

# English Court of Appeal provides clarification regarding the regulation of dividend payments to shareholders

## Introduction

In the recent case of *Global Corporate Ltd v Hale*<sup>1</sup>, the Court of Appeal was asked to assess whether sums, described as “interim dividends”, paid to Mr. Hale (the “**Respondent**”) in his capacity as both a director and shareholder of Powerstation UK Limited (the “**Company**”), had been made in accordance with section 830 of the Companies Act 2006 (the “**Act**”)² prior to the Company’s insolvency.

In doing so, the Court of Appeal’s Judgment has provided welcome clarity regarding the regulation of dividend payments to shareholders, and is therefore of interest both to companies seeking to declare dividend payments and insolvency practitioners who are considering whether to challenge the validity of such payments made prior to a company’s insolvency.

## Background

The Respondent had been one of two shareholders in, and directors of, the Company. He was paid a small salary each month to cover national insurance contributions, which was supplemented with a separate dividend payment. At the end of each financial year, if there were insufficient distributable profits from which dividends could be declared in accordance with section 830 of the Act, the Company’s accountants would re-characterise the payments to form part of the Respondent’s salary and additional tax would be paid to HMRC. On that basis, each such payment was recorded as an “*interim dividend*” in a “*dividend tax voucher*” prepared by the Company’s accountants for HMRC.

Following the liquidation of the Company in November 2015, the liquidators considered that the Company had insufficient distributable reserves from which the dividends could be made and, thus, claimed

that they were in breach of section 830 of the Act. After the Respondent refused to repay these sums, the liquidators of the company assigned their rights to the claim to Global Corporate Limited (the “**Appellant**”), who duly made a claim seeking a declaration that the sums were recoverable as unlawfully paid dividends. The Appellant also claimed that the payments amounted to a transaction at an undervalue and/or a preference, and that payments were as a result of misfeasance by the Respondent.

The High Court held that:

- a) the payments did not constitute dividends, primarily because the accounting practice described above (whereby a decision was taken retrospectively at the end of each financial year as to whether the payments should be categorised as dividends or form part of the Respondent’s salary) meant that the payments were not finalised at the time they were made. As such, given that a decision was not made as to whether dividends should be paid until the end of each financial year, the payments were not dividends and fell outside the scope of section 830 of the Act; and
- b) the misfeasance claim was dismissed because, even if the Respondent had an obligation to repay the money, he had an equal claim as *quantum meruit* (i.e. the “amount he deserves” under law) for the services he has provided to the Company. Put another way, if the Respondent had not provided these services, someone else would have been required to have been employed and paid to carry out this work. On this basis, the judge held that the Company would have been unjustly enriched if the Respondent had not been paid the additional sums each month in addition to his nominal salary and that this level of remuneration was not excessive in the circumstances.

1 [2018] EWCA Civ 2618.

2 Which states that distributions should only be made out of profits available for the purpose.

## The Court of Appeal's analysis

Whereas the High Court concluded that the sums paid to the Respondent did not constitute dividends, the Court of Appeal disagreed and held that the payments were in fact dividends which fell within the scope of section 830 of the Act. Amongst other things, this was the case for the following three reasons:

- a) firstly, from a review of the available evidence, the payments were clearly intended to be treated as dividends. For example, the payments were declared as “interim dividends” by the directors and were specifically structured as dividends for tax purposes;
- b) secondly, the trial judge had wrongly focused on the Respondent's intention when authorising monthly payments to himself as dividends, rather than asking whether the payments were lawful distributions of the Company's assets. The fact that the Company's accountants could later re-characterise the nature of the payments did not stop them being dividends at the time of payment; and
- c) finally, the High Court Judge had erred in concluding that *quantum meruit* could act as a set off or defence against the claim by the Company against the Respondent. In reaffirming the House of Lords case of *Guinness PLC v Saunders*<sup>3</sup>, the Court of Appeal held that for such a defence to be available, a contract for remuneration would need to be agreed in accordance with the Company's articles of association. There was no such contract. Also, and perhaps most pertinently in this case, as the Company was in liquidation, a *quantum meruit* claim would in any case be an unsecured claim requiring proof of debt in the liquidation.

In light of the above, the first instance decision was overturned by the Court of Appeal. Given that the Company was balance sheet insolvent according to its latest accounts as at 30 April 2014, and there were subsequently no distributable reserves from which to declare dividends, the dividend payments made to the Respondent were unlawful and had to be repaid.

## Conclusion

The first instance decision, which potentially created a dangerous precedent whereby directors of companies (who are also shareholders) could pay interim dividends to themselves irrespective of the financial standing of the company and then retrospectively re-characterise these payments at a later date if there were insufficient profits in accordance with section 830 of the Act, has now been overruled by the Court of Appeal. This is a welcome, albeit perhaps unsurprising, decision and has restored much needed clarity both in respect of when payments will constitute dividends and fall within the scope of section 830 of the Act, and when the defence of *quantum meruit* will apply. As noted at the outset, this is therefore a useful Judgment both for companies wishing to declare dividend payments and insolvency practitioners in assessing whether dividend payments have been made lawfully prior to a company's insolvency.

On a separate note, the Court of Appeal's comments regarding the trial Judge are also interesting. Although the Judgment recognised that certain difficulties may arise where one party has legal representation (i.e. the Appellant) and the other does not (i.e. the Respondent), it continues to state that, in such circumstances, a trial Judge should not seek to overcorrect any perceived inequality of arms. In this regard, the Judgment was critical of the trial Judge's leading questioning of the Respondent during the cross-examination, labelling it “*inappropriate*”, as well as considering that such questions did not even form part of the Respondent's pleaded case.

If you have any questions about the issues raised in this legal update, please get in touch with your usual Mayer Brown contact or:

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