Dividends in The Spotlight – Scrutiny From a Corporate Governance and Insolvency Perspective

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When directors are looking to declare dividends, they must be certain that not only are there sufficient distributable reserves in the company but also that they follow the correct procedure. They must also take care when declaring dividends in circumstances where the company is insolvent or at risk of becoming subject to an insolvency procedure. Foresight is key to avoiding personal liability implications. We frequently advise administrators and liquidators of companies in respect of claims to be pursued against directors and/or shareholders when this issue arises in their cases.

Take an example where directors declare a dividend shortly before a company goes into administration. Those dividends will certainly be scrutinised by the administrator (or subsequently appointed liquidator, if the company later moves from administration into liquidation) who will look to make a recovery for the benefit of the company's creditors. The dividends may be determined as invalidly declared if the directors did not follow the correct procedure in the articles of association (the "Articles") of the company. Even if the dividend procedure was correctly followed, they may be found to be unlawful due to the lack of distributable reserves available to the company at the time of being declared. Scope for recovery will be further enhanced upon the administrator or liquidator establishing a director's knowledge of the company's actual or prospective insolvency and impending administration.

When a company is insolvent, a director's duties shift from being owed to the company's shareholders instead to its body of creditors. A company can be insolvent either on a cash flow basis – if unable to pay liabilities as they fall due; or on a balance sheet test – where its net assets are worth less than its net liabilities. Liabilities will capture actual, contingent and prospective sums due.

Invalid Dividend Declaration – Procedural Issues

The first issue an administrator or liquidator will check is whether the directors have followed the company's procedural meeting requirements as set out in its Articles in recommending the dividend declaration. Where there is no board meeting at which the directors have considered the dividend or recommended an amount for

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declaration, the dividend declaration will be invalid on procedural grounds. A director may separately be conflicted from participating in any decision-making to recommend the declaration of a dividend to himself/herself, and a separate shareholders' resolution may be required to authorise such a conflict.

The company's Articles will otherwise determine the procedure for shareholders to vote on dividends and whether a shareholder resolution is necessary. Typically, interim dividends do not require shareholder approval but final dividends should be declared by shareholders by ordinary resolution once recommended by the directors. For this reason, the procedural steps taken by shareholders will also become subject to scrutiny by an administrator or liquidator.

Challenging Dividends

Leaving aside any issues with procedural compliance, the insolvency of a company will cast a spotlight on the circumstances in which a dividend has been declared. Regardless of a company's solvency position, the law expects that before paying a dividend, the directors of a company should have regard to their common law and equitable duties, and their statutory duties under the Companies Act 2006, in particular sections 171 (duty to act within powers), 172 (duty to promote the success of the company) and 174 (duty to exercise reasonable care, skill and diligence). In addition to that, for a company to be able to declare a dividend there must, as per section 830 of the Companies Act 2006, be sufficient distributable reserves for the company to pay out.

A director who authorises the payment of a dividend in contravention of their Companies Act and common law duties may be personally liable to repay the company, even if the director did not receive the benefit of the dividend as a shareholder. There can be some defence to default where a director has acted honestly and reasonably, but certainly not where there has been a detrimental impact to the company's creditors caused by the dividend.

Separately, there will also be scope for the administrator or liquidator to pursue claims under the Insolvency Act 1986, including:

s238 – transaction at an undervalue: where the dividends were declared at a time when the company was insolvent and there were no reasonable grounds for believing that the declarations would benefit the company, nor were they necessary for the purposes of carrying on the business of the company (there is a presumption of insolvency where the recipient of the dividend is a 'connected person');

s212 – misfeasance: on the basis that the directors breached their statutory and common law duties under Part 23 of the Companies Act 2006 (see the start of this section).

There is also the possibility of making a claim under s423, but it would have to be shown that the actions of the directors were taken with the purpose of putting assets beyond the reach of the company's creditors, which has a greater evidential burden than the two claims above.

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Directors’ Duties on Insolvency

The directors of a company have a tough task in ensuring they fulfil their duties, particularly when those duties and those to whom they owe them, shift at the point that a company becomes insolvent and prior to a formal insolvency appointment.

Whilst a company is solvent, one of the major duties of a director is to promote the success of the company for the benefit of its shareholders as a whole. However, a change arises when the solvency of the company starts to become doubtful. At this point, the duty of a director to act in the interests of creditors as a whole supersedes the duty to promote the success of the company for the benefits of its shareholders (see section 172(3) Companies Act 2006 and the case of *Re HLC Environmental Projects Ltd [2014]*).

However, it can be difficult identifying when a director’s duties shift from being owed to shareholders to creditors. Key to this is determining the trigger point for the company becoming insolvent.

According to recent Court of Appeal case law (*BTI 2014 LLC v Sequana SA and others [2019])*, the duty for directors to act in the interests of creditors as a whole was determined to have been triggered when *the directors knew or should have known that the company was or was likely to become insolvent*, with the Court’s clarification that in that context, “*likely*” means probable.

The case revolved around the declaration of dividends. There was a question mark around the crystallisation of a clean-up liability arising from historic river pollution. Although the dividends were declared before that occurrence, the question for the Court was whether the directors should have factored in the pollution liability and taken into account of the creditors’ interests when causing the company to pay the dividends. The case highlights the need for careful consideration in circumstances where the future insolvency of the company may be on the cards. In many cases, administrators and liquidators scrutinise dividends made when it was (or should have been) apparent that a formal insolvency could not have been avoided (such as in the weeks or days before their appointment and after advice has been sought from the proposed administrator or liquidator on the proposed next steps). In those circumstances, pinning a claim will be more straightforward.

For any decisions, other than specifically relating to a dividend, that involve a large financial outlay, directors of a company should make a detailed contemporaneous record of each decision with an explanation of their reasons for doing so (and explain how it is proposed to benefit the company and/or creditors (as applicable)). This will put them in good stead should the company go into insolvency at some point after that decision as they will be able to explain themselves and thus reduce the possibility of becoming personally liable.

Ultimately, a director should seek independent advice from a solicitor and in some cases an insolvency practitioner if they are concerned about a particular decision, how it will affect the company and how it would appear in the light of the company entering formal insolvency. It is important to understand the consequences before taking a step that could become subject to scrutiny in the fullness of time.

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What does this all mean?

If the directors are considering declaring a dividend, they should (with the benefit of appropriate professional advice):

1. check the Articles of the company for the procedure to make a valid declaration including determining if, and from whom, any consent should be obtained, together with making adequate records of such decisions and consent; and

2. analyse the assets and distributable reserves of the company to determine whether a dividend is possible, taking into account the financial forecasts of the company, actual/contingent and future liabilities and discounting receivables (e.g. intercompany or bad debts) that will not or are unlikely to be paid and, preferably also taking appropriate professional advice.

In summary, directors should take extra care when causing the payment of dividends or otherwise making decisions with large financial consequences if there is any possibility of the company going into insolvency in the future. If and when those decisions are taken, they should be recorded in detail with an appropriate explanation to provide a clear understanding of what the directors were considering, and on what grounds, at the time.

If a director gets this wrong, personal liability is an inevitable consequence. This may include having to reimburse the company for dissipated monies and separately it may give rise to adverse conduct reporting to the Secretary of State on the individual's fitness to act as a director and potential disqualification for up to 15 years. It really is in the interests of the director to get it right.

If you would like to discuss further or have any questions on the above, please do get in touch with a member of our Restructuring and Insolvency Team or email online.enquiries@la-law.com

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