Feature

KEY POINTS

- Shareholders cannot simply approve a dividend, or ratify a director's breach of duty, and thereby absolve the director from liability.
- It is likely that the wording in s 270(3) Companies Act 1985 means that a distribution can only be made if compliant accounts for the *immediately preceding* accounting reference period have been laid.
- A distribution is only illegal to the extent it is in excess of available profits.

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Aspects of dividends: the relevant accounts

In light of the recent collapse of BHS, this article revisits when a director can extract dividends from a failing company. The legal framework surrounding the drawing of dividends is of interest to bank directors as well as to holders of hybrid debt (such as contingent convertible bonds) which can convert into equity on the occurrence of a pre-specified trigger event.

INTRODUCTION

The Companies Act 2006 Part 23 governs the circumstances in which distributions may be made. The main principle is that distributions may only be made out of distributable profits, being in essence accumulated realised profits less accumulated realised losses: s 830.

Public companies have some further requirements in order to ensure that their net assets do not fall below the aggregate of their called up share capital and undistributable reserves (eg share premium account). Investment companies have some yet further requirements, not discussed here.

Some common law principles remain relevant: a company cannot pay a dividend out of capital and the directors must therefore consider whether losses sustained have eroded profits since the last balance sheet date.

ENFORCEMENT OF FORMALITIES

The formalities for the declaration of dividends are strictly enforced:

- In *Bairstow v Queen's Moat House Plc* [2001] EWCA Civ 712; [2001] BCLC 531 at [36], the Court of Appeal held that the then requirements for the valid exercise of a company's power to pay dividends, particularly the requirements of s 270 ff. of the CA 1985, are mandatory and strict, not to be treated as mere technicalities. It therefore found the directors liable for declaring dividends in the absence of available profits, despite the existence of profits elsewhere in the group which could have been paid up.
- A distribution described as a dividend, but actually paid out of capital, is unlawful, however technical the error and however well-meaning the directors who paid it: *Progress Property Company Limited v Moorgarth Group Limited* [2011] 2 BCLC 332 (Supreme Court).
- Shareholders cannot simply approve a dividend, or ratify a director's breach of duty, and thereby absolve the director from liability.

DRAWINGS OR PAYMENTS MADE IN ADVANCE OF PROPERLY DECLARING DIVIDENDS

There is a distinction between dividends and other drawings:

- In *Re Duomatic* (1969) 2 Ch 365 the court considered an application by a director for relief from liability under a forerunner of s 1157 of the CA 2006, in relation to drawings taken in anticipation of remuneration being voted in the future. Mr Justice Buckley commented in his judgment as follows:

> 'Directors must, I think, take the trouble to discover just what their rights and obligations are, and if they draw on account of remuneration to which they are not entitled in anticipation of its being voted to them in the future, then normally the director could not be said to be acting reasonably and ought not to be excused.
>
> However there is, in the present case, I think, this important circumstance, that at the time he made these drawings Mr. Elvins was in control of this company. He could have passed, in general meeting, any resolution he chose. It was an oversight that no resolution was ever passed authorising him to retain the amount of these drawings.'

- There is a distinction between drawings which the company can approve, and dividends. Dividends cannot properly be guessed at, and shareholders cannot approve an illegal dividend, so directors cannot guess at what the distributable reserves will be, relying on the shareholders to approve the dividends in due course.
- Further, if the directors do guess or estimate the reserves without relevant accounts, it is likely that the payments are not dividends at all and directors will be liable to repay them.
- In *First Global Media Group Limited v Larkin* [2003] EQCA Civ 1765, [2003] All ER (D) 293, directors were advised to take dividends rather than salary in order to avoid the payment of tax. The Court of Appeal held that these drawings were neither dividends (deriving from no recognised statutory procedure) nor remuneration (the whole object being that they should not be regarded as such).

Dividends declared by reference to the last relevant accounts

Section 270(3) of the CA 1985 provided that:

> 'The company's accounts which are relevant for this purpose are its last annual accounts, that is to say those prepared under Part VII which were laid in respect

of the last preceding accounting reference period in respect of which accounts so prepared were laid; and for this purpose accounts are laid if section 241(1) has been complied with in relation to them.' (emphasis added)

Section 836(2) and 837 of the CA 2006 provide that:

'The relevant accounts are the company's last annual accounts … The company's last annual accounts means the company's individual accounts-

(a) that were last circulated to members in accordance with section 423 (duty to circulate copies of annual accounts and reports), or
(b) if in accordance with section 426 the company provided a summary financial statement instead, that formed the basis of that statement.'

On a literal reading of ss 836(2) and 837, the relevant accounts could mean the last accounts prepared and circulated to members for a preceding accounting reference period, even if a further reference period has passed before the making of the distribution.

In *Logic Alliance Ltd (in liq)* (24 November 2006, unreported), a case under the CA 1985, it was argued by the directors that since the "last annual accounts" are defined by s 270 as meaning those prepared under Part VII which were laid in respect of the last preceding accounting reference period in respect of which accounts so prepared were laid, the court must look at the last time that compliant accounts were in fact laid (when the company in question had available profits) regardless of whether a further account period has in fact since passed without compliant accounts having been filed. The liquidators on the other hand argued: (i) that this literal interpretation was contrary to the policy of the CA 1985; and (ii) even if the literal interpretation was correct, there was a residual duty on directors which would prohibit the distribution (which was presumably a reference to the common law duty), since the company was insolvent.

Bernard Livesey QC (sitting as a deputy) held, but only on an application to amend the originating application, that it was more likely that the wording in s 270(3) meant that a distribution could only be made if compliant accounts for the immediately preceding accounting reference period had been laid. He said:

'27. It seems to me that the meaning for which the defendants argue is not likely to be what the legislature will have intended. If the defendants' interpretation were correct, the provision would expose companies and creditors to the potential for the most extraordinary abuse. The statutory safeguards could be avoided, after one good set of accounts, by directors failing to produce proper or indeed any accounts for subsequent periods when the financial results for those periods were such as would wipe out the distributable reserve. The defendants' argument would entitle directors, after enjoying one good year, to ignore the results of following disastrous years by delaying the preparation of accounts and even where statutory accounts had been prepared and filed, where those accounts did not include the information to ensure compliance with the requirements of Part VII of the Act. On the basis of such an interpretation, such abuses would not be a breach of section 263; they could be practised almost with impunity and enable directors to extract the last remaining assets from the company to the prejudice of creditors.'

In fact, the position of a company the fortunes of which have deteriorated since its last accounts were filed would be protected to some extent by the liquidators' second argument above, that even where accounts have been filed showing available profits, there remained a duty on them to consider the up to date position in deciding whether to declare a dividend. Nevertheless, the reasoning of Bernard Livesey QC is clearly powerful, and applies equally under the CA 2006.

In *Cook v Green* [2009] BCC 204 HHJ Pelling QC approved the judgment in *Logic Alliance Ltd*, albeit not in the context of the payment of dividends. He had to consider whether the company had distributable profits available for the provision of financial assistance, and held that a company could only show that it had distributable profits by reference to statutory accounts for the financial period *immediately preceding* that in which the assistance was provided.

INTERIM ACCOUNTS

The same argument applies. If (contrary to *Logic Alliance Limited*) the phrase "last annual accounts" were not interpreted as meaning the accounts for the immediately preceding accounting period, the rules on the use of interim accounts to declare dividends might also be open to abuse:

Section 836(2) of the CA 2006 provides that:

'The relevant accounts are the company's last annual accounts, except that -

(a) where the distribution would be found to contravene this Part by reference to the company's last annual accounts, it may be justified by reference to interim accounts, and
(b) where the distribution is proposed to be declared during the company's first accounting reference period, or before any accounts have been circulated in respect of that period, it may be justified by reference to initial accounts.'

On a literal reading of ss 836(2) and 837, the relevant accounts could mean the last accounts prepared and circulated … for a preceding accounting reference period

- These provisions appear to be designed to cater for an improvement in the company's fortunes which justifies a distribution.
- But if the last relevant accounts are simply the last accounts circulated, then this could lead to companies delaying the preparation of their final accounts for the last preceding accounting year (Year 2), relying on the inability to declare a dividend by reference to Year 1, and using interim accounts to declare a dividend.
- Why does this matter, if the interim accounts appear to justify the distribution?
  - If the company does not have the benefit of the audit exemption then its final accounts must be audited (and if the auditor's report is qualified, the auditor must have stated whether such qualification is relevant to whether a distribution can be made: s 837(4) of the CA 2006);
  - By contrast, interim accounts need not be audited;
  - With private companies, interim accounts must enable a reasonable judgment to be made as to profits, losses, assets and liabilities, provisions, share capital and reserves. There is no filing requirement;
  - For a public company, stricter rules apply: interim accounts must be properly prepared under the CA 2006 in areas material to the proposed distribution, and must be filed at Companies House prior to making the distribution.
- So allowing companies to rely on interim accounts instead of audited accounts for the immediately preceding accounting period might permit troubled companies, whose last filed accounts do not permit them to declare a dividend, to delay scrutiny of their most recent accounts by allowing them to declare dividends without an auditor's statement based on interim accounts.

This all points to the good sense of construing "last annual accounts" as meaning accounts for the immediately preceding accounting period, rather than the last ones which were in fact circulated however long ago.

So under s 836(2), a company whose circulated accounts for Year 1 do not show sufficient distributable profits to declare a dividend can nevertheless do so at any time before the end of Year 2, provided its interim accounts show sufficient improvement to enable it do so.

But what about the position of a company which shows distributable profits in Year 1 (but does not distribute them), and then just after the end of Year 2 but before its annual accounts for Year 2 have been finalised and circulated (and within the time for doing so, so there is no delay by the company), wishes to declare a dividend by reference to interim accounts which show that the company's healthy profits are continuing?

- On a literal reading of s 836(2) it could not do so, because that only says that interim accounts may be used where the distribution would contravene the Act by reference to the last annual accounts; and if "last annual accounts" does mean accounts for the immediately preceding accounting period, it cannot be said that the distribution would contravene the Act by reference to the last annual accounts, because these do not yet exist (and if they did, would presumably show sufficient distributable profits).
- So is the company really to be in a worse position than the recently unhealthy company referred to above, or even a brand new company (s 836(2)(b) – see also above)?
- An answer might be to say that in these circumstances the requirements for the company to be able to use interim accounts *are* satisfied, because the company *is* unable to rely on the accounts for the last accounting period; if this means the circulated accounts for the immediately preceding accounting period, then the company cannot rely on them precisely because they do not yet exist (and can therefore rely on the interim accounts). But this is tortuous. Unfairly, the company may have to wait until its accounts are ready. There is currently no authority directly on this point.

> This all points to the good sense of construing "last annual accounts" as meaning accounts for the immediately preceding accounting period ...

ILLEGALITY

The consequences for directors and shareholders of making a distribution in contravention of the CA 2006 are that a shareholder may be liable to repay the distribution where he has sufficient knowledge of the facts, and a director may be liable for breach of duty. Will the dividend always be illegal in its entirety?

- In *Bairstow* it was held that the directors were liable for the entire dividend and not just for the difference between what they paid and what they could have paid had they taken steps to pay profits up from subsidiaries. The point was made that a company's accounts had to be taken as they were, not as they might have been had some different course been taken.
- But if the company's accounts show that there were profits available for distribution, albeit less than was in fact distributed, the dividend may be partly lawful if the declaration can be construed as a valid declaration in respect of those profits that were in fact available at the time.
- So in *Re Marini Limited* [2003] EWHC 334 (Ch), [2004] BCC 172 HHJ Seymour QC was asked to decide that the entirety of the dividend paid in that case was unlawful, despite there being some available profits. He distinguished

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Bairstow on the ground that there the distribution would only have been lawful if the directors had taken steps to pay profits up to the company, whereas in *Marini* some profits were available; and held that the distribution was only illegal to the extent that it was in excess of available profits.

RELIEF UNDER S 1157 CA 2006: RELUCTANCE OF COURT TO RELIEVE DIRECTORS

Honesty and reasonableness are preconditions for relief under s 727 of the CA 1985 and under s 1157 of the CA 2006 (which is in materially identical terms): *Bairstow v Queen's Moat House Plc* [2001] EWCA Civ 712, [2001] 2 BCLC 531 at [63] per Robert Walker LJ.

- The test of reasonableness is whether the director acted with the reasonable care and circumspection which could reasonably be expected of him in the circumstances: *PNC Telecom Plc v Thomas (No 2)* [2007] EWHC 2157 (Ch), [2008] 2 BCLC 95.
- In *Inn Spirit v Burns* [2002] EWHC 1731 (Ch), [2002] 2 BCLC 780 Rimer J was asked to consider what the position would have been had the companies in question, instead of paying a supposed dividend without formality, taken a course whereby a dividend was lawfully declared. Rimer J rejected that approach, and could not conceive that relief would be granted at the expense of creditors of the company, even in circumstances in which it might be said they had acted honestly and reasonably:

> '[30] In these circumstances I am prepared to accept that Mr and Mrs Burns have at least a real (meaning more than fanciful or imaginary) prospect of persuading a court that they acted 'reasonably' for the purposes of s 727. By itself, that would not entitle them to relief under s 727 since they will also have to satisfy the court that they 'ought fairly to be excused' for their breach of duty. As to that, I cannot see that the court could or should excuse them from liability at the expense of the creditors of the companies…'

The approach of Rimer J was followed in *Re Marini Ltd* and by the Court of Appeal in *First Global Media Group Ltd v Larkin* (above), in which two cases relief under s 727 of the CA 1985 was refused. In *Re Marini Ltd* HHJ Seymour commented as follows:

> '[57] However, like Rimer J I have the greatest difficulty in seeing that it is ever likely that "*in all the circumstances of the case*" it is going to be right that a defaulting director "*ought fairly to be excused for the negligence, default, breach of duty or breach of trust*", if the consequence of so doing will be to leave the director, at the expense of creditors, in enjoyment of benefits which he would never have received but for the default. However honestly the director acted, however much it may have appeared at the time of the act complained of that the only person who might be harmed by the act would be the director himself, it just is not fair, as it seems to me, that if it all goes wrong the guilty director benefits and the innocent creditors suffer.'

- In *Re In a Flap Envelope Co Ltd, Willmott v Jenkin* [2003] EWHC 3047 (Ch), [2004] 1 BCLC 64, it was said that it would require an extremely powerful case to persuade the court to exercise its discretion to relieve a director from liability if he has obtained a material personal benefit through breach of duty. ■

Further Reading:

- The new audit exemption for subsidiary companies and the requirement of a statutory parent company guarantee [2013] 1 JIBFL 45.
- Intra-group transfers at "market value": good intentions count [2011] 7 JIBFL 416.
- LexisNexis RANDI blog: The decline and fall of British Home Stores.