CLIFFORD CHANCE

DIRECTORS' LIABILITY FOR UNLAWFUL DIVIDENDS

When businesses fail it is not unusual for the blame game to start. Those responsible for its management are most likely to be in the firing line. Transactions that may have taken place years before any formal insolvency, may suddenly become subject to the close scrutiny of insolvency officeholders. Often with the benefit of hindsight, decisions taken years before are assessed to ascertain whether they have contributed to the failure of the business. For creditors, unwinding transactions may be the best hope they have of recovering what they are owed from the company.

On 19 June 2019 in the case *Re Burnden Holdings (UK) Limited (in liquidation)* the English court considered whether directors had overstepped the mark and breached their duties by paying a dividend and creating security. In addition to the breach of duty claims, the transactions were also challenged as defrauding creditors.

Key issues

- Importance of directors' judgement that there are sufficient distributable reserves, including obtaining financial and legal advice where necessary and properly documenting the transaction
- Consideration of whether breach of fiduciary duty imposes strict liability
- Reminder that an otherwise lawful distribution can be a transaction defrauding creditors (under section 423 Insolvency Act 1986)
- Grant of security may not fall under transaction defrauding creditors, after all

The Burnden case serves as an important reminder of directors' duties when considering a dividend, and identifies the potential consequences of any breach of those duties. The good news is that directors taking reasonable care in establishing the availability of sufficient profits to render the dividend lawful will not be personally liable even if it later turns out that there were no sufficient reserves. The court also held that the directors were entitled to rely on the judgement of others to carry out specialist roles (e.g. financial and legal advisers). The case is also useful in clarifying the susceptibility of challenge for dividends and security as transaction defrauding creditors under section 423 of the Insolvency Act 1986 (IA 1986). Whilst dividends are in scope, those taking security in commercial financing transactions in particular, will be pleased to learn that in this judge's view, security should not fall to be challenged under this provision of the insolvency legislation or a similar provision relating to transactions at an undervalue under section 238 of IA 1986. This marks a return to the commonly held approach dating back to the 1990s and articulated in the renowned case *M C Bacon Limited [1990] BCC 78*.

The claim in this case was initiated by a liquidator, six years after the transactions in question had taken place, and four years after the start of the liquidation. In this respect, it is a lesson that years after the event, claims can still be initiated, as long as they fall within the statutory limitation period. The limitation period can be as much as 12 years (or more) in certain circumstances. The claim in this case involved a demerger by which a subsidiary of the company was demerged from the group by way of a distribution in specie (in this case shares in a subsidiary). It also considers the provision of a fixed and floating charge granted to the directors of the company, who were also the majority owners of the group. Unsurprisingly, the judge found that in relation to the preparation for the demerger, there was nothing wrong or suspicious in the creation of profits where a holding company with no trade of its own, creates profits by procuring a dividend to it from the subsidiary, as long as there are sufficient distributable reserves in the subsidiary. The judgment provides some useful practical guidance and analysis of the case law on directors' liability for unlawful dividends and for directors when considering whether there are sufficient distributable profits. In particular the starting point for directors is to consider the most recent annual accounts, but the directors may also rely on interim accounts for the purposes of coming to the decision that there are sufficient profits. Helpfully in this case it was noted that "whether there are sufficient distributable profits may turn on fine questions of accounting judgment. Directors are not required to be accountants".

POTENTIAL LIABILITY

The judge also helpfully summarised the legal position in respect of potential liability for such distributions:

- directors are treated *as if* they were trustees in relation to a company's funds
- if they know of facts that constitute an unlawful dividend, they are liable for breach of trust, irrespective of whether they knew if the dividend was unlawful
- if directors are unaware of the facts that render a dividend unlawful then provided they take reasonable care to establish the availability of sufficient profits, they are not to be held personally liable if it turns out there were insufficient profits
- directors are entitled to rely on the opinion of others, in particular auditors.

STANDARD OF CONDUCT: KNOWLEDGE IS EVERYTHING

A director will be held liable to repay an unlawful dividend if:

- he knows it was unlawful (whether or not the knowledge amounted to fraud)
- he knew the facts that establish the impropriety of payments (even if he doesn't know the impropriety renders the payment unlawful)
- he must have known all the facts that render the payment unlawful in the circumstances
- he ought to have known, as a reasonably competent and diligent director, that payments were unlawful.

INTERESTS OF CREDITORS

The case also provides some useful guidance on breaches of duty under section 172(3) of the Companies Act 2006 (CA 2006). That section imposes a duty requiring directors to consider and act in the interests of creditors. The test is found in the recent *Sequana* case (see our briefing). That case is authority for the proposition that the duty to consider creditors' interests is engaged when the company is or is likely to become insolvent, where "likely" means probable. In the present case given the nature of the company being a holding company (funded by lending and with limited debts falling due), the focus was the balance sheet test. For these purposes the court is required to make a judgment, looking at the company's assets and making proper allowance for its prospective and contingent liabilities, as to whether it cannot reasonably be expected to meet those liabilities. In assessing the value of the assets and liabilities the court takes into account their commercial value and will only consider the present assets of the company (this test was articulated in *BNY Corporate Trustee Services Ltd v Eurosail 2007-3BL plc [2013] IWLR 1408)*. In the Burnden case the claimants (who had the burden of proving insolvency) failed to do so. Therefore, the duty was held not to be engaged.

VALUATION

The valuation of the shares distributed would have been determined by how any compensation due in respect of those shares would have been measured, if a breach has been established.

Given the finding that there were no breaches of duty in this case, it wasn't necessary for the judge to consider what the compensation ought to be for a breach, however careful assessment of the expert evidence and approach to valuation may be useful for future cases. There are for example, some interesting observations about the different types of valuation mechanism. In this regard the judge favoured an earnings based valuation with certain discounts applied, rather than a discounted cash flow or extrapolating the consideration paid for 30% of the shares. There is no suggestion that a valuation of the shares was necessary at the time of the distribution, but clear emphasis is put on the expert valuation evidence provided in regard to the claim.

RELIEF FOR LIABILITY (SECTION 1157 CA 2006)

Another useful part of the judgment comes in the consideration of relief from liability under the statutory provisions where there has been negligence, default, breach of duty or trust where it appears the director has acted honestly and reasonably. If however directors are at fault or the liability is strict, then relief under section 1157 CA 2006 would not be available.

TRANSACTIONS DEFRAUDING CREDITORS (SECTION 423 IA 1986)

Following the decision in *Sequana*, it is established law that the payment of dividends is capable of falling under section 423 IA 1986 and for the purposes of this section, insolvency is not a requirement, either at the time of transaction or at the time the claim is initiated, or indeed subsequently. In this case, the judge whilst recognising that insolvency was not a requirement, from a factual perspective considered the risk of prejudice to creditors to be more remote if solvency was not an issue. Furthermore, in this case the original purpose of the demerger was to separate different businesses, and attract employees by enabling an employee share incentive scheme to be promoted. Therefore there was no question of the demerger having the intention of putting assets beyond the reach of creditors, which is a key requirement of section 423 IA 1986.

GRANT OF SECURITY

Perhaps the most interesting aspect from a lender's perspective in this case is the analysis provided regarding whether the grant of security can ever fall within the provisions of section 423 IA1986. Doubt had been cast on the long held belief that it could not be, as the grant of security did not involve the diminution of value in the insolvent estate, per obiter remarks made by the court in *Hill v Spread Trustees [2007] 1 WLR 2404.* In the Burnden case, the judge clarifies the original understanding that security should be left out of account, because section 423 IA 1986 only requires value given and received to be viewed from the company's point of view. Therefore the judge held that the granting of security in the present case did not fall within that section. This will be welcome news to those taking security in commercial financing transactions, especially in relation to defending any potential future challenges brought under section 423 IA 1986 and similar provisions in section 238 IA 1986 (transactions at an undervalue).

TIME LIMITS

On the basis that the parties accepted the essential nature of the claim challenging security to be for the ultimate payment of a sum of money, the six year time limit in section 9 of the Limitation Act 1980 applied.

As such, had the claim been found to be within the scope of section 423 IA1986 (which in this case it was not), it would have been time barred in any event.

PRACTICAL GUIDANCE

- Claims may be initiated some years after the transactions in question have taken place.
- Directors should ensure they have taken adequate steps to ensure there are sufficient distributable reserves, including obtaining financial and legal advice.
- Properly documenting the transaction and including the purpose of the transaction will assist from an evidential perspective in the event of potential challenges.
- The risk of transactions defrauding creditors under the insolvency legislation, is not confined to insolvency cases and can apply to lawful dividends.
- Those taking security in commercial financing transactions may take some comfort that security granted ought not to fall within the scope of section 423 IA1986 (and 238 IA 1986).

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CLIFFORD CHANCE

CONTACTS

Giles Allison
Senior Associate

E giles.allison
@cliffordchance.com

Ryan Byrne
Lawyer

E ryan.byrne
@cliffordchance.com

Charles Cochrane
Partner

E charles.cochrane
@cliffordchance.com

Adrian Cohen
Partner

E adrian.cohen
@cliffordchance.com

Claire Freeman
Senior Associate

E claire.freeman
@cliffordchance.com

Philip Hertz
Global Head of
Restructuring and
Insolvency

E philip.hertz
@cliffordchance.com

Jeremy Kosky
Partner

E jeremy.kosky
@cliffordchance.com

Juliet McKean
Knowledge Director

E juliet.mckean
@cliffordchance.com

Maxine Mossman
Partner

E maxine.mossman
@cliffordchance.com

Deborah Neale
Knowledge Director

E deborah.neale
@cliffordchance.com

Gabrielle Ruiz
Knowledge Director

E gabrielle.ruiz
@cliffordchance.com

Nigel Wellings
Joint Head of
Corporate, London

E nigel.wellings
@cliffordchance.com