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“Disguised Distributions” – lawful or unlawful, that is the question

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Intra-group transactions are the subject of close scrutiny, particularly where the financial condition of the group is in question. Directors must carefully consider whether each proposed transaction would amount to a distribution and, if so, whether or not it is an unlawful distribution out of capital in breach of the Companies Act 2006 (the Act), which gives rise to liability for directors and relevant group members.

Case law has established that the courts will apply a test of *substance*, rather than *form* when considering whether a transaction amounts to a distribution. In a recent case, *SSF Realisations Ltd (In Liquidation) v Loch Fyne Oysters Ltd & Ors [2020] EWHC 3521*, the High Court held that a management charge made to its holding company for services already provided was in fact an unlawful and “disguised” distribution. In that case, it was found that a company cannot disguise a distribution where its clear purpose is to offset, partly or wholly, the debt of its shareholder.

The key lessons for directors are:

- review the substance and not merely the form of a transaction;
- be wary of transactions which attempt to retrospectively recharacterise payments between companies and their shareholders; and
- be aware that individual skills and experience will be taken into account in determining whether a director will be excused from liability under section 1157 of the Act.

We take a look at the facts of the decision and highlight the key points for directors to take note.

What happened?

SSF Realisations Ltd (the Company) was a wholly owned subsidiary of Loch Fyne Oysters Ltd (LFO) and both companies operated in the wholesale and retail seafood business. Over the years, LFO became indebted to the Company as the latter had principally assumed the costs of sourcing and supplying seafood to LFO’s customers on LFO’s behalf.

By 2011, both companies were experiencing financial difficulties and in September 2011, it was decided that LFO should be sold to a third party, subject to two conditions imposed by LFO's buyer being that:

- the Company should also be sold to another third party, and
- no debt should be owed by LFO to the Company.

Consequently, a potential buyer was found for the Company and, in order to offset the debt owed by LFO to the Company (to satisfy the buyer's second condition), the directors of the Company held a board meeting to approve an interim dividend of £500,000 (the Dividend) and a management charge of £330,000 (the Management Charge) in favour of LFO, relying on the management accounts for October 2011. After some weeks, both the Dividend and Management Charge were entered into the Company's books and records with an effective date of 27 November 2011. However, the Company's management accounts for November 2011 indicated that the Company was insolvent as a result of both payments. Following several years of trading, the Company did not return to solvency and consequently, entered into creditors' voluntary liquidation in November 2016.

What was the claim?

The Company (acting through its joint liquidators) brought legal proceedings against LFO and the Company's directors claiming that:

- the management charge was in fact a "disguised distribution" by the Company to LFO;
- the Dividend and the Management Charge together comprised an unlawful distribution (together being the Distribution) out of capital in breach of Part 23 of the Companies Act 2006; and
- consequently LFO and the Company's directors were required to repay the unlawful distribution and compensate the Company.

What did the court decide?

The court upheld the claims brought by the liquidators and ordered LFO and certain of the directors to repay the unlawful part of the Distribution.

Was the Management Charge a genuine charge for services?

A key question for the court to consider was whether or not the Management Charge was a genuine charge or a 'disguised distribution'?

In coming to its decision, the court acknowledged previous case law which provides that one must look at the substance, rather than form of a transaction to determine whether or not it amounts to a distribution under section 829 of the Act. Whilst the defendants' argued that the Management Charge was a proper exercise of the directors' powers to reimburse LFO for providing services which the Company benefited from, the court noted that prior to any financial difficulties, LFO had never previously imposed any management charge on the Company and, further, the Company was under no contractual (express or implied) obligation to reimburse LFO for the costs that constituted the Management Charge at the time it was approved. It followed that the legal relationship between LFO and the Company was that of "shareholder" and "company", rather than a relationship between "debtor" and "creditor". Consequently, LFO's benefit of

incurring the costs for its services will accrue from its rights as shareholder of the Company (such as its right to dividends or to any increase in the value of its shares).

The court therefore held that the Company, by assuming a liability to pay the Management Charge to LFO (rather than pay by way of a dividend) was agreeing to make a payment for no consideration recognised in law – and so the substance of the Management Charge was found to be a voluntary (and disguised) distribution to LFO.

As the October 2011 management accounts contained significant errors (by understating the Company's liabilities and overstating its assets), the distributable reserves as stated in those accounts were not enough to justify the entire amount of the Distribution and consequently, the amount which exceeded the correct amount of distributable reserves was paid out of capital and was therefore unlawful.

Were all the directors found liable?

Under section 1157 of the Act, the court may relieve a director, either wholly or in part, from his or her liability on such terms as it thinks fit if that director who is or may be liable acted honestly and reasonably and, taking into account all other circumstances, it is fair that he or she ought to be excused. In this case, the court refused to grant relief under this section to two of the directors who it deemed to be "highly experienced businessmen" with a clear understanding of financial statements and the legal and accounting requirements of the Act. However, it did excuse one of the directors on the basis that, despite being in breach of duty as a director, he had a very limited role in relation to the Distribution and was much more reliant on the other directors, having had no financial or accounting expertise at all.

What are the key lessons for directors?

This decision is another which supports the body of case law establishing that it is the substance, rather than the form of transaction that is crucial in determining whether a transaction amounts to a distribution. It is therefore critical for directors to scrutinise every transaction by a company to its shareholder or holding company and consider whether the facts and circumstances do in fact reveal that the company has made a 'distribution', rather than try to justify the transaction with a label disguising its true nature.

Key factors to consider include:

- whether there is a legal obligation between the parties which gives rise to the payment, either set out in an express contract or implied by previous conduct between the parties
- whether to draw up a legally enforceable written contract where there are commercial arrangements between a company and its subsidiary and the parties expect consideration for services
- the current and future solvency of a company and the wider group
- if a distribution is made, whether the company has sufficient distributable reserves

Additionally, the case reminds us that directors' skills and experience will be taken into account when determining whether relief should be granted under section 1157 of the Act. Given that this is a subjective assessment, it might be prudent for directors to consider taking out appropriate insurance to protect their position.

If you have any queries on structuring intra-group transactions or re-organisations, please do speak to your usual contact at Hogan Lovells or one of the listed contacts.

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