concept of limited liability not as a question of privilege; if anything, it was a right. However, the concept of limited liability was viewed by others as unnecessary and even unnatural.

Today, these viewpoints are still valid, even though the effects of the introduction of limited liability neither had the expected impact on the economy nor caused any major drawbacks for the market. Thus, the limited liability can be viewed as a necessary technical tidying-up of company law (Johnson 2010, p. 139). The principle has, without a doubt, eased access for companies to seek capital and for investors to diversify their risk. However, the principle causes disputes among

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51 Cf. further discussion in footnote #27.
52 The law of incorporation and the introduction of limited liability allowed owners to convert their partnership to a limited company. Consequently, owners could retain their powers of control and shirk their responsibilities of ownership. Thus, they could avoid or minimize liability for debts, torts and other unfair actions without forfeiting fully or partly control of the company or any parts of the company’s profits. (Johnson 2010, p. 163).
53 John Micklethwait and Adrian Wooldridge (2003) assert this and draw a rosy history of the limited company in their book, The Company: A short history of a revolutionary idea, and may undoubtedly be considered to support the concept of limited liability.
54 ‘The principle is the freedom of contract and the right of unlimited association – the right of people to make what contracts they please on behalf of themselves, whether those contracts may appear to the Legislature beneficial or not, as long as they do not commit fraud or otherwise act contrary to the general policy of the law.’ (HCDeb, 1 Feb 1856, col. 129). Lowe’s speech was subsequently reprinted as Robert Lowe, Speech on the Amendment of the Law of Partnership and Joint Stock Companies (London, 1856).
55 As McCulloch (1856, p. 10-11) states in his book: ‘In the scheme laid down by Providence for the government of the world, there is no shifting or narrowing of responsibilities, every man being personally answerable to the utmost extent for all his actions. But the advocates of limited liability proclaim in their superior wisdom that the scheme of Providence may be advantageously modified, and that debts and obligations may be contracted which the debtors, though they have the means, shall not be bound to discharge. Borrow, say they, as much as you please, and pay as little as you like, - the less, it would seem, the better!’
scholars, politicians and other critics as to whether the benefits, following from the invention of the principle, exceed its disadvantages in general use in society. Please note that the debate has increased after the recent financial crisis which revealed that this company form is misused, with the sole purpose of being a vehicle with which to mask individuals from personal liability. The criticism is extremely controversial, since the fundamental principle of the company form is indeed to avoid personal liability. However, in the light of the economic shakeup taking place in the world economy, this must be viewed as natural considerations regarding the fundamental characteristics of the limited company form, in order to develop the limited company form to the better, and not the worse, and strengthen efficiency and credibility of the form.

2.2.4.2 Function in society

The principle of limited liability is simply ‘a method of protecting the shareholder from claims against the corporation in which she is invested’ (Kahan 2009, p. 1088). Shareholders will therefore not be held personally liable for claims against a limited company, which exceed their capital contribution to the company. They are only liable for the amount invested in the company or the amount they have committed to buy shares for. This is assumed to be one of the fundamental principles of modern company law. Thus, the principle protects the shareholders’ personal assets from any claims that are brought against the company by its creditors, and leaves the company’s assets as the only subject to fulfilment of such claims.

When incorporating and registering a limited company, the principal legal benefit of the shareholders is the perpetual succession of their investment, which means that the investment can increase in value and generate endless dividends of the profits for the shareholders. They are therefore the economic beneficiaries of the company and entitled to the residual profits the company generates, either by receiving dividends on their shares or profiting when disposing of their shares. The fact that shareholders will never have to lose more money, than originally invested, and the possibility for the perpetual succession of their investment, enables shareholders to spread their investment risk by contributing capital to several smaller investments (McQueen 2009, p. 1).

56 Critics have argued that harmful corporate behaviour is encouraged by the negative effects limited liability generates. The criticism is premised on the notion that the principle of limited liability was originally meant to ensure the freedom of contract. The main objective was to protect shareholders from corporate liability, but not from tort liability and involuntary creditors. Opponents of the principle have indeed suggested reforms in order to eliminate limited liability in the case of corporate torts (Kahn 2009, p. 1087).

57 The principle is introduced in a similar way in all of the jurisdictions in question and laid down in s.1(2) DKCA, s.1(2) ISCA and s.3 UKCA.
Limited liability can therefore be seen to reduce the individual monitoring cost as the investors can diversify their risk by building diverse stock portfolios by purchasing shares in multiple firms. The decreased monitoring cost minimises risk adversity for investors and encourages other investors to provide capital to the equity markets, as opposed to a situation where their liability as shareholders was unlimited (Kahn 2009, p. 1086). Therefore, the limited liability has been recognised as important for social economic growth and for sustaining the development of the equity markets, providing companies with easier access to capital and investors with a variety of business opportunities, which might suit every investor’s investment capability. If the shareholders’ liability was not limited it could, and definitely would, reduce the resources of financing the company, since fewer investors would consider it feasible to invest in the company (Hansen 2003, pp. 35-37). However, limited liability increases the risk for creditors to reclaim their capital contribution in the form of loans, as their claims can only be filed against the company itself, which again is reflected in the increased cost of loans to limited entities.

2.2.4.3 Free ridership

Limited liability grants shareholders with the possibility to act as free riders\(^{58}\) in a limited company. A shareholder can simply hold his investment in the company, without exercising his rights connected to his share. Thereby, he may avoid any responsibility as regards participating in running the company or supervising the control of the company, by allowing others to monitor the company’s affairs. This is convenient for a shareholder who neither wants to invest a lot of money in the company nor to take on the costs of monitoring the management by exercising their administrative rights, connected to their shares. Thus, it is not necessary for shareholders to be skilled businessmen or to dedicate themselves as active participants in the company’s business affairs in order to invest in limited companies. Monitoring is therefore undertaken by the shareholders who prefer to be influential in the company and who exercise their rights to monitor it. A shareholder can only claim rewards of his investment if the company generates profits, and the cost of acting as a free rider is reflected in increased monitoring costs which in turn result in reduced profits on the shareholder’s investment. A tort liability for a passive shareholder who only considers his shareholding an investment is therefore generally not possible.

\(^{58}\) A free rider or a ‘sleeping partner’ is someone who invests in the company without participating in the management of the company.
2.2.5 Exceptions from the corporate personality

The principle of corporate personality, and consequently the principle of limited liability, provides immunity to shareholders, from any claims against the company exceeding their contribution, as well as to directors, from any personal liability if they act within their capacity and authority as agents of the company. Statutory provisions regulate the obligations of the members of the company and impose personal liability upon them in the case of breach of their duties or abuse of their powers. However, there are numerous exceptions to the principle established in the case of *Salomon v. Salomon*, in which the members of the company can undertake liability, voluntarily or not, beyond what they are entitled to under the veil of incorporation (Hansen 2003, p. 118). Liability can therefore not only be imposed upon individual members of the company, when conducting the business irresponsibly, or in an opposite manner to the company’s articles of association or the law in general. There are various situations in which the corporate personality can be disregarded and the separation of ownership and control be removed.

2.2.5.1 Suretyship and individual capacity

One exception to the corporate personality is a *suretyship*\(^{59}\) of an individual member of the company in which he grants guaranty of a defined claim against the company and, therefore, becomes personally liable in case the company is unable to pay its debts. Furthermore, limited liability is certainly inapposite if a member of the company incurs debt or liability for damages in his individual capacity. Contrariwise, the creditors of the shareholder’s personal debt may not be able to satisfy their claims by reaching for the company’s assets (Kahan 2009, p. 1090).

2.2.5.2 Failure to use the company’s name

It is assumed under Nordic company law that an individual member of the company, acting on the company’s behalf, can become personally liable if he forfeits to inform the contracting party that a contract is made on behalf of the company (Stefánsson 2003, p. 68). A similar view was confirmed in the UK’s former companies act,\(^{60}\) but has been removed in the new Companies Act from 2006.\(^{61}\)

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59 Suretyship is defined by the Lectric Law Library’s Lexicon as: ‘An accessory agreement by which a person binds himself for another already bound, either in whole or in part, as for his debt, default or miscarriage.’ Source: [http://www.lectlaw.com/def2/s208.htm](http://www.lectlaw.com/def2/s208.htm), retrieved on January 4, 2011.

60 Section 349(4) of the Companies Act 1985 (c. 6), 11 March 1985.

61 Although UKCA s.84 imposes criminal penalties for failure to use the company name on relevant documents, there is currently no equivalent provision imposing such a personal liability as confirmed in the former Act. However, the judicial practice exists and therefore the principle must be assumed to prevail in the jurisdiction.
2.2.5.3 Invalid incorporation

Despite the company being formed and registered validly as a limited company, incorporation of the company in breach of the companies act or insolvency act can lead to the personal liability of its directors (Ohrenstein 2009, p. 2). When the incorporation of the company is not legitimate, the company can be considered a fiction which does not serve the purpose of being the entity it was originally intended to be. If it is not incorporated according to the statutory requirements of limited companies, the company is not incorporated as a limited company and its liability cannot be limited. Thus, under such circumstances, the directors of the company, which are often also the shareholders in smaller companies, must undertake personal liability for the corporate affairs (Björgvinsdóttir, 2008).

The same principle applies if obligations are established before the company obtains its legal recognition as a separate legal person by registration. The members of the company must therefore undertake full liability for the acts conducted as they have acted on their own. Thus, valid incorporation of the business is of essential importance in order for the members of the company to be protected by the limited company form.

2.2.5.4 Identification

There are situations where the separation of ownership and control is unclear and where it has, therefore, been considered unnecessary to uphold such a separation. The identity between the shareholder and the company can therefore make the shareholder liable for the company’s debts for the reason that the corporate form has been disrespected. Identification is therefore a sanction in order to protect the corporate form, and the view is well-known in other legal aspects and within company law (Krüger-Andersen 2010, p. 506). Identification is particularly relevant in cases with a dominating shareholder or a sole shareholder who mixes the assets of the company with his own.

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62 Incorporation means that a minimum of requirements by law must be upheld, for instance the number of board members, regular board meetings and that general meetings are lawfully convened. Financial accounts must be delivered to the companies’ registry, and the registry must be informed of increases or redemptions as regards share capital.
63 This view was confirmed by the Icelandic Supreme Court in the case of Möotorskip Hrd. 1993:1653. The court considered the company not being incorporated as a limited company and on those grounds the corporate personality was set aside and the shareholders were therefore not guarded by the principle of limited liability.
64 The statutory provision laid down in the UKCA art.767(3) confirms the view that where a public company fails to obtain a trading certificate in addition to its certificate of incorporation before trading; “the directors of the company are jointly and severally liable to indemnify any other party to the transaction in respect of any loss or damage suffered by him by reason of the company’s failure to comply with its obligations.”
65 Identification is where a person, either natural or legal person, assumes the characteristics of another, which corporate personality is consequently set aside.
These circumstances can involve a situation where the assets of the shareholder and the company are not separated sufficiently in order to tell them apart. This can result in the disappearance of the principle of corporate personality and make the shareholder liable for the company’s debts. This principle has been established in the Danish jurisdiction by court decisions, although without a direct basis for such establishment in the legal statutes (Krüger-Andersen 2010, p. 533).

2.3 LIFTING THE VEIL OF INCORPORATION

Despite the fundamental principle laid down in the case of *Salomon v. Salomon*, concluding that a company is an entity distinct from, and not an agent of, its shareholders, and aside from the aforementioned exceptions to the principle of corporate personality, there are certain instances in which courts have intervened to disregard the principles of incorporation. Thus, even if the company is incorporated as a limited entity, providing immunity to its members under normal circumstances, judicial practice has led to instances where courts have interfered and imposed personal liability upon the members of the limited company.

The interference by courts is referred to as *lifting the veil of incorporation* which means that the main principles of incorporation of limited companies are set aside and the members of the company are entitled to undertake personal liability for the company’s obligations. This includes situations where an agency relationship exists between the company and its shareholders, and where the corporate form is used as a mere sham or a façade to conceal the true facts, thus it is used for the only purpose of shielding the individual members of the company from liability of tort, contract obligations or statutory duties.

The practice of courts being able to lift the veil of incorporation is well established in the common law jurisdictions. Contrarily, the practice is vaguely established in the Nordic jurisdictions and it is therefore uncertain how the courts will elaborate on this matter and establish liability upon members of limited companies which reach beyond the statutory limitation. In Denmark, however, a non-statutory principle is assumed to exist for the courts to lift the veil of incorporation and consider the

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66 An example is when a parent company is in close connection with its subsidiary and has to set up mutual bank accounts displaying the companies’ corporate affairs (Björgvinsdóttir, 2008).

67 In Danish case of *Midtjys Festival-case U 1997.1642 H*, the court did not find that the economy of the majority shareholder and the company was blended and therefore the shareholder was not jointly liable for the company’s debt. Instead, the court found there to be a mix of assets with the sister company and thus they were both liable for the debts of the company. Here, the principle was not used on a shareholder but a relationship of a sister company. However, the case has been discussed later and has not been followed by other cases (Krüger-Andersen 2010, p. 506).
members of the company personally liable or bound by obligations of the company (Werlauff 2009, cited in Christensen 2010, pp. 184-185). Although such a non-statutory principle is assumed to exist, no actual court decision has recognised such a principle that allows courts to set aside the shareholders’ limited liability. Thus, the following discussion refers mostly to UK procedures where courts have established principles upon determination regarding occasions when the veil may be lifted, in order to provide guidance of the matter to any future proceedings in the Nordic jurisdictions.

2.3.1 Corporate groups

The growing complexity of modern business structures has generated concepts like corporate groups. Corporate groups usually consist of a parent company and its subsidiaries, which in turn can have their own subsidiaries, and the parent is usually a sole shareholder. Although the principle of corporate personality is the general rule of subsidiaries, legal procedures have been developed in order to disregard the corporate personality and identify one company’s business conduct with another, particularly regarding group structures. The problem with a corporate group is that the companies within the group are closely connected. Therefore, it can be hard to distinguish between them and the liability within.

The close relationship of companies in a corporate group can therefore lead to circumstances where courts can lift the veil of incorporation. This involves situations where the corporate form is being used as a vehicle to perpetrate fraud or to avoid pre-existing legal obligations of a parent company. Thus, in these instances, it is assumed that courts may look behind the corporate structure, identify a subsidiary with its parent and hold the parent company liable on the basis of vicarious liability for the acts of its subsidiary. The general principle is, however, that the behaviour of a subsidiary

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68 A similar principle appears to be recognised by courts under Icelandic law, although not clearly established. Under the Icelandic jurisdiction there is in fact only one case, the earlier mentioned case of Hrd. 1993:1653 (Mótorskip), where the practice has been established and the veil of incorporation seems to have been lifted by courts, for the purpose of placing personal liability upon the members of the company. It was however concluded by the court that the company was simply not incorporated as a limited company and therefore the practice of lifting the veil was not established clearly by the court. Cf. footnote #63.

69 The case of UfR. 1980.806 V (Frigor) can possibly be seen as such a case. However, it was seen as an avoidance of the rules of employee representation by establishing daughter companies and moving the employees thereto, in order to avoid employee representation. Thus, lifting of the veil of incorporation was not established clearly by the court.

70 Liability of a parent company in parallel to its subsidiary company can be established in two ways in most jurisdictions; either when the principle of corporate personality is being abused and the courts may lift the veil of incorporation, or when a subsidiary company is involved in human rights abuses and the parent company took part in conducting the abuses or was negligent in its surveillance (International Commission of Jurists 2008, p. 47).
cannot be identified with its parent, for the intention of assigning legal responsibility to the parent only (International Commission of Jurists 2008, p. 47).

2.3.2 Agency relationship

The doctrine of agency is sometimes relied on in an attempt to lift the veil of incorporation. It was confirmed in the case of Salomon v. Salomon\(^\text{71}\) that a company cannot be an agent of its shareholders, seeing as it is a registered entity, with a separate legal personality. Thus, the decision in this case confirmed that the principle of corporate personality precludes the possibility of a company, established as a legal entity and accepted as a separate legal person, to act as an agent. It acts in its own capacity and is responsible for its own actions. If the entity is not a separate legal person, it cannot be an agent at all. Thus, it is impossible to assume that a legal entity both does and does not exist.\(^\text{72}\)

In spite of this allegation in the case, an agency relationship can be established under exceptional circumstances (Ohrenstein 2009, p. 10). Following the decision in the Salomon case, as a general rule, courts have provided their decisions in judgements with the principle of corporate personality. Meanwhile, courts have also tried to keep a watchful eye on any abuse of the corporate form and disregarded the corporate personality under such circumstances.\(^\text{73}\) In certain situations, evidence of an obvious agency relationship between a company and its shareholders can lead to the veil being lifted by the courts. This is of particular importance in corporate groups where the parent company uses its subsidiary to execute its tasks and take on responsibility that follows from the execution. The parent is naturally reluctant to admit any agency relationship in order not to incur any liability from its subsidiary’s acts (Hannigan 2003, p. 67). This was evident in the case of SS&K v. Birmingham Corporation (hereinafter referred to as SS&K) where the court was willing to lift the veil of incorporation on the grounds of an agency relationship between the company and its


\(^{72}\) Ibid. See chapter nr. 2.2.3 The separate legal person, and footnotes #44-46 & 48 for further discussion.

\(^{73}\) Considerations of Lord Denning in the case of Littlewoods Mail Order Stores Ltd v. Commissioners of Inland Revenue [1969] 3 All ER 855 at 860, in relation to keeping a watchful eye of the corporate form and situations where courts can lift the veil of incorporation:

‘The doctrine laid down in Salomon v Salomon has to be watched very carefully. It has often been supposed to cast a veil over the personality of a limited company through which the courts cannot see. But that is not true. The courts can and often do draw aside the veil. They can, and often do, pull off the mask. They look to see what really lies behind. The legislature has shown the way with group accounts and the rest. And the courts should follow suit…’
controller. The case confirmed an exception to the main rule laid down in the *Salomon* case. Despite being a subsidiary and incorporated as a legal entity with corporate personality, the court brought forward a *test of agency* in the case which was based on control. Thus, it was examined who was in fact controlling the executed tasks of the subsidiary. The test provided evidence of the subsidiary being a part of the parent, which only executed its tasks as an agent and was sufficient for the veil of incorporation of the subsidiary to be lifted and hold the companies as the same entity. Several cases have been critical on the test and have claimed that the concept of control is not sufficient to create an implied agency between the company and the controller. The test was moreover criticised by *Judge Besanlo* in the case of *SS&K*, as he pointed out that the element relating to profits was an important factor in determining agency. The rest of the elements laid down in the test related to control, which has been deemed an insufficient permission for courts to lift the veil. The fact that the subsidiary in this case was just an empty shell, without a running business, has been assumed to have made the application of the agency test easier for the court in order to lift the veil of incorporation.

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74 The case of *Smith, Stone & Knight Ltd v. Birmingham Corp* (1939) 4 All ER 116 has been viewed as a landmark case for courts to lift the veil of incorporation on grounds of agency relationship between the company and its controller. The facts of the case were that Birmingham Corp. (B) had shown interest in buying a land from SS&K for establishment of a university on the land. SS&K wanted compensation for expropriation since its subsidiary was running business on the land and obviously would have to move its business. SS&K raised its claim on the ground that there was only an agency relationship between it and the subsidiary. The court laid down criteria and considered which of the companies in the group was in control of the business, which persons exercised the tasks of the corporation and which profits was it. The court concluded that the control of the parent over the subsidiary was overwhelming and the profits were of the parent. Therefore the subsidiary was in fact an agent, an essential part of the business conducted by the parent and on those grounds SS&K was granted the right to file claims for expropriation.

75 Ibid. Judge Atkinson noted that an agency relationship will exist between a parent company and its subsidiary on the basis of answering all of the following six questions affirmatively and therefore granting the court to lift the veil of incorporation:

- Were the profits treated as the profits of the parent?
- Were the persons conducting the business appointed by the parent?
- Was the parent the head and the brain of the trading venture?
- Did the parent govern the adventure, decide what should be done and what capital should be embarked on the venture?
- Did the parent make the profits by its skill and direction?
- Was the parent in effectual and constant control?

76 An Australian case of *ACN 007 528 207 Pty Ltd (in liq) v. Bird Cameron (Reg)* [2005] 91 SASR 570, is an example where the agency test has been criticized in a Common law jurisdiction.

77 ‘...the only evidence of its purportedly independent existence was its name on the stationery...’ (*Smith, Stone & Knight Ltd v. Birmingham Corp* (1939) 4 All ER 116)

78 In the case of *Tate v. Freecorns Pty Ltd* [1972] WAR 204, the court noted that the existence of an agency relationship between a subsidiary and a parent company is not necessarily determined by the concept of control. Despite control exercised by the parent company, some courts consider the fact that the subsidiary is running its own independent business to emphasize that there does not exist any agency relationship.
Thus, the agency test laid down in the case of SS&K is still unsettled and can no longer be viewed as a complete statement of the law. A later case of DHN v. Tower Hamlets\textsuperscript{79} also influenced the determination of agency relationships, although the court did not confirm a clear test in this regard. The case concerned a corporate group, where a subsidiary of DHN owned land which another company within the group issued a compulsory purchase order on. The court recognised the group as a single economic entity and therefore held that DHN was able to claim compensation. However, the members of the court were influenced by different factors and, thus, the reasons for the decision were unclear. One member justified the decision by noting that the subsidiaries were fully owned by their parent, another mentioned that the companies within the group shared common interests, shareholdings and directors, and a third member noted that not all corporate groups would be treated in this way, and referred to ownership and the fact that the companies had no business operations outside the group.

Despite various justifications for the determination of agency relationships in the earlier cases, wholly owned subsidiaries have not been identified in later cases as a single economic entity along with their parents, on the same reasons as were given in DHN v. Tower Hamlets.\textsuperscript{80} The decision has also seemed to run counter to many court decisions in other common law jurisdictions (Ohrenstein 2009, p. 11). In the case of Woolfson v. SRC,\textsuperscript{81} an agency relationship was declined by the court. The company in question was considered a separate legal person and not controlled by its shareholders as principals. The decision of DHN was not followed by the court, and an agency relationship was not acknowledged.

The landmark case of Adams v. Cape Industries emphasised that courts could only lift the veil of incorporation under very limited circumstances.\textsuperscript{82} The key question in the case was whether the

\textsuperscript{79} DHN Food Distributors Ltd v. Tower Hamlets London Borough Council [1976] 3 All ER 462.

\textsuperscript{80} Lonrho Ltd v. Shell Petroleum Co Ltd [1981] 2 All ER 456. The court abolished the arguments laid down in DHN and considered them not satisfying for the determination of an agency relationship.

\textsuperscript{81} Woolfson v. Strathclyde Regional Council, [1978] 248 E.G. 777. The facts of the case regarded the right to expropriation, which the shareholders claimed on the grounds of an agency relationship. Agency relationship was refused and therefore the company itself had the right to expropriation, not its shareholders.

\textsuperscript{82} The case of Adams v. Cape Industries plc [1990] Ch 433, was a landmark case in UK company law regarding the principles of corporate personality and limited liability of shareholders. Cape was registered English public limited company, a parent of many subsidiaries running business of mining and marketing asbestos in the U.S. One of the subsidiaries was sued in U.S. jurisdiction for personal injuries of workers arising from the inhalation of asbestos in a factory. The parent, Cape, protested that the Court had jurisdiction where the case was filed. Meanwhile, the presence of Cape and its subsidiaries in the U.S. had been reorganized for tax purposes and other liability issues, by selling the asbestos business in the U.S. and leaving no assets in the subsidiary, which claims was raised against. As no assets existed to cover the claims, Adams the plaintiff, sought the enforcement of the U.S. default judgement for English courts against the parent and claimed that the corporate group was a single economic unit.
parent company could be considered present within U.S. jurisdiction via its conduct or its subsidiaries. Thus, in order to do that [1] the court would have to lift the veil and consider Cape and its subsidiaries one single economic entity, [2] the incorporation of the subsidiaries would have to be a sham, or [3] its subsidiaries must have acted as Cape’s agents. When considering these assumptions, the court decided that it could not disregard the corporate personality of the subsidiaries and consider the corporate group one single economic entity. The court stated:

Save in cases which turn on the wording of particular statutes or contracts, the court is not free to disregard the principle of Salomon v. Salomon & Co Ltd [1897] AC 22 merely because it considers that justice so requires. Our law, for better or worse, recognises the creation of subsidiary companies, which though in one sense the creatures of their parent companies, will nevertheless under the general law fall to be treated as separate entities with all the rights and liabilities which would normally attach to separate legal entities.83

When the court considered the application of the agency principle, it was noted as a general rule that a subsidiary is not an agent of its parent. However, the actions of the subsidiary would bind the parent if it was in fact an agent of Cape and acted within its actual and apparent authority. The court concluded that the U.S. subsidiaries were independent entities, free from the day-to-day control of its parent and with no general power to bind the parent. Although a parent exercises supervision and control over its subsidiary in a foreign country, Cape could not be present in the U.S. through its subsidiary which conducted business in its own right, since no circumstances could allow for the veil to be lifted.

Finally, when determining an agency relationship, it is relevant to consider the purpose for which the relevant company structure was created. A subsidiary can be deemed an agency relationship when obviously used as an extension of its parent and executing its tasks for tax purposes only.84 In the case of Pioneer Concrete Services v. Yelnah Pty Ltd,85 the view-point in Cape was confirmed as it was concluded that the veil should only be lifted where there was in law or in fact an agency relationship between the companies, or where the company was only a mere sham or façade.

83 Ibid.
84 FG (Films) Ltd [1953] 1 All ER 615. In the case, an American holding company produced a film and set up a British subsidiary, in order that it might be classified as a British film and thereby might grant the holding company certain tax privileges. The Board of Trade refused to register the subsidiary as such, and the matter came to court. It was held that the British company’s participation in the making of the film was so small as to be practically negligible, and that it had been brought into existence for the sole purpose of being put forward as having made the film, and for thus enabling it to qualify as a British film, and that therefore there was a relationship of agency.
85 Pioneer Concrete Services v. Yelnah Pty Ltd [1986] 5 NSWLR 254.
2.4.3 Pro forma establishment

Courts have confirmed repeatedly that the principle in the case of *Salomon* may not be used as a vehicle for fraud, or with the purpose to avoid pre-existing legal obligations. Thus, when a limited company is incorporated only to hide the real purpose behind it, the corporate personality can be put aside by lifting the veil of incorporation. In the aforementioned case of *Woolfson v. SRC*, the court laid down criteria to determine abuse of the corporate form. The House of Lords deemed it appropriate to lift the veil of incorporation only under special circumstances which indicate that the corporate structure is a mere façade concealing the true facts. As the company was already declined to be an agent, the House of Lords could not determine that Woolfson and its subsidiary were a single economic entity on the grounds of the criteria laid down in the case, and thus the corporate personality of the company had to be observed.

The possibility of the corporate form being used as a vehicle for committing fraud has led to statutory provisions being enforced and courts intervening to hinder such a sham and abuse of the corporate form. It was furthermore confirmed in the case of *Standard Chartered Bank v. Pakistan National Shipping Corp* that a director, being an agent of the company, was not granted immunity for his acts while he executed fraud on behalf of the company. The key element in the decision was deception as the cause of action, and therefore it was unnecessary to provide any special relationship or assumption of responsibility between the wrongdoer and the claimant. However, the mere fact of fraudulent activity does not raise a sufficient basis for lifting the veil and imposing liability on the members of the company; other elements must be provided (Ohrenstein 2009, p. 6).

Another instance of hiding the real purpose of a company is when a legal entity or an individual tries to avoid legal obligations or liabilities to a third party by incorporating a subsidiary and thereby using its corporate structure to hide behind the principle of corporate personality. If a company is incorporated with this purpose, to mask the identity of its shareholders, providing them

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86 Cf. footnote #81 (*Woolfson v. Strathclyde Regional Council*, [1978] 38 P & CR 521, HL). It was confirmed that in order to lift the veil, avoidance from legal obligations or other liabilities towards a third party would be required.

87 In the case of *Re Darby; Ex Parte Brougham* [1911] 1 KB 95, the court lifted the veil of incorporation where the establishment of the company was clearly for perpetrating fraud.

88 The possibility of using the corporate form as a facade to conceal the true facts or to perpetrate fraud, has lead to the introduction of provisions in several British legal statutes that function with the aim of disregarding the doctrines of limited liability and corporate personality. Examples of provisions are for instance s.994 UKCA against unfair prejudice and ss.213-215 of the UK Insolvency Act 1986 regarding fraudulent trading and wrongful trading.

with security from their obligations, the courts may lift the veil of incorporation and consider the companies a single economic entity.\(^{90}\)

The case of *Jones v. Lipman\(^{91}\)* was another departure from the principle of corporate personality, resulting in the veil being lifted. A contract of land was signed by Lipman as the seller. Seeing as the transaction was not completed, Lipman changed his mind about the sale and wanted to annul the agreement. In order to avoid the sale, Lipman formed a company and transferred the land into the company instead. Thereafter, he claimed that he could not comply with the contract as he no longer owned the land. Thus, the court looked behind the corporate veil and considered the newly established company nothing but a mask for Lipman to avoid recognition of the contract. Therefore, a specific performance of the contract was ordered for enforcement of the contract and completion of the sale. Clement Chigbo (2007) believes, however, that it would have been difficult for the court to reach the same conclusion if Lipman had passed the land to another company in which he had no interest; a company which had no knowledge of the contract between Lipman and Jones. He further claims that there was no illegality as the newly established company was validly incorporated; instead, it was Lipman’s motive for trying to avoid liability by using the corporate form which led to the court’s view of the company as a mere façade.

Similar circumstances characterised the case of *Creasey v. Breachwood Motors Ltd\(^{92}\)* where third party liability was avoided by the formation of a new company. A former director intended to file claim against Breachwood to pay entitlements arising from wrongful dismissal. In the meantime, and in order to avoid paying Creasey damages, Breachwood formed a new company and transferred the entire business of the old company to it. However, the court allowed for the substitution of the new company for the old one as defendant in Creasey’s claim. The court lifted the veil and considered Breachwood and the newly formed company one economic entity and thus liable for paying entitlements to Creasey on the grounds of deliberately transferring assets, though fully aware of the previously filed claim. The newly formed company was therefore concluded to be a mere sham which formed the underlying basis for the lifting of the veil.

\(^{90}\) In the case of *Gilford Motor Co Ltd v. Horne [1933] Ch. 935*, the newly formed company was considered as a mere sham and that it had been used by Horne to avoid his contractual obligation to his previous employer. According to his resignation contract, Horne was forbidden to solicit customers from his former employer, Gilford Motor. Horne however, established a new company, which subsidiary was in competing business with Gilford Motor and thereby soliciting its customers. As the only shareholders of the company were Horne, his wife and another former employee of Gilford Motor, the court granted an injunction against Horne and the company with the purpose of enforcing the resignation contract and preventing the use of a customer list which belonged to the former employer.

\(^{91}\) *Jones v. Lipman [1962]* 1 WLR 832.

\(^{92}\) *Creasey v. Breachwood Motors Ltd [1992]* BCC 638.
The decision of Creasey was rejected and considered to be wrong in the case of Ord & Anor v. Belhaven Pubs Ltd, where the claimant was denied substitution of the defendant’s parent company on the grounds that the original company had not been a mere façade for the holding company, nor vice versa. Contrary to the subsidiary company in Creasey, neither had the company been established as a sham to avoid obligations nor had there been any element of asset stripping. Thus, the veil could not be lifted as there were neither evidence of the company being a mere sham nor were there evidence of deliberate intention to avoid the obligations (Ohrenstein 2009, p. 7).

This may be comparable to the decision in the aforementioned case of Cape where the court recognised the test of mere façade as a well-established exception to the principle of corporate personality laid down in the case of Salomon. The court in Cape referred to the case of Jones v. Lipman and pointed out the motive of those behind the alleged façade as a crucial factor for determining whether a company is a mere façade. Although Cape’s motive was to try to minimise its presence in the U.S. for tax purposes and other liabilities, which might render the company morally culpable, the court noted that there was nothing legally wrong with this. On those grounds, Cape and its subsidiaries could not be considered a single economic entity.

2.3.4 The façade test

When comparing the cases of Adams v. Cape and Jones v. Lipman, it is obvious that the deliberate motive of avoidance appears crucial in the latter case, while it does not in the former. Despite pointing out the possible moral culpability of Cape, the court finds the avoidance of liability irrelevant in the case and the mere façade test would, therefore, not apply (Clement Chigbo, 2007).

The decision in Cape revealed the court’s reluctance to lift the veil in the absence of a sham. It will certainly not be lifted simply because justice requires it. The case of Cape has dominated the case law since, and this seems to be the continuing view in earlier judgements. The view was also indicated in the case of Williams v. Natural Life Health Foods Ltd in which negligent advice given

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94 Ibid. Hobhouse LJ, giving the judgement of the court, stated: “There may have been elements in that case [i.e. Creasey] of asset stripping. I do not so read the report of [Richard Southwell QC’s] judgement… But it seems to me to be inescapable that the case in Creasey v. Breachwood as it appears to the court cannot be sustained. It represents a wrong adoption of the principle of piercing the corporate veil and an issue of the power granted by the rules to substitute one party for the other following death or succession. Therefore in my judgement the case of Creasey v. Breachwood should no longer be treated as authoritative.”
by a director on behalf of the company was not believed to incur personal liability, since it could neither be shown that the director had assumed personal liability when giving the advice, nor had the claimant reasonably relied on that assumption of responsibility. These tests were not met, because there had been no personal contact between the director and the claimant, and therefore the veil could not be lifted. When comparing the case of Williams with the case of Ord, neither case involved a company being considered a façade. As Ohrenstein (2009, p. 9) asserts, the case of Ord should not prevent the veil from being lifted in cases where there is a sham or façade. Accordingly, and as recent practice has revealed, the main principle is still that the courts will be willing to lift the veil of incorporation in cases where there is a sham or a company which is only acting as a façade concealing the true facts.

When taking all this into consideration, it is important to identify shams or façades in order to lift the veil of incorporation. However, such identification can be difficult, as courts have been reluctant to provide precise guidelines on how to identify a sham or façade. Based on the aforementioned judicial practice and the rationale of the law in general, Ohrenstein (2009, p. 9) provides a useful criterion to be employed in support of such identification; the sham or façade test:

i. Are the relevant entities in common ownership?
ii. Are the relevant entities in common control?
iii. Was the company structure put in place before or after a particular liability (or serious risk) arose, and if the latter then to what extent was the liability or risk a motivating factor for those who set up the structure?
iv. Was the company structure put in place in an attempt to allow an activity which would be unlawful if carried out personally?

Thus, by relying on this test, the courts can easily determine whether the veil can be lifted on the grounds of the presence of a sham or a façade. When the UKCA was passed in 2006, the parliament deliberately left this topic alone and did not use the opportunity to try amending the principle. Apparently, the courts seem to have very little enthusiasm for such revision either (Ohrenstein 2009, p. 15).

2.3.5 Summary

One can assume from the previous discussion that courts will hold tight to the landmark decision of Salomon v. Salomon and be attracted to resolutions which allow the corporate veil to remain intact. Thus, most direct assaults against the principle of corporate personality will likely struggle to succeed (Ohrenstein 2009, p. 15). Although limited entities will be preferred to remain, by honouring the fundamental principles of the limited company form, the corporate personality can and will be set aside.
by courts under certain circumstances. These instances involve either *agency relationship*, or *pro forma establishment* of a company in order to conceal a fraudulent conduct or to avoid obligations.

When considering the abovementioned principles and criteria established, with regard to the recent judicial development, an agency relationship will only be established when special circumstances apply. The present position seems to be that the courts are unwilling to lift the veil against corporate groups unless there is a clear agency relationship, e.g. where a parent can be assumed in an obvious control over its subsidiary, on the grounds of lack of clarity in the subsidiary’s structure, where an agreement of agency is established between companies, or where a company has obvious powers to carry out binding acts on behalf of the parent etc.

In the absence of an agency relationship, it is necessary to identify the company as a sham in order to lift the veil of incorporation. The judicial procedure has varied through the years and led to different criteria for the purpose of such determination. However, the concept of shams is vague and the identification of one seems to be somewhat difficult to obtain, and courts are more reluctant to lift the veil than ever before. However, the judicial practice and the methods used, reveal the most important elements in determining whether a company is a *mere façade concealing the true facts*.

Due to limited judicial practices lifting the veil of incorporation in the Nordic countries, the aforementioned criteria and tests can be an important guidance for the courts in the Nordic jurisdictions, as a number of cases questioning the liability of shareholders will increase. This would be a normal procedure, as courts commonly seek advice and look for precedents in the nearest jurisdictions when the law is unclear and their judicial experience is limited. Thus, one can assume that the Nordic courts will be able to elaborate on the praxis of lifting the veil in a way that is similar to the British courts.

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97 *Cf.* footnote #6.
PART 3 - SHADOW DIRECTORSHIP

3.1 INTRODUCTION

3.1.1 Important role of directors within limited companies

While the limited company is considered a separate legal person, it only has a legal existence. Thus, the management of a limited company must be entrusted to natural persons – the company’s directors. A director is empowered under the company’s articles of association to direct, and to share responsibility with the other directors for, the governance of the company’s affairs (Harper 2006, p. 189). Thus, directors serve a very important role within limited companies which is reflected in their onerous duties towards the company.

As a consequence of the important role of directors, they can be held liable for the decisions conducted on the company’s behalf, if they turn out to be in breach of their duties or if the decision in any other way does not aim at the interests of the company as a whole. This is reflected in the fact that directors are liable through simple negligence in their acts, while shareholders can be liable through gross negligence. Thus, they can be held personally liable if they do not act within their capacity and can be subject to claims for any damages against the company.

Considering all of the aforementioned, it is of great importance to distinguish and determine who the courts will hold to be a director and subject to the duties and liabilities that follow. It is of even greater importance to analyse how the alleged directors can face liability as one, and from which situations director liability arises (Hobson 1998, p. 3).

98 Conducting the business without due care, i.e. failing to take every step to minimise loss to creditors once the person in question knew or ought to have known that the company was unlikely to avoid insolvent liquidation, or contrary to the company’s articles of association or the law in general, would be considered wrongful trading, which can render an individual member of the management liable to the company, seeing as the duty is not the members’ collective responsibility (Hansen 2003, p. 118). The same would apply when the members of the management organs conduct fraudulent trading, i.e. when they carry out acts with the intention to defraud the creditors by incurring debts while the company was insolvent, such as entering into new obligations under financial distress, knowing that the company’s difficulties would not enable it to meet its obligations in time.
3.1.2 Acting as a director

As asserted earlier, it is often not until limited companies have come into financial difficulties and have become insolvent that the question of liability arises. When a company has reached its inability to fulfil its obligations in time and become insolvent, the creditors will seek to get their claims and file for insolvency proceedings. Without filing for insolvency proceedings the creditors risk receiving lower repayments for their loans from the insolvent company’s assets. As mentioned earlier, the principle of insolvency law is an equal treatment of the creditors of the insolvent company and classification in between them. If the principle of equality has been disregarded under the proceedings, or from the time when the company became insolvent, personal liability can be imposed upon the directors of the insolvent company for any harmful acts. Thus, the directors must act with due care in order to guard the interests of the company as a whole, not the interests of individual shareholders. In order to fulfil their duties, they must exercise independent advice and seek to prevent further losses for the company.

Under circumstances of financial difficulties, there may be others, aside from the members of the management, who have participated in the decision-making of the company’s affairs and conducted harmful acts, simply by acting as a director or exercising excessive influence over the management of the company. Thus, the company’s directors may have been incentivised by those persons to take on excessively risky projects in order to guard the interests of the influencing party. The interests of the company and, at the same time, the creditors can therefore be disregarded, often for the benefit of the influencing party. Consequently, the directors become liable for breach of their duties as they act in the interests of a third party and disregard the interests of the company as a whole. In order to avoid such instances, those interlopers, the persons who interfere with the decision-making within a limited company, must be identified in order to impose liability upon them for not having protected the company’s capital and thus jeopardised the interests of the company as a whole.

As the law imposes onerous duties and responsibilities on the management of limited companies, it must be natural to conclude that those who are in possession of real control over the company may be proper individuals, designated as directors of the company, and they may be held liable as such in case the business was not conducted in a responsible way. That seems to be the rationale of the

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99 The reason for the switch and intense duties under insolvency is that creditors do not receive any higher returns as the shareholders do if the company generates profits, and they are very reluctant to accept losses as that may reduce their possibility of receiving full returns of their claims (Wood 2008, p. 67). Therefore, it is considered normal to protect the interests of the creditors on insolvency.
law, whether by statutory provisions or a judicial practice, in all of the jurisdictions in question, although the profoundness of the practice varies between them. The law is, however, far from settled when it comes to who can be considered a director and how he can be designated as one (Topp and James 2004).

Although the Nordic jurisdictions have very limited experience in establishing director liability upon a person who has acted as a director without being one, the basic procedural principles do not seem to differ between the jurisdictions in question. The common law system has developed a comprehensive judicial practice for designating a person as a director, upon whom all the duties and liabilities of the duly appointed directors are imposed. In order to establish director liability of a person who is not appointed as such, but nevertheless acts like one, it is of paramount importance to analyse who can become a director and how directorship can be established.

The following chapters will reveal the recognition of the judicial practice which establishes the possibility of an outsider being able to assume the role of a director and become subject to the many duties and liabilities applying to the directors of the company. This can involve shareholders, parent companies or other stakeholders of the company, which act as directors or are in the position to influence the management excessively and, therefore, can be designated as one. Thus, the duties and liabilities of the management can be incurred upon a person, who is neither appointed as a director nor entitled to act as one, but who still exercises effective control over the management as a regular director of the company.

3.1.3 Different types of directors

As previously analysed, the directors of a limited company must manage the business affairs of the company in a responsible manner and in the interests of the company as a whole. Determination of directors is not always clear from the law, since the definition of the term director varies from one jurisdiction to the other, and designation of directors, aside from the duly appointed ones, is often only interpreted from the law by the courts.

Within limited companies, there are different types of directors which can be categorised into classes in accordance with the power they possess and their recognition as directors. This division of directors is recognised in all of the jurisdictions in question, although only to a limited extent in the Nordic jurisdictions. The categorisation of directors does not however lead to any difference in
their liability standard, and this is assumed to apply in all of the jurisdictions in question (Davies 2006, p. 312).

3.1.3.1 De jure directors

The first type is the regular directors of limited companies, known as de jure directors. They are validly appointed to the board of directors by the shareholders at the general meeting and hold the fundamental responsibilities for the company’s business affairs. De jure directors are the persons who the members of the general meeting trust will run the company in the best interests of the company as a whole. The directors are registered in the national companies’ register and entitled to the rights and obligations laid down by the company’s articles of association and the general provisions of applicable law.

The one who occupies the position of a director usually carries the term director in his title. Nonetheless, under the UKCA, the term director is given a broad scope and said to include any person occupying the position of director, by whatever name called, and, therefore, it can involve anyone who seems to manage the company’s affairs like a director, even if he holds a different title. Thus, the provision makes it clear that the title is not the determining factor when it comes to deciding whether someone might be a director (Hannigan 2003, p. 135). The provision is further interpreted in Girvin et al. (2010, p. 315) who state that despite the current view that the provision applies to persons properly appointed as directors but who may operate under a different title, e.g. as governor, it is a common understanding and a normal interpretation of the provision that it allows for others who are not lawfully appointed as directors to be regarded as such.

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100 A ‘de jure director’ is a director who has been validly appointed in the position pursuant to the company’s Articles of Association (Markovic 1996).
101 Section 250 of the UKCA defines a director: ‘In the Companies Acts “director” includes any person occupying the position of director, by whatever name called.’ Equivalent definition of directors is neither to be found in the ISCA nor the DKCA.
102 Ibid. The explanatory notes of section 250 of the UKCA, state that the section does not attempt a more detailed definition of a director from the previous act (the UK Companies Act, 1985) because it is deemed important ‘to ensure that the term is applied to anybody who exercises real power within the company, particularly in relation to decision taking. The term “director” therefore includes:
- an executive director who has been properly appointed by the company;
- a non-executive director who has been properly appointed by the company;
- a de facto director (that is, a person who has assumed the status and functions of a company director even though he has not been properly appointed).’ (Explanatory notes p. 42, part 10, article 278)
103 Ibid. The Explanatory notes refer specifically that the term director includes de facto directors, see further previous footnote. The purpose of the Explanatory notes is clear; ‘to assist the reader in understanding the Act. They do not form part of the Act and have not been endorsed by Parliament.’ Furthermore; ‘The notes need to be read in conjunction with the Act. They are not, and are not meant to be, a comprehensive description of the Act. The notes need to be read in
person, who is not a lawfully appointed director, may therefore incur the same liabilities as a de jure director, by virtue of the management control which that person exercises. Thus, those who have not been properly appointed as directors, but who nonetheless exercise real influence over the company, will generally be subject to the liabilities of regular directors, just as if they had been properly appointed as regular directors. They can be categorised as so-called de facto directors and shadow directors.

3.1.3.2 De facto directors

Those who act as if they were directors of a company, without being lawfully appointed, are known as de facto directors. These persons become responsible as directors by assuming the status and the functions of registered directors (Hannigan 2003, p. 139).\(^{104}\) An essential characteristic of a de facto director is his intention to act as a director, whereas he purports to be a director of the company and is approved as one at the outset. It can be sufficient if he presents and describes himself as a director of the company on the surface or simply carries the title;\(^{105}\) although only using the title can never be sufficient for determination.\(^{106}\)

The question of whether someone can be designated as a de facto director is likely to arise when a person avoids obligation or liability as a director, laid down by statute, by relying on the fact that he is not a de jure director.\(^{107}\) The general assumption is that the acts of a director are legally binding

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105 In the case of Re Kaytech International plc, Secretary of State for Trade and Industry v. Kaczer [1999] 2 B.C.L.C. 351, CA, it was sufficient that the alleged director had only used the title or simply described himself as a director on the outside. The Court of Appeal had no problem of considering the person in question as a de facto director, even though he did not in fact consider himself to be a regular director of the company. The individual had assumed the status and functions of a director, and exercised influence over the corporate governance of the company by being a moving spirit in setting up the company, pretending to raise the capital and variously describing himself as a director and as chief executive.

106 In the case of Secretary of State for Trade and Industry v. Tjolle [1998] 1 B.C.L.C. 333, it was concluded that an employed manager by a holiday company who sometimes attended board meetings without being involved in any financial matters or had no access to information of the company’s accounts, was not a de facto director as he was never in a position of real power, despite having carried various titles within the company, including sales and marketing director and deputy managing director.

107 Hannigan (2003, p. 140) discusses ‘whether a particular statutory provision applies to a de facto director, having assumed the position of a director, is subject to the fiduciary and other duties of a director.’ She claims that ‘it would seem that a de facto director, having assumed the position of a director, is subject to the fiduciary and other duties of a director.’ She furthermore clarifies the position by referring to The Company Law Review, (Company Law Review, Final Report (2001) para 6.7), which intends that its proposed statutory statement of directors’ duties will apply to de facto and shadow directors.
irrespectively of any defect that may be revealed in his appointment or qualifications at a later point in time. Thus, a person who appears to be lawfully appointed and of minimum qualifications, with respect to the powers he exercises, must be assumed to be a director by any third party.\textsuperscript{108} This implies that a person who attends and participates in board meetings is just as much a director as a duly appointed one. Via the actions and intention of such persons, courts have recognised them as directors for the purpose of imposing the same liability or restriction upon them as other lawfully appointed directors.\textsuperscript{109}

Determination of a de facto director is usually effortless, since the alleged director purports to be a director at the outset, and he often considers himself one in relation to the duties and responsibilities of general directors. Based on their actions and apparent intention, those who act as de facto directors are usually fully aware of their obligations and liabilities as directors of a company. Thus, when disqualified or in breach of their duties, liability is imposed upon them, often without any rejection on their part. This, however, is not always the case; there may for instance be situations in which the alleged director refuses to be a director or to have acted as one. It can therefore be necessary to provide evidence of directorship in order to determine that these persons are de facto directors and thus impose liability upon them.

Due to the problems that can arise, British courts have established certain tests to determine whether a person has assumed the status and function of a director and thereby become a de facto director (Girvin et al. 2010, pp. 315-317). An important element in the determination is whether the person has in fact purported to be a director of a company. In the case of Hydrodam,\textsuperscript{110} it was considered insufficient that the person in question, who acted as a director, was only implicated in the company’s management or that he undertook tasks that only could be performed by the directors on the board. The court deemed it necessary [1] that the alleged director was accepted as a director by

\textsuperscript{108} A de facto director must therefore be treated as a de jure director. It is possible that a de jure director, is in fact a de facto director, as that person might discover that there was a defect in his appointment at a later point of time, and therefore he has only acted as a regular director without being lawfully appointed as such. (Anon 2010)

\textsuperscript{109} Determination of de facto directors is well established in the common law jurisdictions, both by statute and case law (Wood 2008, pp. 73-74), as the discussion reveals. The Nordic countries have a very limited number of judicial examples regarding the issue, although courts have increasingly focused on providing similar measures to impose director liability upon persons who are not lawfully appointed as directors.

\textsuperscript{110} Hydrodam (Corby) Limited, Re [1994] 2 B.C.L.C. 180 at 183. Hydrodam was a wholly owned indirect subsidiary of Eagle Trust plc. It became insolvent and was being liquidated. The company liquidator filed claims against several defendants on the grounds of wrongful trading provision in UKIA, section 214. Two of which defendants were duly appointed directors of the parent company and evidently not of the subsidiary, Hydrodam. It was nevertheless argued that these two directors were in fact directors of Hydrodam, and were therefore personally liable. The court therefore had to determine on the matter.
the company, [2] that he *claimed and purported to be a director* himself, and [3] that he *undertook tasks* in the affairs of the company which *could only be properly discharged by a director of the company*. Aside from accepting a person as a director, the company can also claim at the outset that the person is a director of the company. If so, and with the connivance of the alleged director, this is considered sufficient in order to determine that the person in question is a *de facto director* (Girvin, et al. 2010, p. 317).

The test laid down in *Hydrodam* was developed further in a later case of *Richborough Furniture Ltd*, where the previous requirements, in the terms of making one liable as a *de facto director*, were redeemed significantly, and where clear evidence was considered an important element for the determination of a de facto directorship. The court found it necessary ‘*to have a clear evidence that the person in question had either been the sole person directing the company*’ or, if others were lawfully appointed as directors, ‘*that he was acting on an equal footing with the others in directing the company*’.

In a later case of *Tjolle*, the English court found it difficult to formulate a single test in terms of making a person a *de facto director*. The requirements provided in the case partially combined the requirements set forward in the two earlier mentioned judgements. The court found it important [1] to provide *evidence of activities* which could only be discharged by a director and, additionally, [2] that the alleged director was the *sole person directing the company* or that he acted on an equal footing with the other directors. A person who has proper information on which to base decisions, and who actually makes major decisions within the company as a normal director, can therefore be determined as a de facto director. A consultant or an adviser hired by the company can therefore be designated as a de facto director, if he is given excessive powers in the business to take on tasks entitled to the registered directors and make decisions, which clearly exceeds his authority in advisory work. It was therefore proven in the case of *Tjolle* that there is no single decisive factor.

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111 This view was confirmed in the recent case of *Shepherds Investments Ltd v. Walters* [2007] 2 B.C.L.C. 202.
113 Ibid.
115 This was confirmed in the case of *Re Tasbian (No.3)* [1992] B.C.C. 358, where an accountant was considered a de facto director of the company and liable as a de jure director. The accountant was hired to assist in the business of Tasbian Ltd and to get the company on right track to generate profit. The accountant got very powerful in his role and his approval was needed for all payments. He was leading in the company’s contracts and reorganization of the business. Thereby, he exceeded his powers as an advising accountant and became a de facto director since he took all decisions by himself and represented the company, thus fulfilling all requirements of a de facto director.
for the determination of de facto directors, and the elements mentioned above have proven inexhaustible.

The judgement in the case of *Keytech*\(^\text{116}\) confirmed the view set forward in the case of *Tjolle*,\(^\text{117}\) that it would be impossible to have one decisive test in determining whether a person can be designated as a de facto director. The court concluded that several relevant factors must be answered in the affirmative in the determination: [1] whether the person *assumed the status and the functions* of a regular director, [2] whether he *used the title or generally purported to be a director* of the company, [3] whether he *was presented as one* by the company, [4] whether he *had access to important information* and was able to participate in important decisions at board meetings.\(^\text{118}\) A single test applying to all cases would therefore seem unfair, as the circumstances in each case are different. Thus, *Keytech* provided that determination of a de facto director must be considered on a case by case basis, with due consideration of all relevant factors.

When taking all of the important factors of determination into account, the crucial factor that seems to connect all of the aforementioned tests is whether the alleged director was a part of the corporate governance structure and took part in decision-making and thereby acted as a normal director of the company (Hannigan 2003, p. 140).\(^\text{119}\) One particular act which amounts to a de facto directorship, however, does not necessarily signify that the person is still acting as a director. It is assumed that a de facto director can cease to be one, simply by ceasing to act as such. If it is difficult to establish

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\(^{116}\) *Keytech International plc, Secretary of State for Trade and Industry v. Kaczer, Re [1999] 2 B.C.L.C. 351.* The case is one of the most fundamental cases regarding *de facto directors* as thorough analysis of the determination of de facto directorship is set forward in the case and various instances are considered.


\(^{118}\) In the case of *Keytech International plc, Secretary of State for Trade and Industry v. Kaczer, Re [1999] 2 B.C.L.C. 351,* a public limited company went into voluntary liquidation, after having traded for a period of 1 year despite an estimated deficiency. Out of the three respondents, respondents 2 and 3 claimed that they were not directors of the company. The second respondent contended that he was merely the company secretary and was never appointed as a director of the company. The third respondent contended that he had signed a form giving his written consent to be appointed a director, but was never formally appointed as one. The Court of Appeals held here that to ascertain whether a person is a de facto director, the crucial question to be answered is whether he had assumed the status of a company director so as to make himself responsible as a de jure director. With regard to the second respondent, they had no doubt in holding that he was a de facto director, as he had been deeply and openly involved in the company’s affairs and business from the very beginning. Furthermore, on certain occasions he very blatantly acted as a director, and therefore, he was held to be a de facto director. The third respondent was also held to be a de facto director, as he held nominee directorships and was inactive in the performance of his duties. His honest but unreasonable belief that he was not a director was not a defence that could be taken up. The court went on to state that while determining whether a person is a de facto director or not, one must take into account all relevant internal and external factors, and these should be determined as a question of fact.

\(^{119}\) *Ibid.* In the case of *Keytech,* a person was designated as a *de facto director,* as he was involved in the company’s affairs to a significant extent, and took on relations and communications with the company’s creditors, suppliers and professional advisers.
clear evidence of the person’s conduct as a director or if it is uncertain whether the acts of the alleged director can be attributable to acting in a capacity other than that of a director, the person shall enjoy the benefit of the doubt (Girvin et al. 2010, p. 316).

### 3.1.3.3 Distinction between de facto directors and shadow directors

The latter category of persons, who can be designated as directors without being formally appointed as such, is the so-called *shadow directors*. They share many of the same characteristics as de facto directors, as they both exercise influence over the governance of the company (Girvin et al. 2010, p. 317). The distinction between the two categories, and the question of determination of the persons involved, will most often arise when liability is considered upon wrongful trading or disqualification proceedings (Hannigan 2003, p. 141). However, the distinction does not have any significance towards liability imposed upon them as directors.\(^{120}\) It is necessary, though, to distinguish between the two types of persons, as they are of opposite natures, and the requirements for determination of each category thus differ significantly.

British courts have made a clear distinction between a de facto director and a shadow director. The main difference between the concepts was emphasised in the earlier mentioned case of *Hydrodam*.\(^{121}\) While a de jure director is validly appointed, a de facto director is a person who claims to be a director of the company and acts like one at the outset without being appointed as one. On the contrary, a shadow director neither purports to be a director nor does the company hold him out to be a director. He exerts control from behind, as an interloper or a *puppet master*, by giving the directors of the company instructions according to which they are accustomed to act. In that way, he attempts to hide behind those who are in possession of the company’s official managerial powers. Therefore, and from the nature of the powers he exercises over the board of directors, a shadow director is said to ‘lurk in the shadows’; it is from this expression that the concept derives its title (Girvin, et al. 2010, pp.315-317).\(^{122}\)

The difference between the two directors lies in whether the alleged director conceals his influence over the company, or whether he prefers it to be in the open and blatantly acts like a director. A

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\(^{120}\) In theory, there is a common understanding that there is no necessity to distinct between the two concepts since it is irrelevant for the liability standard (Davies 2006, p. 312).

\(^{121}\) In *Hydrodam (Corby) Limited, Re* [1994] 2 B.C.L.C. 180, the court distinguished between de jure, de facto and shadow directors as the allegation was that two of the defendants were either shadow or de factor directors.

\(^{122}\) *Ibid.* In the case, the court stated: ‘A shadow director…does not purport or claim to be a director. On the contrary, he claims not to be a director. He lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself. He is not held out as a director by the company.’
shadow director prefers to exercise control behind others and does not purport to be a director, while a de facto director acts as a director and purports to be one by assuming the duties of the regular directors. To distinguish between the two, it can be assumed that a de facto director exercises his powers in a more obvious manner than a shadow director, since he purports to be one to begin with. Therefore, he would carry out all the functions of regular directors in the same way as a de jure director does, such as participating and even voting in board meetings. Conversely, a shadow director can neither be a member of the board of directors, nor can he participate directly in the decision-making procedure, as de facto directors can. Moreover, a de facto director often works with the regular directors and is accepted as one of them, while a shadow director would be directing and instructing the rest of the directors from a distance.

The determination of the two groups of directors is therefore very different, as they consist of dissimilar nature and therefore constitute alternatives which rule each other out.\textsuperscript{123} Due to the fact that courts have found it difficult to set forward one decisive test in the determination of de facto directors, the law can be concluded uncertain in this field. Recent judgements have furthermore demonstrated difficulties in distinguishing between de facto directors and shadow directors.\textsuperscript{124}

\section*{3.2 Who is a Shadow Director?}

\subsection*{3.2.1 In general}

As the directors have such extensive powers entrusted to them, and since they carry onerous duties to guard the interests of the company as a whole, they should refrain from acting on the directions or instructions of any other person and risk being held liable for acts that were not made in their independent capacity. However, directors occasionally allow themselves to be subjected to the

\begin{itemize}
\item\textsuperscript{123} \textit{Ibid.} In the case of Hydrodam (Corby) Ltd, Re [1994] 2 B.C.L.C. 180 at 183, two directors of Eagle Trust plc were alleged to be liable under s.214 of the Insolvency Act 1986 as de facto directors or shadow directors, in connection with the affairs of the company. As the allegation was not clear on whether they were liable as de facto or shadow directors, Millet J. defined shadow directors and de facto directors in his judgement, between which he differentiated by setting forward a clear assertion regarding the matter: ‘I would interpose at this point by observing that in my judgement an allegation that a defendant acted as de facto or shadow director, without distinguishing between the two, is embarrassing. It suggests – and counsel’s submissions to me support the inference – that the liquidator takes the view that de facto or shadow directors are very similar, that their roles overlap, and that it may not be possible to determine in any given case whether a particular person was a de facto or a shadow director. I do not accept that at all. The terms do not overlap. They are alternatives, and in most and perhaps all cases are mutually exclusive.’
\item\textsuperscript{124} Refers to the discussion in the following chapters of determination of shadow directors, in particular the case of \textit{Secretary of State for Trade and Industry v. Deverell} [2000] 2 B.C.L.C. 133, where the court considered various elements of the determination of shadow directors. It has been assumed that the court adopted a broad and even too liberal definition of shadow directors in order to determine such persons (Anon 2010).
\end{itemize}
control and authority of others. Thus, acts conducted by the duly appointed directors of the company may in fact be controlled, dictated or influenced by persons who are not appointed as directors, but who nevertheless exercise control over the company. The directors who allow themselves to be subjected to such control are in breach of their duties as directors.

These interlopers, who interfere with the affairs of the company, are in possession of the real management powers of the company and are able to instruct the duly appointed directors, like marionettes, to carry out important decisions in the company’s affairs in the interests of the interloper or his associates. They lurk in the shadows of the other directors of the company and try to escape whenever the question of liability arises. These persons have been recognised by law, in legal statutes as well as in judicial practice, whereas the rationale behind is to have them subjected to the same liability as regular directors of companies.

Thus, a person who is neither a de jure director nor a de facto director can be designated as a shadow director of a limited company. The question that remains unanswered or at least uncertain to this day is how shadow directors are determined and which situations lead to that determination. In order, comprehensively, to understand who a shadow director is, it is of paramount importance to analyse the definition of the concept.

3.2.2 Statutory definitions

As the previous discussion has revealed, it can be difficult to distinguish one who is designated as a director without being lawfully appointed as one. As shadow directors refrain from being accepted as directors and do not purport to be so, it can become even more difficult to designate them as directors in order to impose liability upon them. However, the law has recognised the existence of shadow directors and has imposed the duties and liabilities of regular directors upon them by virtue of their control over the directors of a company.

The common law system has developed criteria to determine shadow directors, just as de facto directors, and the judicial development has led to statutory provisions defining shadow directorship. However, this has not been the case in the Nordic jurisdictions where the concept of shadow directorship is relatively new and is neither defined by statute, nor is it well established in judicial practice. The concept has been elaborated on by courts to a very limited extent, although the practice appears to run in the same direction as established in the common law system. Scholars have furthermore recognised and accepted the existence of the concept in the Nordic
jurisdictions.\textsuperscript{125} It is therefore natural to expect that courts will follow the established practice in the neighbouring jurisdictions, where the concept has been developed to a significant extent. Thus, an analysis of the practice in the common law system applied in Britain can be considered important guidance for defining and determining shadow directors in future judgements in the Nordic jurisdictions.

Contrary to the Nordic jurisdictions, the term \textit{shadow director} has been established in British legal statutes. The term is defined in section 251 of the UKCA\textsuperscript{126} as ‘\textit{a person in accordance with whose directions or instructions the directors of the company are accustomed to act}’\textsuperscript{127} However, the provision excludes advice given by a person in a professional capacity and, therefore, such a person cannot be deemed a shadow director.\textsuperscript{128}

There are a number of provisions under British law which apply evenly to shadow directors as well as to the normal directors of limited companies. This is, in particular, provisions requiring disclosure and regulating certain types of transactions by directors, and the general duties of directors\textsuperscript{129} which are to apply to all directors, including shadow directors.\textsuperscript{130} A shadow director is therefore liable in the same way as a duly appointed director of a company and can be the subject of proceedings in a derivative claim made by the shareholders.\textsuperscript{131}

\begin{footnotesize}
\begin{enumerate}
\item Hansen (2003, p. 97) concludes from Danish judicial practice that shadow directorship can lead to liability of a third party in Denmark and assumes that this would apply in all the Nordic countries.
\item Section 251 as laid down in the UKCA:
\begin{itemize}
\item \textit{(1)} In the Companies Acts “shadow director”, in relation to a company, means a person in accordance with whose directions or instructions the directors of the company are accustomed to act.
\item \textit{(2)} A person is not to be regarded as a shadow director by reason only that the directors act on advice given by him in a professional capacity.
\item \textit{(3)} A body corporate is not to be regarded as a shadow director of any of its subsidiary companies for the purposes of—
\begin{itemize}
\item Chapter 2 (general duties of directors),
\item Chapter 4 (transactions requiring members’ approval), or
\item Chapter 6 (contract with sole member who is also a director), by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions.’
\end{itemize}
\end{itemize}
\item Ibid. This definition is the same as the definition contained in s.741(2) of the former Companies Act 1985. (Explanatory notes p. 42, part 10, article 279)
\item Ibid. Section 251(2) UKCA.
\item The general duties can be found in ss.171–177 of the UKCA.
\item On grounds of section 170(5), the general duties also apply to shadow directors.
\item Ibid. Section 260(5) of the UKCA is a consequential effect of the fact that the statutory duties of directors in the UKCA apply to shadow directors. The provision makes it clear that when referring to a director in Part 11 of the Act, both former director and a shadow director are included in the provision and are to be treated as any other directors in derivative proceedings. \textit{Cf.} ss.260(5)(a)&(b) of the UKCA.
\end{enumerate}
\end{footnotesize}
In addition to any liabilities imposed on shadow directors by the provisions above, the Insolvency Act (hereinafter referred to as UKIA) cannot be ignored, regarding the position of shadow directors in British law. The act defines shadow directors in the same way as the UKCA. It further refers to shadow directors in several sections, in order to impose the same liability upon them as other directors, to which they are subject for the purpose of the provisions, and are therefore to be included within the meaning of the term applied in the provision, e.g. an officer, a member or a director. The provision, which is of the utmost importance with regard to director liability, is the wrongful trading provision in the UKIA, in which shadow directors can be held liable for any wrongful acts under insolvency, just as the regular directors of the company, and thereby prohibiting insolvent trading. Moreover, the Company Directors Disqualification Act must be mentioned as it lays down further obligations on shadow directors.

The aim of the statutory provisions of directors is obviously to extend the reach of the provisions to include those who have real influence over the governance of a company, but are, nevertheless, not appointed as members of the management (Hannigan 2003, p. 141). Thus, any person, whether a natural or a legal person, can be subject to the provisions and considered a shadow director. The common law jurisdictions have developed the rules and elaborated on this practice in order to find those who are in possession of the real powers of control within the company and to impose liability upon them.

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132 The UK Insolvency Act 1986, c. 45.
133 Section 251 UKIA clarifies the expressions of ‘shadow director’ used generally within the UKIA, where the definition of the UKCA is practically repeated: ‘…“shadow director”, in relation to a company, means a person in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity)...’
134 To mention a few provisions where duties are laid on to shadow directors as well as other directors of a company: s.6A(3) on false representations, etc.; s.206(3) regulating fraud, etc. in the anticipation of winding up of the company; s.208(3) regulating misconduct in the course of winding up; s.210(3) on material omissions from statement relating to company’s affairs; s.211(2) on false representation to creditors; and s.214(7) on wrongful trading. Section 249(a) designates a person to be connected with a company if ‘he is a director or a shadow director of the company or an associate of such a director or shadow director...’
135 The UKCA refers to shadow directors in a similar way and holds them subject to many sections of the act, which purpose is to apply equally to shadow directors and regular directors.
136 Section 214(7) of the UKIA.
137 The UK Company Directors Disqualification Act 1986, c. 46.
138 Section 4(2) deals with disqualification of shadow directors for fraudulent trading and s.6(3) deals with disqualification of unfit directors of insolvent companies, including shadow directors.
139 Similar extended definitions of director are contained in the companies legislation of many common law jurisdictions including Singapore, Hong Kong, New Zealand and the United Kingdom The aim of the provisions is clear; any person who interferes with the affairs of the company and exerts influence over the management of the company must be conducted as a company director and bearing the responsibilities and liabilities that follow from that designation. (Hobson 1998, pp. 3-4)
3.2.3 Determination of shadow directors

Although the statutory definition of shadow directors in the common law system seems ‘self-explanatory’, the scope of the definition has been found to be uncertain. While de facto directors can be distinguished by their conduct, the determination of shadow directorship seems to be more difficult. This can be explained by limited judicial practice and a lack of consistency within the field (Hobson 1998, p. 4). Thus, the elements of shadow directorship, which appear to be somewhat unclear, must be identified. However, the general procedure demonstrates that the distinctive features of shadow directorship are quite similar throughout the world’s jurisdictions, and recent judgements in the common law system have shed substantial light on ‘the law of shadow directorships’ by providing important criteria for the determination.

In the landmark case of Hydrodam, the court determined whether shadow directorship could be established and set forward a test via which determination was based on the location of the actual decision-making powers in the company. The test of determination of shadow directorship set forward in the case presupposes that the lawfully appointed directors and the de facto directors of the company are identified; they are controlled by the shadow director who gives them instructions on the governance of the company, and following these instructions they act in that manner. Thus, if a person is in possession of the real seat of power in the company, and his instructions are carried out by the normal directors on a regular basis, that person can be designated as a shadow director. A shadow director may therefore be designated as a puppet master who prefers to control the actions and decisions of the board of directors by pulling their strings. His reluctance to be recognised as a director emphasises his enthusiasm for being in control, without being held liable for his conduct. The resistance from recognition is the most difficult part of the determination and can incur difficulties when it comes to imposing liability upon such persons. As the duly appointed directors and the de facto directors are responsible for the business affairs and will be held liable for any harmful acts against the company, it is natural to seek to determine the real controllers of the company and impose liability upon them.

141 Ibid. In order to decide whether the alleged directors were shadow directors or not, Millett J. laid down a test consisting of four elements:
- The de jure or de facto directors of the company must be pointed out.
- The alleged shadow director must have directed or instructed the directors of the company on how to act, or he should be one of the persons who directed the directors to take the action they took.
- The directors of the company must have acted according to these directions or instructions.
- And finally, that these directors were accustomed to act in that manner.
instead of accusing the marionettes, who happen to be in the position of official control and, consequently, be held liable for conducted acts.

As judicial procedure evolved and courts had elaborated on the test laid down in Hydrodam, a later case of Deverell\(^{142}\) has been assumed to have provided an important addition to the determination of shadow directorship, as the court answered a number of important questions regarding the subject. The court considered that the term shadow director must be broadly construed, as the primary purpose of having included the concept of shadow directors is the protection of the public.\(^{143}\) The case of Deverell has been considered an attempt to amend some of the mistakes made in earlier cases on shadow directorship which focused too much on mere technicalities (Anon 2010). However, some scholars claim that they might have adopted too liberal a definition for shadow directors.\(^ {144\&145}\) The prerequisites, established by earlier judgements for the determination of

\(^{142}\) In the case of Secretary of State for Trade and Industry v. Deverell [2000] 2 B.C.L.C. 133, the company in question was a tour operator. It acquired a particular license from the Civil Aviation Authority, membership of the ABTA, and also obtained an ABTA bond. From the time of the foundation of the company, Mr. Deverell was involved in its management. For the purposes of promotion of sales of flight seats, the company formed a subsidiary company called Euro Express, of which the Managing Director was Deverell. This company was subsequently acquired by Pilgrim Air, but Mr. Besant continued to be a director as he was earlier, while Deverell continued to play an important role in the management of the company. The company did badly and Pilgrim Air wished to close down operations of the company, but Besant went in for a management buyout. He was now the sole director of the company. Hopkins, who was earlier the Chief Executive of the holding company of Pilgrim Air, was approached by Besant and Deverell for the purposes of expansion of their business. Hopkins claimed he agreed to assist in the expansion, although only on a consultancy basis, and bought one-third of the issued shares. After this, the company expanded its business under another name. Besant and Deverell had financial difficulties in the business, following which Besant resigned. The difficulties became insurmountable and eventually they had to go in for creditors’ voluntary liquidation. Under the liquidation, disqualification claims were filed against two individuals, Deverell and Hopkins, who both denied any directorship and purported to only have been consultants of the insolvent company. The court concluded that both of them were shadow directors, since one of the alleged directors was involved in the governance of the company and the other’s involvement clearly exceeded what can be expected of a consultant with regards to the company’s financial affairs.

\(^{143}\) The definition of a shadow director is to be construed in the normal way to give effect to the parliamentary intention…” The proposition was set out by Morritt L.J. regarding the statutory definition of a shadow director in the case of Secretary of State for Trade and Industry v. Deverell [2000], 2 B.C.L.C. 144-145. The company was facing enormous problems in its business, and eventually had to be liquidated. Morritt L.J. stated that the primary purpose of having included the concept of shadow directors was for the protection of the public, which is why the term has to be broadly construed. See further in Hannigan (2003, pp. 141-142).

\(^{144}\) The assessment made in the case of Deverell is to some extent debated by scholars. While it is acceptable that this provision must be broadly construed for the protection of the public, a line must be drawn somewhere. Shadow directorship would therefore not be fairly established if the directors of the company have enjoyed complete freedom in making their decisions, simply by following their independent considerations without being directed by anyone. Thus, the provision must be read as a whole, and be interpreted accordingly (Anon 2010).

\(^{145}\) Hannigan (2003, p. 143) claims that the extended definition on shadow directors laid down in the case of Deverell, leads to the question whether there still exist the need to distinguish between the two categories of shadow directors and de facto directors. Hannigan implies that the court seems to be confused in the distinction as it considered both of the alleged directors to have acted as shadow directors. The fact is that Deverell played an important role in the management of the company and it is therefore arguable that he was a de facto director rather than a shadow director (Secretary of State for Trade and Industry v. Deverell [2000], 2 B.C.L.C 133).
shadow directorship, were abolished in the case of *Deverell*, which therefore makes it more difficult to identify and distinguish between shadow directors and de facto directors (Anon 2010).

### 3.2.4 Main characteristics

Under British law, natural persons as well as legal persons can be subject to the determination and be designated as shadow directors. This is due to the fact that limited companies have separate legal existence. Legal entities can therefore be designated as shadow directors of a limited company and be held liable as its regular directors. Thus, a shadow director may not only catch shareholders and other natural persons to be designated as shadow directors, but also parent companies, banks and other legal persons who, by virtue of their bargaining powers, interfere in the management of the company in financial difficulties (Wood 2008, pp. 73-74).

Apart from the fact that any person can be designated as a shadow director, there are several elements that courts take into consideration when determining whether shadow directorship can be established. These elements have been elaborated on by courts in the common law jurisdictions and are therefore an important guide to how the Nordic courts will establish shadow directorship in future judgements.

#### 3.2.4.1 Refrains from recognition

An obvious characteristic of a shadow director is his avoidance of being recognised as a director, and that he does not purport to be one at the outset. He prefers to lurk in the shadows of the duly appointed directors and to control the affairs of the company from behind, without incurring any liability for his conduct.

However, the avoidance of recognition is not considered an essential element towards establishing shadow directorship. The statutory definition of what constitutes a shadow director was considered and expanded in the case of *Deverell*. The notion of *lurking in the shadows* was deemed an unessential part of the definition in this case. Even so, it cannot be denied that the notion of a person controlling the company from behind and acting as a director, but who neither purports

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146 Section 250 and 251 of the UKCA define and refer to a director and a shadow director as ‘a person’ or ’any person’.

147 The concept of shadow director seems have the potential to apply more extensively to persons who assist in the company’s managerial and financial affairs, such as accountants or other advisors (Harper et al. 2009).

148 Section 251 UKCA. Cf. footnote #126.

149 Secretary of State for Trade and Industry v. Deverell [2000] 2 B.C.L.C. 133. For further discussion of broadened scope of the statutory definition, see further in footnotes #143-145.
to be a director nor is accepted as one, is inherent in the nature of shadow directors and, therefore, is an indissoluble part of the definition. If it was not so, and the person in question would contrariwise blatantly execute the acts of a director, he would simply be designated as a de facto director.

The simple notion of *lurking in the shadows* is therefore an essential part of the nature of shadow directors and a factor which could be one of the first things to suggest the presence of shadow directorship. Despite being unessential in the determination of shadow directorship, the notion must be assumed an inevitable characteristic of shadow directors.

### 3.2.4.2 Real influence

As previously discussed, the purpose of the statutory definition\(^\text{150}\) is to identify those who are not professional advisers but who exercise *real influence* over the company’s corporate affairs. Thus, an essential element of the determination of a shadow director is that the alleged director, who is not a member of the management but nonetheless in possession of the effective decision-making of the company, has exercised real influence over the governance of the company.

Nevertheless, it is not a necessity that such influence has been exercised over all or most of the company’s corporate activities. A shadow director does therefore not need to control every aspect of the company’s affairs. For him to be designated as a shadow director and become liable as a regular director of the company, it is sufficient that his powers only refer to certain fields of the business (Hannigan 2003, p. 141).\(^\text{151}\) The day-to-day management of some aspects of the company’s affairs would therefore be sufficient in order to render a person liable as a shadow director (Girvin et al. 2010, pp. 318-319). It has even been considered possible that a set of acts, dealing only with one issue which has led to insolvency, could be sufficient in order to demonstrate real influence (Hannigan 2003, p. 141). In the case of *Deverell*, the court asserted that determination of a shadow director would naturally be easier to establish if real influence was wielded over a larger area of corporate affairs.\(^\text{152}\) However, real influence must be supported by the requirements in the following discussion in order to establish shadow directorship, many of which are direct consequences of the real influence of an alleged director.

\(^{150}\) Section 251 of the UKCA.

\(^{151}\) This view was confirmed and emphasized in the case of *Secretary of State for Trade and Industry v. Deverell* [2000] 2 B.C.L.C. 144-145. One of the propositions set out by Morritt LJ regarding the statutory definition of a shadow director, was that of to what extent should the shadow director wield influence over the company. He held that it needed not to extend to all the activities of the company, and can be restricted to only a few corporate sectors. However, he concluded necessary that the shadow director exercises real power over the board of directors.

\(^{152}\) *Secretary of State for Trade and Industry v. Deverell* [2000], 2 B.C.L.C. 133.
3.2.4.3 Communication

3.2.4.3.1 Directions or instructions

Through his influence, a shadow director has the real powers of running the company by controlling the members of the management with simple communication. The statutory definition defines a shadow director as: ‘a person in accordance with whose directions or instructions the directors of the company are accustomed to act’. Although the provision refers to directions or instruction, it is unclear which communication can fall within the ambit of the terms directions and instructions.

For communication between an alleged shadow director and members of the management to be categorised as instructions or directions, the court in the case of Deverell decided that it must be objectively determined in the light of all the evidence, and not simply construed by reference to the label used. The objective test does therefore not allow a person to wrap the communication into a packaging and claim that the communication is something else than it is (Hannigan 2003, pp. 141-142). Furthermore, it was deemed unnecessary to demonstrate the understanding of either party regarding the communication provided by the alleged director. To decide whether the communication amounts to directions or instructions, it was concluded sufficient that evidence of the communication taking place was provided, along with the consequences deriving from it. Thus, whether the communication is vested in any form of instructions, directions, commands, wishes or advice, it is therefore sufficient to show that the directors have complied with the instructions in order to fulfil this assessment.

3.2.4.3.2 Advice

It has been assumed that a distinction must be made between communication involving compulsory guidance towards the management on corporate affairs, and a purely advisory guidance, which the management is not forced to comply with (Girvin et al. 2010, p. 319). While the terms directions or instructions suggest a slight degree of compulsion, the term advice is merely an opinion which

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153 Section 251(1) UKCA.
154 In order to determine whether the communication made could amount to ‘directions or instructions’, an objective test was laid down by Morritt LJ in the case of Secretary of State for Trade and Industry v. Deverell, [2002] All E.R. 365 (CA). It was one of the most essential issues dealt with in the case (Anon 2010, endnote nr.6).
155 If a memorandum is treated by the members of the board of directors as instructions from the person who in practice had real influence and controlled the company’s affairs, that would render the person in question as a shadow director even though he had referred to the memorandum as Information Sheet or for information only (Girvin et al. 2010, pp. 318-319).
156 These proposition were set out by Morritt LJ regarding the statutory definition of a shadow director in the case of Secretary of State for Trade and Industry v. Deverell [2000], 2 B.C.L.C. 144-145. For further discussion see Hannigan (2003, pp. 141-142).
seems only to include a choice which the directors of the company can discretionally accept or refuse to follow (Topp and James 2004). Thus, it seems unfair to establish liability and designate a person as a shadow director if the communication involved is purely advisory and the directors, to whom the advice was given, did have a clear option: to follow the advice, or not (Anon 2010).157

While considering determination of shadow directorship and whether the communication amounts to directions or instructions, a distinction must be made between those who give advice in a professional capacity and those who do not. This is so because professional advisers are exempted from being designated as shadow directors by the provision.158 While any advice given in a professional capacity is excluded by the provision, non-professional advice has consequently been considered a part of the ambit of the notion directions or instructions, if frequently acted upon.159 Therefore, it must be assumed that non-professional advice can only be included within the ambit of the definition, if the consequences of the advice reveal that the directors felt they were compelled to act according to it and were accustomed to do so. Accordingly, any advice given in a non-professional capacity, which incurs real influence on the management, and is complied with by the management, without any clear option to accept or refuse, shall be designated as instructions or direction (Fidler 1992, pp. 97-100).160 This can be accepted, considering the fact that the guidance involved in the term advice does not seem to be of less existence than in the terms direction or instruction (Hannigan 2003, p. 142).

3.2.4.4 Directors as marionettes

While a shadow director will only have the powers to run and control the company through the duly appointed directors, determination of shadow directorship requires that the members of the management accept his powers of control and [1] act in accordance with the communication given by the shadow director. Moreover, it is an essential element of the determination that [3] a majority of the directors are [2] accustomed to act in that manner on a regular basis. These propositions are

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157 Re PFTZM Ltd [1995] B.C.C. 280. A rescue plan, initiated by a bank in order to extend the credit of the insolvent debtor, could not result in establishing shadow directorship of neither the bank nor its advisors, as the directors of the insolvent company had a clear choice to accept or refuse the offer.

158 Section 251(2) of the UKCA.

159 Morritt LJ set out the following proposition: ‘all that is really required is that what is stated by the shadow director not be professional advice, and it should be followed over a wide enough area, and for long enough. This seems to suggest that non-professional advice frequently acted upon is sufficient.’ Secretary of State for Trade and Industry v. Deverell [2000], 2 B.C.L.C. 144-145.

160 A person who has real influence over the governance of a company and provides advice on the affairs of the company, would be designated as a shadow director if the directors of the company are accustomed to act according to the advice provided (Fidler 1992, pp. 97-100).
essential in order to establish shadow directorship and provide evidence of the influence the alleged shadow director has on the management and the main reason for determining that he is one.

3.2.4.4.1 Acting in accordance

The statutory definition of shadow directors in the UKCA presupposes that the company’s directors act in accordance with instructions given by a person outside the management. Thus, in order to establish shadow directorship, the directors must have complied with, and acted according to, the communication from the alleged shadow director, without exercising any discretion or judgement of their own in their acts (Anon 2009). The influence exercised by the shadow director may therefore be assumed to render the directors of the company marionettes of the shadow director, as he directs them with simple communication which his marionettes obey.

In the case of *Deverell*, the influence over the company was analysed and the alleged directors were considered to have controlled the directors of the company as their marionettes, since the directors acted upon everything they said, and thereby rendered them liable as shadow directors. In the case of *Deverell*, the influence over the company was analysed and the alleged directors were considered to have controlled the directors of the company as their marionettes, since the directors acted upon everything they said, and thereby rendered them liable as shadow directors.\(^\text{161}\)

Therefore, in order to establish shadow directorship, it seems adequate to demonstrate that the duly appointed directors took on a subservient role to please the shadow director, either by following his will and intentions, by exercising very little independence or simply by giving up their freedom to act by following his lead (Girvin et al. 2010, pp. 318-319). However, while this assessment was in fact concluded sufficient in the case of *Deverell*, the judge found that it was nevertheless too excessive for cases in general, seeing as ‘...such a requirement would be to put a gloss on the statutory requirement that the board are “accustomed to act in accordance with such directions or instructions”...’\(^\text{162}\). It is therefore not a requirement for the establishment of shadow directorship that the directors have cast themselves in such a role to please the shadow director (Girvin et al. 2010, pp. 318-319).

3.2.4.4.2 Accustomed to act

The statutory provision also presupposes that the consequences of the real influence exercised by shadow directors must also display a pattern of behaviour, showing that the directors of the company are accustomed to act according to the communication given, as a regular course of conduct and not simply because they choose to, but because it is their duty to do so (McGregor

\(^{161}\) In the case of *Secretary of State for Trade and Industry v. Deverell* [2000], 2 B.C.L.C. 144-145, Morritt LJ considered both of the alleged directors as shadow directors of the company.

However, in order to present evidence of such a pattern, it is sufficient to reveal a conduct where instructions are obeyed on a regular basis.

The notion of being *accustomed to act* could therefore apply when a person exercises real influence over the board of directors, whose communication the directors are accustomed to comply with, on a regular basis and during a significant period of time. It is therefore natural to conclude that the notion *accustomed to act* implies behaviour between the directors of the company and the alleged shadow director which has been upheld for a period of time (Anon 2010).

To satisfy this assessment, it would be difficult to establish shadow directorship if the directors of a company only once acted according to instructions or wishes of an alleged director. A single communication, which the directors are not accustomed to comply with, can hardly fit within the ambit of *accustomed to act*. This was confirmed in the case of *Becker*,¹⁶⁴ where an alleged director was not considered a shadow director, seeing as there was neither evidence of real influence nor proof of instructions that had been given and in accordance with which the directors were accustomed to act. Furthermore, shadow directorship could not be established by virtue of the involvement of the alleged director in a single activity, which occurred at the end of the company’s life.¹⁶⁵ To support the assumption from the case, the statutory provision of shadow directors in the UKCA presupposes that there must be “…*directions or instructions*…”¹⁶⁶ in the plural, suggesting that there have been a number of acts. Therefore, the directors are unlikely to become *accustomed to act* due to a single act (Topp and James 2004). Thus, the general assumption must be that shadow

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¹⁶³ ‘What is needed is […] a pattern of behavior in which the board did not exercise any discretion or judgement of its own, but acted in accordance with the direction of others.’ *Hydrodam (Corby) Ltd, Re* [1994] 2 B.C.L.C. 180, (art. 19).


¹⁶⁵ *Ibid.* A was the financier of the business activities of Balfour Ltd and his son was appointed as the sole director. The company came under financial difficulties and insolvency proceedings were filed. A new company was set up, called Bluenew Ltd., which started trading under the name of Balfour Associates. Before Balfour was liquidated, its contracts were transferred to the new entity, Bluenew. Thereafter, A was appointed as a director of Bluenew. The Secretary for Trade and Industry alleged that A was either a shadow director or a de facto director of the company on grounds of being the financier of Balfour and sole owner; his son was the sole director of the company and his subordinate; he played an active role in the discussions that led to the liquidation of Balfour; he was deeply involved in the affairs of the company and all decision making of the company. The main allegation was essentially that at the time of liquidation, A had played a big part in the decision making and had acted in such a manner that Bluenew and he himself benefited, while Balfour suffered. Rattee J. held that A was not a shadow director. He stated that just because A was a director of Bluenew, a company that wrongfully obtained contracts from Balfour, did not in any way prove that he was a shadow director of the Balfour. He further stated that proof of influence exercised by A over his son during the period of liquidation could not in any way establish the existence of a pattern of conduct that is considered necessary in order to justify the conduct as being customary. Finally, he said that involvement in one activity which came at the end of the company’s life was not sufficient to render A as a shadow director of the company.

¹⁶⁶ Section 251(1) of the UKCA.
directorship cannot be determined when a single act leads to the question of liability, and a behavioural pattern cannot be established through a period of time.

Nevertheless, as the notion accustomed to act proved to be problematic in the case of Becker, this assumption is far from being realistic. Many exceptional circumstances could arise in which a single act might fit the definition of shadow directorship. An argument in favour of that assumption could be that a single instruction, which is of extreme importance, could fall within the ambit of accustomed to act if it results in an act repeatedly executed by the company’s directors (Topp and James 2004). Another realistic argument could be that a short life period of a company would support determination of shadow directorship, even if the alleged director had only been involved in a single action on insolvency (Anon 2010). Moreover, it can be argued that single acts which appear to be crucial for the survival of the company, and therefore have tremendous effects on its business affairs, should fall within the ambit of the notion, e.g. if all assets were sold simultaneously without the board’s decision. The notion could also be problematic in situations of alteration within the business affairs of the company, which could lead to the question of liability, based on a single act. Thus, a frequent question is whether the terms directions or instructions and accustomed to act go together or not (Anon 2010). If so, the notion accustomed to act limits directions or instructions to communication deriving from a person who has repeatedly given instructions to the directors of the company for a period of time. Therefore, it seems unreasonable that shadow directorship cannot be fixed on a person with who the company has recently entered into a business relationship, and who evidently exercises effective control over the company and directs the directors of the company. Considering all of this, it would seem unfair and unjust if a single act could not fall within the ambit of the notion accustomed to act, under exceptional circumstances such as the ones suggested. However, courts will have to elaborate on the issue and clarify situations where a single act could fall within the ambit of the notion, and simultaneously provide fairness to the procedure of determination of shadow directorship.

Another question, regarding behavioural patterns, is whether a shadow directorship can be established where the influence does not extend to all transactions. Even though the notion

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167 This assertion is in particularly relevant where a company or a business relationship is recently established. It would counteract the rationale provided by the law, if obvious elements of shadow directorship would not be seen as sufficient in order to designate a person as a shadow director, simply because of no evidence of behavioural pattern, which in fact might be impossible to demonstrate on grounds of the short lifetime of the company in question.

168 Anon (2010) suggest a solution to this problem, by replacing the notion ‘accustomed to act’ with ‘obliged to act’. Such an amendment would ease the procedure of establishing shadow directorship to a significant extent and allow for a single act as sufficient basis in fulfilling the statutory requirements of shadow directorship.
accustomed to act does imply a certain degree of customary behaviour of the directors, it does not necessarily entail that every wish or instruction received from the shadow director is complied with by the directors of the company (Anon 2010). It is only suggested by the notion that the directors accept the instructions on a general basis. Thus, for the purpose of establishing shadow directorship, the notion hardly entitles directors to accept and comply with everything received, simply based on customary behaviour and without independent consideration (Topp and James 2004). Thus, in order to consider a person a shadow director, it does not seem to matter that some of the transactions executed by the directors of the company were made by virtue of instructions of an alleged director, while others were made by the directors at their own discretion (Anon 2010).  

3.2.4.4.3 Majority of directors

While it is indisputable that the duly appointed directors must be accustomed to act in accordance to the communication set forward by the alleged director, it is far from clear how many of the board members must act in that manner (Topp and James 2004). As section 251(1) defines a shadow director, it does not clarify whether all of the directors are entitled to act in that manner or if only a few are sufficient to satisfy the provision. This may not be of less importance for determination of shadow directorship than the aforementioned characteristics. In many cases, the practice has been interpreted so that it will only be sufficient if the majority of the board is accustomed to act in this manner. It would therefore be insufficient if influence was only exercised over one or a few members of the management, who are not in possession of the majority of the decision making powers within the company. Nevertheless, the courts have tried to clarify this, and several judgements have supported the need for all the members of the board of directors to be accustomed to act on the instructions of a person, in order to establish shadow directorship (Topp and James 2004).  

169 In the case of Australian Securities Commission v. AS Nominees. [1995] 13 A.C.L.C. 1822, the court considered that the instructions or directions of a person, who exercises significant control over the management of the company, do not have to be entirely complied with in order to designate the person as a shadow director. The court concluded that directions and instructions given to directors do not have to extend to all decisions. The court further concluded that the statutory definition (Australian provision which is identical to the UK provision) only requires that as and when the directors are directed or instructed, they are accustomed to act according to these directions.

170 An early case of Lo-Line Electric Motors Ltd, Re [1988] B.C.L.C. 698, suggested that ‘the board’ must act according to the instructions of another person in order to establish shadow directorship. This was assumed to imply that a simple majority of directors accustomed to act so would be sufficient since it was the same majority required for the board to make decisions.

171 In the case of Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd [1990] B.C.L.C. 868, two of the five directors of the board, who acted in accordance to instructions of their principal, were not considered sufficient to render the principal as shadow director. The court stated that since there was no allegation that the rest of the board
However, later cases have refused the assumption that every member of the board must be involved. The most preferable position is that a majority of the board must be involved, in order to establish shadow directorship, since normal decisions are made via majority voting on the board (Topp and James 2004). Accordingly, it has been argued that if the majority of the board members are accustomed to behave according to the person’s intention, it will be sufficient to establish a shadow directorship (Hobson 1998). In a later judgement, it was found insufficient to designate a person as a shadow director if only one or two of several directors were under the influence of the alleged director, who was not in the possession of a majority of decision-making powers within the company. Thus, liability can be assumed to arise when at least the majority of the board members are under the influence of a shadow director and act according to his instructions.

This has nevertheless been questioned and arguments have been provided for exceptional situations, where only a single member of the board, who was under the influence of an alleged director, could suffice in order to establish shadow directorship, provided that his viewpoint was of essential importance for a decision within the company (Anon 2010). It would also be arguable if instructions were given by a person to one managing director, who apparently dominates the board of directors in one way or another, and customarily gives orders that the other members of the management complied with. Thus, if this can be proved, the person in question should be designated as a shadow director by virtue of his influence (Topp and James 2004). Thus, the implication is that it is necessary to consider the determination in the light of all evidences, and as each case differs from another, it must depend on a specific assessment, i.e. on a case by case basis.

acted in accordance on that principal’s instructions, shadow directorship could not be established. Thus, the decision of the court indicated that shadow directorship could neither be established when a certain minority of the board is accustomed to act (Topp and James 2004), nor can it be assumed that a certain majority is sufficient. According to the poorly explained assumption of the court, it has been interpreted that shadow directorship can only be established if all the members of the board are accustomed to act on the instructions of the alleged director. Thus, total compliance of the whole board was necessary in order to establish shadow directorship. In Unisoft Group Ltd (No. 2), Re [1994] B.C.C. 766, it was not considered sufficient in designating a person as a shadow director, that the person in question had real influence over two out of five members of the board. It can therefore be assumed from the case that if the third member of the board had also been under the influence, shadow directorship could have been established on grounds of majority of the board were under real influence of the shadow director. Thus, majority is sufficient for the determination of shadow directorship.

Due to the split of executive powers in the dual executive model applied in the Nordic jurisdictions, one can assume that this principle would suffice for either of the boards. Thus, if influence is exercised over at least half of the board of management, it would render the interloper with the equivalent liability as the members of that board, and not incur the liabilities of the board of directors, and vice versa.

An example would be a board consisting of five directors which is tied in its decision. If the fifth director is influenced by a person outside the board, whose influence is not exercised over other members of the board, and therefore his viewpoint is exceptionally important for the decision-making process. If the decision, which is based on the communication from the outsider, is later to be revealed as wrong or harmful to the company in any way, the outsider should naturally be designated as a shadow director and held liable as such (Anon 2010).
However, Hannigan (2003, p. 143) finds it difficult to justify establishment of shadow directorship on the grounds of one director being accustomed to act on the instructions of another person, in particular if there is no evident abuse of the position involved.\footnote{Hannigan (2003, p. 143) refers to the Company Law Review, which refused to extend the statutory definition to encompass such situation due to uncertainty of any such alteration of the definition.}

### 3.2.4.5 Non-professional capacity

As the statutory definitions of directors and shadow directors in the UKCA are intended to encompass everyone who is part of the governance, and who participates in the decision-making within a company, a statutory limitation of shadow directorship is provided for those who act in a \textit{professional capacity}.\footnote{Section 251(2) of the UKCA.} The rationale behind the provision is obviously to guard the role of those who provide advice in a professional capacity,\footnote{Those who give advice in professional capacity are often banks, auditors or legal advisors.} as they must be able to carry out their duties following from a contract to a third party.\footnote{Advice given in a professional capacity could be described as if a solicitor, from whom the directors of the company are accustomed to seek legal advice, provides advice to the directors in order to comply with a contract between them. As professional advice is excluded from the definition of shadow directors, the advice provided would not render the solicitor a shadow director as it is given in his legal capacity (Girvin et al. 2010, pp. 318-319).} Thus, a distinction must be made between acts executed in a professional capacity, and those executed individually. The provision is laid down as follows:

\begin{flushright}
A person is not to be regarded as a shadow director by reason only that the directors act on advice given by him in a professional capacity.\footnote{Section 251(2) of the UKCA.}
\end{flushright}

A professional advisor can therefore only be excluded from being a shadow director if he provides advice in relation to his professional capacity. If advice is not provided in relation to his profession, it cannot be considered his professional advice (Anon 2010). Thus, if an auditor gives legal tips, which the directors of the company comply with, he would not be considered a professional advisor seeing as he is only able to give advice on auditing as this is within his professional capacity. Instead, he would be have given so-called extra advice, which in turn could render his communication within the ambit of the definition of shadow director, provided that the directors felt obliged to comply with the advice on a regular basis.\footnote{It seems unfair to compel a professional adviser to restrict his advisory role only to his field of expertise as situations may concern various issues (Anon 2010). However, unless courts conclude otherwise, and in order to avoid liability as shadow directors, advisors must be extraordinarily careful in their conduct and refrain from giving advice which does not fall within their profession.}
A professional advisor can be admitted to the decision-making process of the company and participate in board meetings. Thus, he might be able to avoid designation as a shadow director on the grounds of the statutory limitation of professional capacity. However, the statutory limitation would not protect him in case he would be deemed a de facto director from his conduct within the company and be subject to the duties and liabilities of the company’s regular directors (Harper 2006, p. 189).181 This is in particular relevant for company doctors,182 who undertake an inspection of the company’s financial affairs and operations, in order to help businesses recover from financial distress. If they assume the duties of directors and exceed their legal capacity while performing their assistance, they might run the risk of being designated as directors of the company (Topp and James 2004).

It is a possibility that advice, provided in a professional capacity, to a management of an insolvent company, may fall within the ambit of the notion directions or instructions, according to which the directors are accustomed to act, resulting in designation of the advisor as a shadow director (Topp and James 2004). There is indeed a very thin line between being advisory in a professional capacity, and being abusively influential by giving compulsory advice in a capacity of control as a shadow director. This is essentially relevant for banks and other credit institutions, which may run the risk of becoming shadow directors of their insolvent clients. It is nonetheless recognised and accepted as inherent in the nature of banks as lenders to be able to guard their interests to a large extent, when their customers experience financial difficulties.183 In these situations, banks and other credit institutions are keen to interfere with the affairs of their corporate clients. They are sometimes eager to restrict the dispositions of their clients’ accounts in order to guard their interests,184 and, thereby,

181 In the case of Tasbian (No.3), Re [1992] B.C.C. 358, the overlap between directions and instructions on the one hand, and advice on the other was considered. An accountant was hired to Tasbian to assist with a turn-a-round of the company in order to generate profits. The accountant became deeply involved in the company’s business affairs and took effective control of the company as he handled with all payments, customers and creditors of the company. Thus, he exceeded his role as an advisor of the company by exercising decision-making powers and control over the company to a great extent as a regular director of the company. The unprofessional conduct indicated that he could not be excluded from being a director on grounds of the ‘professional advice exemption’. Thus, he was assumed to be a director of Tasbian and subject to disqualification and other sanctions. Cf. also footnote #115.

182 ‘Company doctors’ are often lawyers or auditors with special expertise in insolvency.

183 A bank can guard its interests by appointing an inspector to examine the economic situation of the company, demand increased security, or demand increased information of the company’s affairs.184 For example, a subjective consideration must be undertaken to demonstrate that the bank has in fact had the intention to control the company and not only guard its own interests. In the case of Re PFTZM Ltd [1995] B.C.C. 280, the advisors of the bank were not considered as shadow directors as their conduct on behalf of the bank was only assumed to be merely for guarding of the bank’s interests by imposing terms of the extended credit for the protection of those interests. The actions the bank took were deemed to be a normal course in protecting its undoubted rights as a secured creditor (Wood 2008, pp. 73-74). Thus, banks and other credit institutions cannot be considered as shadow directors if they only set forward requirements for continued support towards their insolvent client.
they can control the financial affairs of the company to a large extent, which can be very detrimental to the undertaking in question (Topp and James 2004). 185&186

Professional advisors can therefore be believed to be in a position of control and designated as shadow directors if the directors of the company feel compelled to act according to their advice, without being able to accept or refuse the advice given, by virtue of the control exercised by the shadow director. Considering all of this, the aforementioned professional advisers’ risk of becoming shadow directors, may prevent them from assisting a company in connection with the financial affairs, or from participating in informal work-outs of the insolvent company.

3.2.5 Summary

In order to answer the question who is a shadow director?, the assumption from the discussion in this chapter is that a shadow director is a person with whom the effective corporate decision-making powers lie. The location of the powers is only problematic if a person, who is not a lawfully appointed director or a de facto director of the company, is in possession of the company’s management powers. In that case, the person in question will be subject to all duties and liabilities, equal to lawfully appointed directors, although their rights are not the same as the duly appointed directors.

The crucial factors of the determination to be considered are: a person, who exercises real influence over the management of the company, by imposing simple communication towards the members of the management, according to which the majority of the members are accustomed to act. As follows from the British statutory provision defining shadow directors, these elements are all interrelated as the previous discussion revealed. Even though the statutory definition in the UKCA is quite clear, it does not contain any direction with regard to determination of shadow directorship and the situations involved. Therefore, the established judicial practices are essential factors in the

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185 One of the most controversial cases of lender liability is abusive credit by banks or individual directors. (Wood 2008, p. 74) Thus, a special practice has been established regarding financiers as shadow directors, whereas the law of shadow directorship has been adapted to the special nature of the relationship between a financier and a debtor. However, if the involvement of the bank is to the extent that the bank is assumed to make decisions on its behalf, and the directors of the company are unable to make decisions in their own discretion, the bank runs the risk of being designated as a shadow director of the company.

186 Liability of banks and lender liability in general, are nevertheless out of the scope of this discussion and would in fact be a comprehensive topic for another discussion and thorough analysis. For further discussion on lender liability and financiers’ risk of being determined as shadow directors, see: Harper et al. (2009).

187 Section 251 of the UKCA.
procedure of determining shadow directorship in the near future, providing the Nordic jurisdictions with an important guidance in the matter.

3.3 SHAREHOLDER AS A SHADOW DIRECTOR

In spite of the fact that the shareholders are not entitled to interfere with the business affairs of the company, the hierarchical structure applied in the jurisdictions in question provides the shareholders with powers to influence the board of directors, and give them directions on the management of the company to a significant extent (Hansen 2003, p. 71). This is considered a natural course of the governance structure, and it is therefore not seen as problematic in the jurisdictions (Hansen 2003, pp. 74-75). Although shareholders are ensured influence on the board of directors on the grounds of the majority principle, the directors may not be incentivised by the shareholders’ will in their decisions, as they are entitled to guard the company’s interests. Thus, excessive influence by shareholders can give rise to complications under insolvency proceedings and incur liability upon them beyond the statutory limitation. It is therefore important to recognise those who interfere excessively with the business affairs and act as directors by exercising effective control over the company. This is one of the main reasons why the law recognises shadow directors in the one-tier system applied in the UK, and apparently in the dual-executive system of the Nordic countries.

3.3.1 Protection of interests

The relationship between the controllers and the shareholders of limited companies has increasingly been brought into the discussion of questions of liability. When a limited company experiences financial difficulties, shareholders tend to interfere with the management of the company, for the purpose of protecting their own interests and, unfortunately, to the detriment of others who have interests in the company. The interference of the shareholders often involves forcing the directors of the company to undertake unwarranted and risky decisions, in the shareholders’ vague desire to rescue the business of the company. Decisions within the company, which involve excessive risk to be undertaken in difficult times, is most likely to incur increased risk for the company’s creditors, as they will face the risk of receiving lower repayments if the rescue proves to be unsuccessful.

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188 The possibility of removing members of the board of directors is of particular importance as it is natural that the directors will try to obey any instructions from the shareholders in order not to be set off as a director. Thus, this provides the shareholders with ability to exercise significant influence over the management.
The reason why shareholders are eager to interfere with the business affairs during financial difficulties is that they want to avoid the company being filed for insolvency proceedings. This is because they are the last to get paid under such proceedings and therefore will only receive a very small portion of their investment in the company, if any. Shareholders’ only hope is to keep the company in business and hope for that it will generate profits and pay out dividends to its shareholders at a later point in time. Thus, the shareholders have in fact nothing to lose upon insolvency, except for their original investment, which is potentially lost if the company files for insolvency proceedings.

While the shareholders have their interests vested in the fact that the company generates profits, or at least that it does not incur losses repeatedly, the creditors have their interests vested in reclaiming their loans without risking more than is necessary. They are therefore generally risk averse and will want to interfere at an early stage to regain their claims, and without risking more money on rescuing the company if they deem it infeasible. As a consequence of the opposed interests of the stakeholders within a limited company, a harmful race between the shareholders and the creditors of the company will begin, when the company experiences financial difficulties. The creditors will attempt to have their claims paid back to them as soon as possible, while the concern of the shareholders is the continued business. In such a situation, the directors have onerous duties to guard the interests of the company as a whole, and not the interests of an individual stakeholder. This is of particular importance due to the shareholder oriented governance models applied in the jurisdictions in question, because it is easy for the shareholders to influence the management through the general meeting. It is therefore crucial to recognise situations where the risk of influential shareholders becomes imminent and when a shadow directorship might be established. Therefore, it is necessary for the management of a limited company to be extra cautious under insolvency, where such situations are frequent.

### 3.3.2 Shadow directorship

As previously stated, a shareholder may be liable for damages he causes to the company, other shareholders or third parties. Although, a shareholder can only be liable for gross negligence in his conduct within his powers, unless he takes over the real control over the company and can be designated as a shadow director (Christensen 2009, p. 706). Because shareholders are able to influence the management to a significant extent, the influence of one or more shareholders may never become too excessive, as decisions may be determined to be in fact made by the shareholders,
and not by the management which is entitled to act in such a way. The influencing powers of the shareholders often lead to decisions that jeopardise the company’s interests for the benefit of the shareholders’ interests. In turn, shadow directorship can be established in situations where the normal influence of shareholders is exceeded and the real decision-making powers lie with the shareholder.

The definition of shadow directors provides that any person can be considered to be one. Thus, both natural and legal persons can be considered when liability arises and shadow directorship is determined, provided that the previously mentioned elements of shadow directorship are present. Shareholders, whether they are individuals or companies, and who exercise effective control over a company, can therefore be subject to the definition of shadow directors and be held liable as regular directors of the company, in which they hold interest.\footnote{In such case, the liability standard of directors would apply to the shareholder and acts in simple negligence would incur personal liability upon him. Cf. s.361 of the DKCA and s.134(1) of the ISCA.}

Consequently, shareholders have been recognised as shadow directors in all of the jurisdictions in question. As previously analysed, the common law jurisdiction in the UK has extensive experience within the field, and the practice of Danish courts has established liability of a shareholder to the same standard of liability as applies to the members of the management organs.\footnote{The decision by the Danish Supreme Court in the case of Satair, UfR 1997.364 H, confirmed shareholder liability of a parent company as it exercised effective control over its subsidiary and was held liable as the management of the subsidiary.} This practice is moreover assumed to apply in the other Nordic countries (Hansen 2003, p. 97). To determine whether a shareholder can be considered director and consequently face liability as such, one must analyse the influence he has upon the company, and whether all elements of shadow directorship are present for the determination. Moreover, there are certain positions of shareholders which can make them more vulnerable than others.

### 3.3.3 Dominating position

Situations where an act of a shareholder is considered to amount to an act of the management, which in turn results in a shadow directorship, usually involve a \textit{dominating shareholder.}\footnote{A dominating shareholder can be a majority shareholder such as a parent company or other controlling shareholder. Controlling shareholders are those who have sufficient votes to pass a resolution in the general meeting, either by their shareholding or contract with other shareholders.} A shareholder can dominate the company, either by being a majority shareholder or by being able to exercised effective control over the company. In fact, every controlling shareholder is potentially at
risk of being designated as a shadow director. It is only a question of taking into account all the relevant facts, to see whether the alleged director has exercised real influence in the conduct of the corporate affairs (Hannigan 2003, pp. 142-143). If evidence of his influence over at least a majority of the board members can be provided, it does not matter whether a shareholder has obtained legal control or de facto control\(^{192}\) over the company when it comes to rendering him liable as a shadow director.

A shareholder who has legal control, i.e. who owns a majority of voting rights in a company, must be especially careful in his influence over the management in order to avoid being designated as a shadow director. A majority shareholder, who owns a majority of voting rights, would always be seen as dominating the governance of the company, unless extraordinary circumstances provide otherwise.\(^{193}\) This can be concluded from the fact that the majority of the board of directors would be appointed as his representatives, who must be expected to act according to his will, in order not to be set off as a director. His control would therefore prevail, as simple majority is required for most of the decisions made within the board. Thus, an influence exercised by a person, who is entitled to deprive the independence of the company’s directors, will certainly impose liability upon him as a shadow director, provided that his representatives act on his instructions and are accustomed to act in this manner.

A dominating shareholder should therefore refrain from any excessive interference with the management of a company, and leave it to the directors to monitor the company in its best interests. He should nevertheless exercise his lawful rights at the general meeting, and dismiss his representatives on the board of directors if dissatisfied with their work. However, if a shareholder does not interfere with the management at all, he should not fear any liability incurred upon him as a director of the company.

### 3.3.4 Parent as a shadow director

In cases where the question of liability arises, it is important to consider the involvement of a parent company in the management of its subsidiary, as the parent can incur vicarious liability or be held

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192 Legal control, or a de jure control, is when a shareholder is in possession and owns the majority of voting rights and can therefore influence the management by using his right. A de facto control is factual, and focuses on whether a person or an entity has any direct or indirect influence which would result in control over the company if exercised. This could for example be when a shareholder is not in possession of majority of voting rights, but is however able to exercise decisive influence by shareholding, agreement or other means.

193 This could include situations where the articles of association limit the influence of his shareholding, by categorising the shares into different groups with different rights enhanced to them.
Parent companies can not only be held liable for their subsidiaries on insolvency when the veil of incorporation has been lifted. They can also be designated as shadow directors of their subsidiaries. This is relevant when a subsidiary experiences financial difficulties and the parent company exercises effective control over the governance and decision-making of its subsidiary’s affairs. Thus, if the board of directors is accustomed to act according to the decisions of the parent without an independent analysis, a shadow directorship can be established according to the common definition of shadow directors (Topp and James 2004).

3.3.4.1 Determination of a parent

The definition and determination of a parent company varies between the jurisdictions in question, although the main principles seem to be very similar. Surprisingly not, the Icelandic companies act is the least precise of those applied in the jurisdictions, while the new companies acts in Denmark and the UK analyse the concept thoroughly.

3.3.4.1.1 Concept of control

The DKCA expressly states that a parent is determined by the control or influence it has over another company. This is also to be concluded from the provisions in the UKCA and the ISCA. Thus, the company that has the actual control of the affairs of another company can be deemed a parent company. However, only one parent can be determined within a corporate group.

The concept of control is further defined in section 7 of the DKCA, where it is:

...the power to exercise decisive influence over a subsidiary’s financial and operating decisions.

194 Liability of a parent can also be incurred if the parent has tolerated or did not pay attention to the subsidiary’s actions or conduct of criminal abuse, or even if the parent had full knowledge, instructed the subsidiary to act in that manner or approved such acts. Criminal liability of a parent falls however out of the scope of this analysis. For further analysis of parents’ vicarious liability for criminal offences with its subsidiary (International Commission of Jurists 2008, pp. 45-48).

195 The general principle of determining shadow directorship is the same. If control is exercised and decisive influence by the parent over its subsidiary, by giving the directors of the subsidiary instructions on the business affairs, according to which they are accustomed to act, the parent can be designated as a shadow director (Hannigan 2003, p. 142).

196 Section 6 DKCA.

197 Section 7(1) DKCA.
3.3.4.1.2 Legal control

The main rule, in order to determine a parent, is that a company can be considered a parent company when it exercises legal control over a company, i.e. when it owns and exercises the majority of the voting rights within that company. This usually means that the parent holds a majority of share capital and is thereby in possession of the majority of the voting rights within the undertaking, and is thus able to exercise control over the management of that company by influencing the board of directors. This is assumed to apply in all of the jurisdictions in question. 

3.3.4.1.3 De facto control

A company can also be considered a parent company, without owning a majority of the shares and voting rights. A company can be considered parent if it is in control of the majority of the voting rights and can exercise decisive influence over the company, either by its shareholding or an agreement. Thus, if a company owns less than a majority of the shares and voting rights, it can still be considered a parent if it exercises control over the company, either by its shareholding or by an agreement that triggers a majority of voting rights within the company. An agreement can either be a shareholder agreement with the other shareholders of the company, seeking permission to exercise their voting rights, or an agreement which regulates the possession of shares as a security.

Furthermore, the Danish and British acts provide for provisions where a company can be determined a parent if it has the power to control the affairs of the company, either according to the articles of association of the undertaking, or according to an agreement of control. It is also provided in both of the acts that a company has obtained control as a parent if it has ‘the power to appoint or remove the majority of the members of the supreme governing body, and this body has

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198 Section 2(1) ISCA provides for that majority of votes are sufficient for determination of a parent. The same principle is provided in section 1162(2)(a) of the UKCA, and also in section 7(2) of the DKCA unless it is provided that: ‘…in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control.’

199 Section 2(3) of the ISCA provides for a company being designated as a parent company, if it can exercise influence over another company, either by its shareholding or agreements. The same principle applies in the Danish and the British jurisdiction where agreements can be sufficient to establish control of a parent company, see s.7(3)(1) DKCA, and s.1162(2)(d) UKCA.

200 However, in the Icelandic case of Hrd. 292/2003 (TL-Rúllur), which was in fact the only case where shadow directorship was considered and recognised, control was in fact assumed to have been established from a ‘contract’ according to s.2(3) ISCA, since the shadow director was not a shareholder in the company but could however exercise decisive influence over the company. Thus, the company was in fact deemed to be a parent company, on grounds of effective control exercised by contract.

201 Section 7(3)(2) DKCA and s.1162(2)(c) UKCA. Even though the Icelandic law does not provide for similar provisions, the conclusion in the earlier mentioned case of TL-Rúllur Hrd. 292/2003, may be argued to have been established on such measures as ‘power to control the affairs of the company’, rather than by a contract regulating the use of voting rights.
control of the business.'

It must be noted, though, that the UKCA states that in order for a parent company to in fact be a parent company it must hold shares in the undertaking. Therefore, the act further describes in detail how a company can be considered a shareholder of another company.

The UKCA defines a parent to be one who exercises dominant influence or control over the undertaking, or a case where the companies are managed by the same directors. The Danish act provides a similar provision where the control of a parent can be established if it evidently has ‘the power to exercise the actual majority of votes at general meetings or an equivalent body and thus the actual control of the business.’

Thus, a company will be considered a parent company, if it has decisive influence over the subsidiary’s board of directors and controls the majority of its members, directly or indirectly. Although the requirements vary to some extent from one jurisdiction to another, the rationale seems to be the same: to define a company as a parent company when it is able to influence the majority of the undertaking’s management.

3.3.4.1.4 Statutory limitation of a parent

As shadow directorship is a consequence of the fact that the management can be influenced by the shareholders, British law has deemed it important to protect the relationship of the companies within a corporate group. Thus, the UKCA provides an exception in certain situations as regards the designation of a parent company as a shadow director of its subsidiary. Thus, the definition of shadow director does not apply to a parent company in relation to its subsidiary under the circumstances mentioned in the provision, even though the directors of the subsidiary are accustomed to act in accordance with instruction from the parent company. The limitation provides that a parent can manage its subsidiaries, and is moreover supported by the fact that the parent can be a member of the subsidiary’s board of directors (Hansen 2003, p. 71). It is therefore important

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202 Section 7(3)(3) DKCA. Similar provision can be found in s.1162(2)(b) UKCA.
203 Section 1162(3) UKCA. It is sufficient if any of its subsidiaries are shareholders or if shares in the subsidiary are held by an agent of the parent or its other subsidiaries.
204 Section 1162(4) UKCA. It is indeed often the case that the same persons serve as directors in several companies within a corporate group.
205 Section 7(3)(4) DKCA.
206 The statutory limitation is laid down in s.251(3) of the UKCA:
  ‘A body corporate is not to be regarded as a shadow director of any of its subsidiary companies for the purposes of—
  Chapter 2 (general duties of directors),
  Chapter 4 (transactions requiring members’ approval), or
  Chapter 6 (contract with sole member who is also a director), by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions.’
for a British company to be designated as a parent in order to be subjected to the limitation of parent companies in 251(3), and be able to act freely if it has a position on the board of its subsidiary. The Nordic jurisdictions, however, do not provide a corresponding right for legal entities to have a seat on the board of directors of their subsidiaries. Instead, they must appoint natural persons as their representatives to take seat on their subsidiary’s board. Therefore, such statutory limitation would seem unnecessary for the protection of the parent’s conduct as a member of the board.

3.3.4.2 Parent liability

Despite the fact that a parent company has the right to manage its subsidiaries, a subsidiary has a separate legal personality and is therefore a distinct entity from all other legal and natural persons, including the parent company in charge of it. Therefore, on the grounds of the concept of a separate legal person, the main principle is that an individual company may not suffer damages, even if it would benefit the corporate group as a whole (Hansen 2003, pp. 71-72). The interest of the whole group does not necessarily correspond with the interest of the company and, thus, a parent company will not be able to obtain any advantage from being dominant within the general meeting of its subsidiary and try to influence its management in this respect. An act, which entails a loss for one company, but benefits the group, can therefore render the members of the management organs who are responsible for the act liable. A parent company must therefore be responsible for its actions and be aware that it might be subject to the statutory duties of directors as shadow directors, with respect to the management of its subsidiary companies.

As a consequence, legal entities, who are closely connected with other entities, must exercise due care in their conduct, in order not to become a shadow director (Anon 2010). Parent companies often have very intimate relationships with their subsidiaries, and the distinction can therefore be

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207 The proper test to see whether a director has acted with the interests of the company as a whole, and not of the corporate group, is whether: ‘...an intelligent and honest man in the position of a director of the company concerned could, in the whole of the existing circumstances, reasonably believe the transactions are for the benefit of the company. This is not to deny, of course, that the interests of the group may be relevant to deciding what is in the interests of the company.’ Hannigan (2003, p. 80).

208 A special doctrine in French law, The Rosenblum doctrine, allows for such an ‘irresponsible act’ of the management to the benefit of the corporate group, even though it causes losses to a single company of the group. The doctrine cannot be considered to apply in jurisdictions in question, since each company is regarded as an independent economic entity (Hansen 2003, pp. 139-140).

209 The decision by the Danish Supreme Court in the case of Satair, UfR 1997.364 H, confirmed shareholder liability of a parent company, as it exercised effective control over its subsidiary and was held liable as the management of the subsidiary. The parent was a sole shareholder of a private company, which shares were sold to a company who asset-stripped the company, right after the purchase. The assets of the private company included values that had been set aside to cover unpaid tax and other official duties (Hansen 2003, p. 97).

210 In the case of Kuwait Asia Bank EC v. National Mutual Life Nominees Ltd [1991] AC 187, this principle of parent liability and establishment of shadow directorship was recognized and accepted over its subsidiary.
unclear, especially when the same persons exercise executive roles in both entities.\textsuperscript{211} The close connection within companies in a corporate group does not necessarily lead to shadow directorship, because each company within the group is a separate legal entity with an independent board, which is entitled to make decisions on behalf of the company and in its best interests. Thus, the parent risks being held liable as a shadow director, if it does not assure that the board of the subsidiary is able to make independent decisions regarding its business affairs (McGregor 2004).

Furthermore, a shareholder of a company, whether he is a natural or a legal person, may be designated as a shadow director of a company, even when the company in question is not a subsidiary of the shareholder in question (McGregor 2004). In the Icelandic case of \textit{TL-Rúllur},\textsuperscript{212} shadow directorship was established jointly between a parent company and a sister company of the company TL, as both companies were deemed to have exercised effective control over TL. The interesting thing is that the sister company seemed to have assumed the position of a parent on the grounds of its decisive influence over a company in which it was not a shareholder and to which its only other connection was a mutual parent company.\textsuperscript{213}

\subsection*{3.3.4.3 Do directors of parents risk being shadow directors?}

If a parent can be designated as a shadow director, it is often questioned whether those who make the decisions for the parent can be held liable as shadow directors or not. The conclusion is that directors do not risk being designated as shadow directors if they act within their legal capacity as directors. Nevertheless, any instructions from a director of a parent in an individual capacity may render that person a shadow director, and impose director liability upon him (Anon 2009).

\textsuperscript{211} This is particularly relevant in smaller companies and when the parent company is a holding company, i.e. only holding shares in other companies without other activities. Here, the principle of lifting the veil can be considered and the companies been identified as one.

\textsuperscript{212} \textit{Hrd. 2004:1060 (TL-Rúllur)}. The case is in fact the only case under the Icelandic jurisdictions where shadow directorship was considered and recognised.

\textsuperscript{213} \textit{Ibid.} TL was an insolvent company and it was obvious that assets had been transferred to its sister company (H), by decision of the sister company and their mutual parent (T), while insolvent. The Supreme Court accepted the view that the subsidiary TL, was not independent in its work from neither its parent company (T) nor its sister company (H). The executive manager was a board member of both the parent company (T) and the sister company (H). Thus, the decision making powers were in fact in the same hand of all the three companies in the group. The sister company (H) was therefore deemed as a shadow director and jointly liable with the parent (T) for the unlawful transfers of assets for its own benefit, and to the detriment of the TL. The court did not set forward clear assessment if the ownership of the companies was identified with each other by lifting the veil of incorporation, or whether a shadow directorship had been established. However, the sister company (H) was considered to have assumed the position as a parent company of the subsidiary (TL) on grounds of its decisive influence and was liable for the asset transfer. Thus, it seems likely that the court established shadow directorship in the very first Icelandic case.
The liability of a parent and its directors was considered in the case of *Hydrodam*.

The court concluded that even if a parent company is designated as a shadow director of its subsidiary, the directors of the parent company will not necessarily become shadow directors of the subsidiary (McGregor 2004). The court concluded that the personal liability of the parent’s directors could only be established if they, individually and personally, had given instructions, regarding the decision-making process of the company, to the management of the subsidiary.

This restrictive interpretation of determining shadow directorship was also confirmed in the case of *PFTZM*, where advisors of the bank could not be considered shadow directors, since they only acted within their capacity and in order to guard the company’s interests. However, the court in *Hydrodam* did not explain this assessment in detail. The question of what constitutes one’s individual capacity, and whether a director has exercised his discretion or not, is difficult to answer, and arguments have been provided against the restrictive interpretation of the statutory definition.

In order to answer this question, one must assume that the directors honour their onerous duties on a general basis. Thus, it could be argued that the suspicion of a shadow directorship, where an alleged director influences the members of the management, would above all arise when the regular directors act in a way that turns out to be detrimental to the company. However, it would not be fair and in fact ridiculous to establish such a test based on that argument, where liability is established upon a person as a shadow director every time a director makes a wrong decision, even when the decision-making procedure is based on the director’s own discretion and independency. However, it seems obvious that a test has to be developed in order to demonstrate whether the directors acted within their legal capacity and made decisions at their own discretion (Anon 2010).

214 *Hydrodam (Corby) Limited*, Re [1994] 2 B.C.L.C. 180. The case was about two members of the management in a parent company who could not be determined as shadow directors in a wholly owned indirect subsidiary (Hydrodam Ltd). For further discussion, see footnote #110.

215 Thus, participating in the board meetings of the parent company was clearly not sufficient to render them as shadow directors. It would even not be sufficient if they acted in implementing the decisions of the board regarding the subsidiary as they only acted in their legal capacity as agents of the parent company (Girvin et al. 2010, pp. 317-318).


217 Anon (2010) argues that instructions given by one of the directors of the parent to a subsidiary company might be considered to have been given in a personal and individual capacity, even though the director has been directed to do so, as a task within his capacity. That would render him as a shadow director and he would become personally liable for his acts, even though he was only acting as an agent of the parent and exercising directions he obtained. However, Anon (2010) claims that this could be avoided if the board of directors would keep minutes of every meeting where the director’s legal capacity can be illustrated.
PART 4 – CONCLUSION

4.1 SUMMARY FROM DISCUSSION

4.1.1 The limited company

Despite being debated ever since it was first introduced, the limited company is revealed to have benefitted society in general, by presenting the most important principles of modern company law, the principles of corporate personality and limited liability. The principles are assumed to be fundamentals for the development of modern company law as they encourage investors to establish limited companies. The investors do not have to fear being liable for more than they originally invested, since a limited company is distinctly separate from their own individual person and therefore carries its own duties and liabilities (Girvin et al. 2010, p. 4). Investors are therefore incentivised to participate in equity markets as they are granted the possibility for the perpetual succession of their investment and their risk is therefore reduced from any downturns in limited companies. Thus, arguments can be provided for that the limited company form has proven to be a prerequisite for common wealth as it abolishes investors’ risk adversity and provides companies with increased access to capital (Girvin et al. 2010, p. 4).

The principal disadvantage of the limited company form is generally assumed to be an increased risk for creditors in reclaiming their contribution of loans as they cannot file their claims against anyone but the company itself. In turn, the growing risk is reflected in increased cost of loans to limited entities. Accordingly, the fundamental principles connected to the limited company form have been disputed, including whether the benefits following from the invention of these principles exceed the disadvantages in general, and whether the veil of incorporation provides excessive protection for the members of the company, which has generated unwarranted opportunities for abuse of the limited company form. Furthermore, the debate has gained increased criticism after the recent financial crisis. However, the criticism of the limited company form is very controversial. The fundamental principle of the company form is indeed to provide its members with limited liability and the ability to avoid any personal liability of claims against the company, provided that they act responsibly and within their lawful capacity. However, in the light of the economic shakeup taking place in the world economy, it must be assumed natural that considerations
regarding these fundamental characteristics of the limited company form are being considered. Arguments may be provided that the company form can be easily abused, and recent cases reveal that harmful decisions are often made with the intention to disregard the interests of the company as a whole, often without a proper analysis of who is responsible.

4.1.2 The question of liability

Due to the fact that the limited company is a separate legal person, which provides its members with limited liability, onerous duties are laid down on the controllers of the company. They serve an important agency role within a limited company, as they are in possession of the company’s managerial powers. Thus, they must conduct lawful decisions and exercise them with due care, by guarding the interests of the company as a whole. Consequently, they are the ones who can be held liable if the company suffers from harmful decisions.

Contrariwise, the shareholders, being merely the economical beneficiaries of the company, are not entitled to interfere with the company, and they must exercise their limited powers in a lawful manner and with due care. However, the shareholder-oriented governance models applied in the jurisdictions in question provide the shareholders with significant influence over the members of the company’s management. Such an influence, which is unfortunately often exercised for the purpose of creating a beneficial advantage for an individual shareholder or his associates, may never jeopardise the interests of the company as a whole. Shareholders, who interfere with the company’s management, are often revealed to have been those who made important decisions within limited companies, without being entitled to it. Nevertheless, the shareholders often assert that they cannot be held liable for any decisions made within the company: they only hold the shares of the company with very limited management powers and are therefore provided with limited liability. Thus, the examination of shareholder liability and situations in which they can be held personally liable, by virtue of their controlling influence and interference with the management of the company, are of essential importance in order to cope with the problem of abusive use of the limited company form. The question of whether shareholders can assume personal liability is of great importance when a company experiences financial difficulties in its business and has become insolvent.

When considering the liability of shareholders within limited companies, the decision set forward in the case of Salomon v. Salomon is revealed to be of most significance, and may be said to prevail in modern company law. The decision appears to be what courts consider the key element when they
decide on such matters in order to impose personal liability upon the members of a limited company. Therefore, they are reluctant to disregard the principle of corporate personality and they usually refer to the decision in the case of *Salomon v. Salomon* when they seek to provide arguments for their decisions, which aim is to honour the veil of incorporation and protect the limited company form.

The limited company is a unique invention which must be upheld and protected, as it generates great benefits to society in general. Despite the fact that limited entities will be preferred to remain intact for the benefits of society in general, there are, however, certain situations in which the courts have recognised circumstances where the company’s members may incur liability beyond the limitation of liability provided by the veil of incorporation. The courts may decide to lift the veil of incorporation and impose personal liability upon the members of the company, who would otherwise have been protected by the limited company form, despite the fact that the company is lawfully established and incorporated. The courts have established that the veil can be lifted only when special circumstances arise, and these include in particular agency relationships and instances in which courts recognise a limited company to be a sham. The courts have provided important criteria and tests for determining the circumstances where the veil can be lifted, although without pure consistency in that regard. The present position, however, seems to be that the courts are unwilling to lift the veil unless there is a clear agency relationship or the company can obviously be identified as a mere sham. Reluctance to lift the veil is mainly due to the fact that the courts rely on the principle provided in the case of *Salomon v. Salomon* and seek to keep the company form intact and protect the fundamental principle: that the company is a separate legal person and is responsible for its own acts.

However, it must be concluded that instances where the veil can be lifted are necessary in order to counteract against abuse of the limited company form and to protect market efficiency. If the limited company form loses its credibility and abuse of the form is tolerated to some extent, creditors may become reluctant to participate in financing such entities if no one can be held liable for detrimental acts against the company. On the other hand, if the veil is constantly being lifted, investors and directors may become reluctant to participate in a limited company due to the uncertain and imminent risk of liability for the company’s members. Therefore, courts must continue to be aware of situations where the form is simply abused and are clearly used for the purpose of disregarding the interests of a company’s creditors, and they must continue to lift the
veil with due care. It is moreover important to continue to develop and establish a clear set of rules in this respect and produce tests for determining instances where the veil can be lifted.

4.1.3 The risk of shadow directorship

Due to the fact that shareholders have limited management powers, they have difficulties protecting their interests in a limited company. In order to do so, they are often eager to influence the management, with the intention of guarding their interests, which consequently can be detrimental for the company as a whole. Such behaviour, resulting in excessive influence upon the company’s management may lead to the shareholders being designated as directors of limited companies. They can either act blatantly as de facto directors or act in the shadows of the other directors of the company, without purporting to be directors. Thus, determination of such directorship requires consideration and analysis of the shareholder's position, in order to impose director liability upon him. The law, however, is far from settled on who can be considered a director, how one is designated a director and which situations may render shareholders directors. The judicial practice can therefore be expected to develop the instances where shareholders can be said to have assumed the role of a director.

The determination of shadow directorship can be an arduous task as the nature of shadow directors is that they are not to be determined as directors. Therefore, a thorough analysis of the concept has been provided, along with examples from various situations. They prefer to be puppeteers behind the directors of the company and have them execute their instructions, thereby satisfying their own interests. Shadow directorship, however, is not always illegal. A shareholder can act as a shadow director without instructing the directors to carry out harmful actions. It is only when financial difficulties arise and liability is considered that it is examined whether any harmful acts have taken place within the company, for the purpose of disregarding the interests of the company as a whole and creating a beneficial advantage for some members of the company and, consequently, the detriment of others. Nevertheless, a dominating shareholder can easily exercise control over the company by using his influence and he must therefore act with due care in order not to be designated a director of a limited company. In turn, such behaviour raises the question of liability of shareholders when they exercise such effective control over the management. The determination of a shareholder assuming the status of a director has been analysed thoroughly in the previous discussion, and a light has been shed on characteristics of shadow directors, situations where shadow directorship can be established and ways for identifying shadow directors. Consequently,
and to draw a conclusion from the aforementioned, those who are neither duly appointed directors nor purport to be so, but nevertheless have a close connection with a company, must act carefully in order not to render themselves shadow directors.

4.2 DIFFERENCE OF THE BRITISH V. NORDIC LEGAL SYSTEMS

The British provisions, defining the different types of directors, must be assumed to provide a significant certainty for members of limited companies in the UK. Moreover, it seems natural to establish clear rules for those who may be designated as directors without being entitled to such a position, in order to catch those who exercise the actual controlling powers in the company and impose liability upon them. As there are no such definitions in the companies acts of the Nordic jurisdictions, and due to the insignificant amount of judicial precedents established, uncertainty within the field is a fact in the Nordic legal system. Contrarily, it appears that the legislators in the Nordic jurisdictions have refrained from establishing such measures to eliminate this uncertainty. Instead, the judicial practice seems to be expected to develop measures to cope with the matter of lifting the veil of incorporation and establishing shadow directorship. This, however, has not been imminent, and very few cases have been decided on in the Nordic jurisdictions. Nevertheless, and due to the ongoing crisis, the courts should anticipate a number of cases in which they will have to decide on these issues.

Due to lack of statutory provisions and judicial practices within the field, regarding lifting the veil and establishing shadow directorship in order to impose liability upon shareholders, the practice in the Nordic jurisdictions is vague, which underpins uncertainty of the legal system applied in the jurisdictions. The analysis of the British law in this regard has revealed the different types of directors, their characteristics and determination as well as situations where directorship can be established. The vast judicial experience from the UK is therefore an important guidance on how the legal procedures may develop in the jurisdictions in question in the near future. Furthermore, the general elements provided on shadow directorship in the discussion should be a sufficient basis for shareholders to become aware of their position and provide them with knowledge of how to avoid being designated as shadow directors. The aforementioned criteria and tests, provided by the common law system, may be of the utmost importance for future courts’ decisions in the Nordic jurisdictions while imposing liability upon shareholders, when abuse of the limited company form seems obvious or when the shareholders have exercised excessive influence on the decision-making
procedures within such company. The number of cases questioning the liability of shareholders with regard to their acts may without a doubt be expected to increase. This would be the normal procedure, seeing as courts commonly seek advice and look for precedents in the nearest jurisdictions when the law is unclear and their own judicial experience is limited. Thus, one can assume that the Nordic courts will be able to elaborate on the issues in a similar way as the British courts. It must nevertheless be noted that, although the practice differs between the jurisdictions, the rationale of the law in all three jurisdictions appears to be the same: to extend the liabilities of directors to those who are in fact in possession of the real controlling powers within limited companies.

4.3 SUGGESTIONS FOR AMENDMENTS

Thus, to propose suggestions to any future amendments to the Icelandic companies act, or even to an establishment of a new one, it would be a great advantage to provide clear definitions of company’s directors, as is established in the UKCA, because such provisions would provide certainty for members of limited companies and understanding of situations which may impose increased liability on a company’s member. This would, as a minimum, clarify the position of persons who interfere excessively with the management of the company. Such provisions would also provide the courts with a basis for determination of situations where an interloper may be considered to have assumed the position of a director, which the courts then elaborate on as within the British practice. Comparing to the DKCA, the need for determining such concepts was apparently not deemed important. It seems that the legislature trusts the courts to elaborate on the matter and develop a means for placing liability upon those who interfere excessively with a limited company. However, this requires that courts are consistent in their decisions and provide clear tests in order to determine such persons.

However, it must be considered that provisions, defining persons who assume the position of a director, may restrain potential members of a limited company from actually participating in the company. Just as too onerous duties upon the company’s controllers weaken the veil of incorporation (Wood 2008, pp. 66-67), excessive liabilities on other members of the company, such as the imminent risk of being designated as a director, may chill their enthusiasm for becoming members of the limited company and consequently reduce the advantage that the limited company form is intended to provide. However, the practice of courts develops in the direction of recognising
these persons, although with due care and only under limited circumstances. Thus, the advantage of a set of easily understandable rules within the field and increased efficiency in equity markets should rule out these considerations. In turn, it might have preventive effect, result in shareholders being less eager to interfere with the management and conduct in a more responsible way. Most importantly, the limited company will remain intact, as such measures will provide protection and hinder the limited company form being abused. It is therefore of paramount importance that these situations are recognised and the problems related hereto dealt with in a firm and responsible manner.
SUMMARY

Despite having been disputed ever since it was first introduced, the limited company has benefitted society in general by presenting some of the most fundamental principles of modern company law. The principles of corporate personality and limited liability incentivise investors to participate in equity markets and invest in limited companies, as they are thereby granted the possibility of perpetual succession of their investment, without the risk of losing more than they originally invested. However, the fundamental principles connected to the limited company form have been debated, including whether the benefits following the invention of these principles exceed the disadvantages in general, and whether the veil of incorporation provides excessive protection for the members of the company, which has generated unwarranted abuse of the limited company form.

Shareholders, who interfere with the company's management, often make important decisions within limited companies, without being entitled to. Thus, an examination of shareholder liability and situations in which they can be held personally liable, by virtue of their controlling influence and interference with the management of the company, are of utmost importance in order to cope with the problem of abusive use of the limited company form. Thus, there are certain situations in which the courts have recognised circumstances where shareholders may incur excessive liability, beyond the limitations provided by the veil of incorporation. These situations particularly involve the practice where the veil of incorporation is lifted and shadow directorship is recognised. Shareholders are therefore at risk of incurring personal liability when the requirements for these instances are met. This is highly relevant for the jurisdictions in question, the UK, Denmark and Iceland, since the shareholder-oriented governance models applied provide the shareholders with significant influence over the company's management. A shareholder must therefore exercise due care when conducting his acts within a limited company, in order not to incur personal liability for his acts.

The analysis of the situations, in which shareholders are at risk, provides a guidance regarding determination of shareholder liability. Due to lack of statutory provisions and judicial practices within this field in the Nordic jurisdictions, the practices from the UK shed light on the matter. Thus, one can assume that the Nordic courts will be able to elaborate on the issues of lifting the veil and establishing shadow directorship, in a similar way as the British courts, in order to impose personal liability upon shareholders, in future proceedings.
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