The law and regulation governing law company business partnership essay

Law

Introduction

This essay critically examines how the UK company law and regulation attempts to ensure that dividends are paid to shareholders in a manner that is lawful and not detrimental to creditors. It starts by considering dividends and the conflict they create between the shareholders and creditors. Then, it examines the Part 23 of the Companies Act 2006 (" CA 2006") as well as the common law governing the payment of dividends. Finally, the essay critically examines the extent to which the UK law ensure that dividends are paid to shareholders in a manner that is lawful and not detrimental to creditors.

Dividends

A dividend is a payment made by a company to its shareholders according to the number of shares held by them.[1]In the case of public companies, dividends are paid usually twice a year the amount of the dividend being expressed as a percentage of the nominal value of the shares. In most companies, the directors fix the maximum amount of the dividends, but shareholders can reduce the amount proposed.[2]This makes the dividends to sound like a payment of interest, but, at least for ordinary shares, the amount of the dividends is not fixed as this would be regarded as a loan. The payment is decided by the board each year in the light of the financial position of the company. The board may also decide not to make dividends. Unlike creditors, shareholders can use general meetings and directors to control a company’s affairs. This position may enable them to benefit themselves at the creditors’ expense through, among others, dividend payments, thereby reducing the amount available to repay creditors.

Creditors may also get involved in behaviours for their own benefits at the shareholders' expense, but most creditors will not have the control necessary to implement their desired measures. The conflict between shareholders and creditors has led to a view that the law, rather than the contract, should compensate creditors for an unlawful dividend payment. This view was adopted in the Second Company Law Directive,[3]which introduced legal capital rules for public companies. But the UK went far by extending many of the restrictions to private companies.

The law and regulation governing the payment of dividends

The law governing dividends is set out in Part 23 (ss. 829-853) of the CA 2006. Essentially, it requires the existence of available profits to be determined by accounts which has been properly prepared.[4]Section 830(1) provides that " a company may only make a distribution out of profits available for the purpose."[5]Section 829 defines " distribution" as every description of distribution of the assets of a company to its shareholders, whether in cash or otherwise except distribution by way of issuing shares as fully or partly paid bonus shares; the reduction of share capital by extinguishing or reducing the shareholders' liability on any of the shares of the company in respect of share capital not paid up, or by repayment of paid-up share capital; the redemption or purchase of any of the company's own shares out of capital or out of unrealised profits in accordance with the statutory provisions; and a distribution of assets to company's shareholders on its winding up. The most common type of distribution is dividends.[6]But the label given by the parties to a transaction is irrelevant in determining whether it is a distribution.[7]Section 830(2) defines the profits available for

distribution as the company's " accumulated, realised profits so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made."[8]The existence of the sum must be determined by reference to the last annual accounts of the company and to specified items in those accounts.[9]In some circumstances, initial or interim accounts may be used instead.[10]Whether there is a profit or realised profit or loss is a matter of how the accounting principles are applied at the time the accounts are prepared.[11]The Guidance on the Determination of Realised Profits and Loses in the Context of Distributions under the Companies Act 2006 issued by the Institute of Chartered Accountants for England and Wales (" ICAEW")[12]summarises the law and regulation on distribution and also provides guidance on the meaning of realised profits. [13]In accounting terms, profits are treated as realised only when realised in the form of cash or other assets.[14]Unrealised losses are not taken into account unless the company is a public company and the losses mean that the net assets of the company are less than its called-up share capital and un-distributable reserves. The amount of accumulated realised losses must be deducted before any distribution can be made. This abrogates the common law rule that losses made in previous accounting periods do not have to be made good.[15]Section 845 deals with distributions which consist of, or include or treated as arising in consequences of, the sale, transfer or other disposition by the company of a non-cash asset. This applies to distributions under the CA 2006 or distributions under the common law. [16]For companies which have available profits, section 845 determines the

amount of the distribution. Where the amount of the consideration received by the company out of the transaction is not less than the book value of the asset, the amount of the distribution is zero.[17]Where the amount of the consideration received by the company is less than the asset value, the company needs distributable profits equal to the difference between the consideration received and the book value.[18]In addition to having realised profits available for distribution, a public company must satisfy two more conditions before it makes dividends. These ensure that a public company must not make a dividend out of capital and also it must maintain a cushion of assets sufficient to cover the amount of its share capital and assets that are not distributable.[19]Thus, section 831(1) provides that " a public company may only make a distribution if the amount of its net assets is not less than the aggregate of its called-up share capital and un-distributable reserves, and if, and to the extent that, the distribution does not reduce the amount of those assets to less than that aggregate."[20]This ensures that even if it has trading profits, a public company cannot pay a dividend if it has a deficit on its reserves. Un-distributable reserves of a company are its share premium account, capital redemption reserve, the amount by which its accumulated, unrealised profits exceed its accumulated, unrealised losses, and any other reserve that the company is prohibited from distributing by any enactment or by its articles.[21]Where the company has available profits as determined by the CA 2006, this automatically entitles the shareholders to a dividend, provided that the articles expressly provide for the payment of a fixed dividend where the company has distributable profits.[22]Usually, the articles would allow for a declaration of a dividend by ordinary resolution

following the directors' recommendation.[23]The declaration of the dividend creates an immediate debt,[24]unless it is expressed as payable at a future date.[25]In the case of an interim dividend which the board has resolved to pay, it is open to the board at any time before the payment to review its decision and resolve not to pay the dividend.[26]The declaration of dividend by ordinary resolution may decrease but not increase the amount to be distributed to the shareholders. A dividend paid contrary to the CA 2006, the common law, in breach of directors' fiduciary duties, in breach of a restriction in the articles or contrary to some other enactment, is ultra vires and void and cannot be ratified by the company in general meeting.[27]Where unlawful payment of dividend has been made, the company may recover the amount under the CA 2006 or at common law. The two main targets would be the recipients of the unlawful dividends and the directors who declared the unlawful dividends. The company may also bring an action for negligence against the auditors if the accounts have not been prepared properly. Sections 847(1) and 2(a) provide that a shareholder is liable to repay the dividend or part of it to the company if, at the time of the payment, knew or had reasonable grounds to believe that it was being made unlawfully.[28]This statutory liability is without prejudice to any other obligation imposed on a shareholder to repay a dividend unlawfully made to him/her.[29]As for directors, they have statutory duties to exercise their powers for the purposes for which they are conferred;[30]to promote the success of the company for the benefits of the shareholders having regard to a number of factors, including the interests of the company's creditors;[31]and to exercise care and skills.[32]Thus, directors need to consider

whether, regardless of the provisions in Part 23 of the CA 2006, it is prudent to declare a dividend, given the company's trading position and funding needs. However, the CA 2006 does not address the liability of directors for declaring a payment of dividend. However, the common law provides that directors are trustees of the company's assets and as such are jointly and severally liable for the full amount of any unlawful dividend payment to shareholders, regardless of whether the company is solvent or insolvent and whether or not the profits could have been made.[33]In Re RepayCheck Services 3 Ltd,[34]the Supreme Court clarified obiter that the director's liability for repayment is strict, but subject to the court's discretion to grant relief under section 1157 of the CA 2006 where the director had acted honestly and reasonably.[35]

The law and regulation governing dividends and the position of creditors

The company's accounts play an important role in determining whether a company has profits to pay out dividends. The CA 2006 imposes additional requirements on public companies in order to meet the requirements of Article 15 of the Second Company Law Directive.[36]The CA 2006 also expressly retains the common law principle which provides that dividends cannot be paid out of capital.[37]The primary aim of law and regulation governing dividend is to regulate the conflict between shareholders and creditors in favour of the latter. This conflict arises, particularly during insolvency, due to respective priorities between shareholders and creditors. Therefore, despite protecting themselves either by taking security or by other contractual means, the rules attempt to adjust the creditors' position in

their favour.[38]The rules are important component of the regime of capital maintenance. They address concerns that, if the directors and shareholders are able to collude in the distribution of the assets of the company to the shareholders during the lifetime of the company, the creditors will find the company stripped of its assets. In It's Wrap (UK) Ltd v Gula,[39]the court commented that the ability to recover unlawful dividends from the recipient is " designed to protect those who have a prior call on a company's funds from the appropriation of them by those who control the company."[40]Unlike a shareholder, a creditor does not have a locus standi to seek an injunction to prevent an unlawful dividend, unless he has an enforceable security which is thereby put in jeopardy.[41]On insolvency, the creditors must be paid in full before any capital can be returned to the shareholders and an unlawful payment of dividends ahead of the insolvency defeat that priority. As Arden LJ noted in It's Wrap (UK) Ltd v Gula,[42]any leniency to shareholders in receipt of an improperly paid dividend detracts from the protection available to the creditors.[43]Thus, where a company wants to return capital to its shareholders, it must do so through a purchase or redemption of shares or reduction of capital in accordance with the provisions of the CA 2006 on capital maintenance and not through an improper payment of dividends to the shareholders.[44]The CA 2006 treats distributions in cash as well as in kind, but it is not clear whether this catches disguised distributions.[45]Also, section 845 of the CA 2006 removes doubts raised by the decision in Aveling Barford Ltd v Perion Ltd[46]on when a transfer of assets to shareholders amounts to a distribution. According to this case, transactions such as those involving intra-group transfers of assets

would be regarded as improper distributions unless the transferring company has distributable profits to cover the gap between the book value and the market value. However, this provision does not amount to a substantive change of the law on dividends. Thus, where a company has no distributable assets, the decision in Aveling Barford Ltd v Perion Ltd[47]would still apply. The CA 2006 has relaxed the terms and the manner of redemption, but it still permits redemptions and repurchases of shares.[48]The rules on payment of dividends are based on the balance sheet test,[49]which has little information on the true financial position of the company.[50]The test makes reference to the historic contributions of shareholders rather than on the company's assets or financial needs on a going concern basis. In addition, the rules on the payment of dividends do not prevent assets from being dissipated in other ways such as through excessive remuneration to directors, poor management decisions and fraud.[51]Further, private company's directors may avoid the rules which prevent the payment of dividends out of capital by returning capital to the shareholders by means of a share repurchase, provided that the directors declare that the company will remain solvent for twelve months.[52]Recovering of unlawful dividend payments from shareholder recipients, particularly in larger companies, may cause problems because they may be unaware of the circumstances surrounding a distribution in a form of a dividend and rely on the directors to act properly.[53]Unless they are also directors, there is a little likelihood of successfully pursuing the shareholders to recover unlawful dividends. [54]Thus, it is more likely to pursue recovery from the directors who authorised the improper payments. Another possibility is that a creditor,

such as the Inland Revenue, may bring a claim for misfeasance under section 212 of the Insolvency Act 1986 against directors who authorise improper dividends.[55]Disqualification of the directors is also a possibility,[56]but is questionable how this will improve the creditors' position. As a result, questions have been raised as to the effective of the rules in protecting creditors. Creditors continue to rely on the terms of their loan contracts, other protective techniques, insurance and guarantees.[57]It has also been argued that the current rules also do carry unnecessary costs to companies.[58]Other jurisdictions, such as the United States, and some Commonwealth jurisdictions, such as New Zealand, have abandoned the legal capital. In the UK, a proposal has been made to replace the balance sheet test with an approach based on a solvency test.[59]This means that the directors would have to form a judgement about the level of dividend the company could provide without endangering its solvency. However, this has been superseded by market developments and the banking crisis of 2008 have led for demands for tighter regulation of business and tighter accounting standards to prevent optimistic valuations and inappropriate payment of dividends.

Conclusion

This essay has critically examined how the UK company law and regulation ensure that dividends are paid to shareholders in a manner that is lawful and not detrimental to creditors. The relevant rules are contained in Part 23 of the CA 2006 as well as at the common law. The rules attempt to regulate the conflict between shareholders and creditors on the allocation of a company's capital in favour of the latter. However, the rules do not seem to protect the

creditors who continue to rely on their contracts and other protective techniques. Proposals have been put forward to replace the balance sheet test which with an insolvency test, no concrete steps have been taken to reform the law in this area.