BRIEFING

ENGLAND AND WALES

Case update: Directors' liability for unlawful distributions

INTRODUCTION

The recent High Court Judgment in *SSF Realisations Limited -v- Loch Fyne Oysters Ltd and Others* (21 December 2020) is an example of how essential it is for Directors to only sanction distributions out of available profits as supported by the company's last annual accounts (or interim accounts where the last accounts don't evidence sufficient reserves).

Where companies become insolvent, recent cases have shown that the Liquidators have been able to make recovery from Directors who have made payments, or obtained security, that simply could not be justified once closely examined.

In light of this and cases such as *BTI 2014 LLP v Sequana SA* (6 February 2019) (where the court found that a *lawful* distribution was a transaction defrauding creditors), it is important that Directors consciously turn their minds to the solvency of a company (current and future) when recommending or declaring dividends or other distributions, even if there are sufficient reserves. Where there are sufficient reserves, but the future solvency is or reasonably should be in doubt, the Directors are required to consider the interests of creditors in recommending or declaring any distribution.

If not properly considered, the distribution itself, the actions of the company and the Directors are liable to be scrutinised should a creditor feel that it has been prejudiced by those actions.

As more and more insolvencies occur due to Covid-19 and market conditions, Directors are going to be under even more detailed scrutiny, particularly where any recent distribution has been made.

THE FACTS

SSF Realisations Ltd ("the Company") was incorporated in 1974 and supplied fish to shops and restaurants. It was acquired in 2008 by Loch Fyne Oysters Ltd ("LFO") for £1.9 million but both the Company and LFO were in financial difficulty by 2011 and it was decided to sell LFO free from any liability to the Company. At the time, LFO owed the Company a sum of about £900,000 according to the Company's accounts.

CASE UPDATE: DIRECTORS' LIABILITY FOR UNLAWFUL DISTRIBUTIONS

In order to reduce this debt, the Directors of the Company resolved at a Board Meeting in November 2011 to declare a dividend of £500,000, and a management charge of £330,000, in favour of LFO. The management charge was stated to relate to various services that had been supplied to the Company but never charged for. It was subsequently reduced to £244,916.

The effect of the dividend and management charge was to put the Company into a position where it had net liabilities of £142,710 based on its management accounts as at November 2011.

The Company continued to trade but never returned to solvency and, after it went into creditors' voluntary liquidation in 2016, the Liquidators pursued a claim against LFO and the Company's Directors based on the whole amount of £744,916 being an unlawful distribution out of capital in breach of Part 23 of the Companies Act 2006.

THE JUDGEMENT

After a 3 day hearing, the Judge concluded as follows:

- The management charge was not a genuine liability. It was a disguised distribution. Although LFO had supplied various services, it was as a shareholder and not a creditor (as it had never previously charged for these or factored these into any accounts and there had never been any contractual liability on the part of the Company to pay for any of these services). Accordingly, the sum of £244,916 was to be treated as a distribution within S.829 of the 2006 Act.
- To decide whether a distribution is lawful, it is necessary to consider the relevant accounts, either being the last annual accounts or later interim accounts. In this case, the relevant accounts were the October 2011 management accounts which, when corrected for an understatement of liabilities, showed distributable profits of only £428,057.
- The distribution of £744,916 exceeded the distributable profits of £428,057 by £316,859 and this excess was therefore unlawful.
- LFO was liable to repay the excess under S.847 of the 2006 Act as, at the time, it knew, or had reasonable grounds to believe that, based on the relevant accounts as properly stated, this sum was beyond the amount lawfully distributable and was therefore in contravention of Part 23 of the 2006 Act.
- The relevant Directors of the Company were potentially personally liable as well as, although they had not acted dishonestly, they were to be treated as trustees of the Company's funds and they were aware of the relevant facts that made the distribution of the sum of £316,859 unlawful. They were directly involved in relation to the making of the management charge and securing the sale of LFO free from any liability to the Company. Although there were certain accounting issues at the time that confused the true financial position of the Company, this did not absolve the Directors as it was their responsibility to ensure proper books and records were maintained.
- It was open to any Director to seek to be excused from personal liability for breach of duty under S.1157 of the 2006 Act if they acted honestly and reasonably and, in all the circumstances, if they ought fairly to be excused. Of the 3 Directors in question, 2 were highly experienced businessmen who fully understood their actions and took no steps to reverse the transactions when it was apparent they rendered the Company insolvent. So they were not to be excused but the 3rd Director had no financial or accounting expertise and had relied on the others, and he was excused from liability.

BRIEFING

CASE UPDATE: DIRECTORS' LIABILITY FOR UNLAWFUL DISTRIBUTIONS

THE CONCLUSION

The Company, through the Liquidators, was awarded the sum of £316,859. This was awarded largely due to the failure of the Directors to properly prepare the accounts they used to justify the distribution. Additionally, the creation of a management charge that had no historic or legal basis was clearly unjustified and this case serves to remind us that the Court will look at substance in deciding where a management charge is genuine or a sham.

The case also reminds us that Directors can be held to a subjective standard in relation to their own skills and experience, and in this case it is telling that the Director who did not have expertise in, or responsibility for, financial or accounting matters was not found personally liable for the failure relating to the preparation of the accounts. It may be the case that the Directors who were found liable are insured against their liability under D&O cover but that is something the insurers may have something to say about.

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