E-Valuate

For the accountancy profession

May 2017

Unlawful dividends, overdrawn loan accounts and the risks

Overview

Our litigation and insolvency teams are seeing more and more cases where directors have failed to implement dividend, loan account and remuneration structures properly.

This can become an acute problem if the business subsequently fails, with directors often required to repay very significant sums of money. Below is an overview of the problem and issues you may wish to consider with your clients.

Dividends rather than salary

In many businesses director-shareholders will draw sums in lieu of wages or salary over the year and record those drawings against the director's loan account. At the end of the year, a dividend is declared and posted to the director's loan account, bringing the balance to nil.

This approach has a number of taxation advantages and is fairly commonplace in small businesses.

The law

Overdrawn directors loan accounts which exceed £10,000 are unlawful unless fully disclosed and approved by a resolution of the shareholders. Many SME's do not follow these formalities, since the practice is so routine.

If the overdrawn account is unlawful, the transaction is voidable and the loan (which was never intended to be a loan to the director, but settled by the year end dividend) is repayable on demand.

The law on shareholder dividends derives from common law, the Companies Act 2006 and the company's Articles of Association.

The key provisions are:

- Dividends may only be paid from distributable reserves
- Profits available for distribution must normally be limited to those shown in the most recent annual accounts. If these are unavailable or not showing distributable profits, profits may be determined from properly prepared interim or management accounts.

Applying the law

Dividends must be decided by shareholders at a general meeting, but should not exceed the amount recommended by the directors. Directors are usually authorised to pay interim dividends which can be subsequently ratified.

- The directors have a fiduciary duty to act in the best interests of the company. They must consider the future cash flow requirements of the business (at least over the following 12 months) when recommending a dividend
- Dividends must be declared in accordance with the relevant regulations.

If there is a failure to comply with any of the above, the dividend declaration, or the operation of the loan account, may be unlawful.

The potential problem

An unlawful dividend or overdrawn loan account during the company's trading life will not ordinarily present a significant problem. Companies have been structured in this informal way for years, though it is of course not strictly correct to do so.

Problems arise when companies become insolvent or where there are insufficient distributable profits to satisfy the overdrawn loan account.

In these circumstances, the overdrawn loan accounts remain on the balance sheet, as it is no longer possible to declare a dividend. Furthermore repayment is likely to be pursued by a liquidator or administrator.

Additionally, dividends in these circumstances may have been unlawfully declared and therefore invalid. This renders the payments to the director (or director's loan account) void.

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Where the potential problem becomes a real problem

A liquidator or administrator has a duty and powers to investigate the activities of an insolvent company and the actions of its directors. They may take action to remedy any matter which prejudices the creditors of the company.

Here are some scenarios:

A dividend has been declared or paid where there are insufficient distributable reserves

If the shareholder knows or has reasonable grounds for believing this, he or she is liable to repay it, along with interest (s.847 Companies Act 2006).

A dividend is paid after a company becomes insolvent

The liquidator or administrator may be able to recover it from the shareholder quite simply, as a transaction at an undervalue (s.238 Insolvency Act 1986).

The dividend is declared while the company is solvent but not paid or credited to a loan account until it is insolvent

Such a payment or credit can be pursued by a liquidator or administrator against the shareholder as a preference under s.239 Insolvency Act 1986.

A balance remains outstanding on the loan account at the date of administration or liquidation

This balance can be claimed from the director as a debt due to the company.

The liquidator pursues a claim for misfeasance and/or breach of duty under s.212 Insolvency Act 1986 in respect of an overdrawn loan account

In all of the above scenarios a claim may also be brought against the director for misfeasance/breach of his/her duties to the company.

The director may need to consider a defence of acting honestly and reasonably, which may be difficult to demonstrate if there is evidence of repeated failure to comply with formalities. He or she would normally be unable to offset monies owed to them by the company as the liquidator would be bringing the claim.

The consequences

In all these situations directors could be liable to repay dividends received or the balance on their loan account, despite the payments in essence being their 'salaries'

Claims can be significant and come at the worst time, when their business, employment and earnings have come to an end.

This can be compounded by personal guarantees provided to other creditors of the business, such as banks or suppliers. The consequences can therefore be devastating.

Accountants advising these businesses may also be at risk. If they fail to ensure that their clients declare dividends lawfully and manage their loan accounts effectively, they may face a claim of negligence from directors and shareholders suffering loss.

Sadly, many of the situations we have dealt with recently began with good advice from accountants which was initially followed by directors but subsequently undermined by sloppy practices.

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Avoiding the pitfalls

Here are some of the ways to protect directors and shareholders:

- Ensure dividends are declared correctly
- Obtain shareholder approval for any loans to directors exceeding £10,000
- Warn companies not to build up loan accounts when there is any hint of financial instability
- Consider paying directors wages or salary as opposed to drawing dividends monthly – particularly when the financial position of the company is not healthy.

Directors are entitled to reasonable remuneration. Any change to arrangements should be minuted, with the employer/employee relationship evidenced by an employment or service contract.

A relationship of this type entitles the director to claim against the Redundancy Payments Service in the event of insolvency. They can recover up to £400 per week in statutory pay in lieu of notice, redundancy payments, arrears of wages and holiday pay claims.

Such a claim will need to be supported by documentary evidence, 12 weeks' payment at market rates prior to insolvency, and payment through PAYE as with other employees. It is therefore important to ensure that any transition from a dividend payment scheme is carefully managed.

Accountants may wish to raise these issues with clients – particularly where there are any concerns about future solvency.

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Further advice

We have considerable experience of issues created by loan accounts and dividends, particularly following formal insolvency. We would be happy to advise clients on your behalf.

To find out how we can help, contact the Insolvency and Business Turnaround team or log on to **www.verisonalaw.com**

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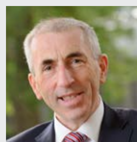

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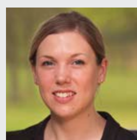

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