A QUESTION OF CHARACTER:

PROBLEMS FACING THE DISGUISED DISTRIBUTION CLAIM

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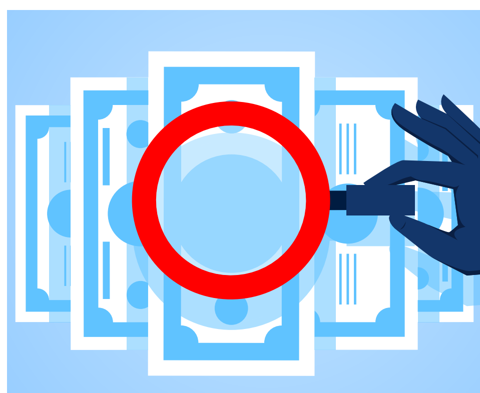
Claims for unlawful distributions are not usually regarded as the most stimulating claims that may arise on a company's insolvency, save perhaps for those with a keen interest in the observance of company law formalities and accounting conventions. Of greater interest are likely to be those claims in relation to disguised distributions, particularly where the company has attempted to restructure group debts informally pre-administration or liquidation, or has participated in tax avoidance schemes. Both may involve the grant of a financial benefit to a shareholder. In the former case this may be by way of set off against or the extinguishing of the debt owed by a parent company. In the latter case, this will commonly involve the giving of some reward for services to shareholder/employees other than by way of conventional (and conventionally-taxed) remuneration. Both have been the subject of recent decisions which indicate some of the difficulties such disguised distribution claims face.



The basic principles are not in doubt.

The definition of "distribution" in section 829 of the Companies Act 2006 is striking as to its breadth, comprising "every description of distribution of a company's assets to its members, whether in cash or otherwise", subject to certain defined exceptions (not relevant here).

The question of whether a transaction is a distribution to shareholders is a question of substance, not simply form or of how the parties have chosen to describe it (Progress Property Co Ltd v Moore and another [2011] 1 WLR 1 at [1]). The question of whether the distribution contravenes Part 23 is answered objectively by reference to the relevant accounts; the factual or legal knowledge or understanding of the company is irrelevant (It's a Wrap (UK) Ltd v Gula [2006] BCC 626 at [43]). The application of Part 23 is strict and cannot be eroded by a plea of ratification (Bairstow & Ors v Queens Moat Houses plc [2002] BCC 91)

These are promising foundations for a claim by the company or its liquidators, offering little latitude for

the director or shareholder in the defence of the claim. This is certainly true in the straightforward case of the director-shareholder simply taking the company's money (e.g. Re TMG Brokers Ltd (In Liquidation) [2021] EWHC 1006 (Ch)) or receiving payment on the basis of a flimsy pretext, for instance the after-the-event assumption of a "management charge" by the creditor company (e.g. SSF Realisations Ltd (in liq.) v Loch Fyne Oysters Ltd [2021] BCC 354). Those examples are both cases where the subjective intention of the director-shareholders is irrelevant, since the characterisation of the payments as voluntary distributions is a conclusion of law derived from the fact that payments were made for no consideration at the time the distribution was made (see Loch Fyne at [78]).

However, the same will not be true where the payments can be said to have a purpose other than effecting a distribution at the time that they are made, as for instance payments made to shareholder-employees for their services to the company, often through indirect means such as employee benefit trusts or share purchases. It is an uncomfortable contradiction that the directors and shareholders will wish to contend (to HMRC) that the payments were not for services provided to the company, while also maintaining (to the company's liquidators) that the payments were not for no consideration.

Even given the artificiality for which tax avoidance schemes are often criticised, the position adopted by the claimant company in Chalcott Training Ltd v Ralph [2020] EWHC 1054 (Ch) could be said to verge on the "brazen" (the word ascribed to the claims by HMRC). The company had entered into a scheme with the aim of avoiding corporation tax, income tax and NIC on monies paid to its director-shareholders. Essentially the director-shareholders received payment for offering to subscribe for shares, and then repaid a small percentage of this sum advanced in return for which shares were allotted as partly paid.

Here, unusually, it was the company (controlled by one of the recipients of the payments) that contended that the transactions should be characterised, not as they were described at the time as reward for the recipients' services to the company, but as unlawful distributions which should be set aside. The company, therefore, contended that a purely objective test should be applied as to whether value had been given for the payments received, the subjective beliefs of the parties involved at the time being said to be of no relevance.

These arguments were rejected, Michael Green QC (then sitting as a Deputy Judge) holding that the question was whether there was a genuine exercise of the directors' powers in the payment out of the company's capital. The purpose of the payments must be a key factor in determining their character. The subjective intentions of the parties involved at the time were relevant to deciding the true purpose and substance of the impugned transactions.

The question for the court was ultimately whether there was a genuine exercise of the power to award remuneration or whether the power was being used to disguise the true nature of the payments which were really distributions to shareholders. (The decision was unsuccessfully appealed, but not on this point and without demur from the Court of Appeal on the question of characterisation ([2021] EWCA Civ 795)).

While the treatment of the question of characterisation in Chalcot makes sense on the unusual facts of that case, it has the potential to create difficulty for liquidators if applied more broadly particularly where the company has participated in a tax avoidance scheme. Applied to Toone v Ross [2020] 2 BCLC 537 on the question of payments to EBTs for instance, it could lead to a different result (although as noted in Chalcott there was no positive case from the respondents in that case as to what the payments to the EBT in fact were). Were respondents to run a positive case that the payments to the EBT were in fact reward for services provided, this could leave the liquidators with the more difficult claims for breach of duty arising from decision to participate in the scheme, no doubt with reliance in defence of the claim upon the professional advice received.

Although Chalcot involved a solvent company, that should not in principle make any difference to the question of characterisation as opposed to the duties owed by the directors. More important perhaps are the obvious reservations about allowing participants in transactions to disavow the very characterisation that they gave to the payments at the time that they were made: a case of having their cake and eating it too.

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