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SHORTER ARTICLE

DIRECTORS' LIABILITY FOR UNLAWFUL DIVIDENDS

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Companies can pay dividends only out of profits available for distribution.[1] The amount for distribution must be justified by reference to the company's "relevant accounts", usually its last annual accounts.[2] If a problem with those accounts emerges later, what is the position of the directors who authorised the payment of dividends in reliance on those accounts? Are they strictly liable to make good the amounts that were paid out to the shareholders, subject to the possibility of the court granting relief under section 1157 of the Companies Act 2006? Or does the liability of the directors depend on "fault"? Either way, the end position for the honest and careful director may be that she does not have to make good the amounts paid away but the route by which that conclusion is arrived at still matters. For a director who cares about her reputation, a finding that she was not in breach of duty at all is likely to be preferable to exoneration only through the court's exercise of a "prerogative of mercy" in respect of a technical or otherwise forgivable breach. Moreover, when she learns that there are relatively few reported cases in which directors have succeeded in claiming this relief, the prudent director is very likely to conclude that this possibility offers only limited practical reassurance.

An instinctive reaction to the questions just posed is that it is impossible to decide without more facts. A wide range of possibly relevant background circumstances can be postulated. Pertinent matters may include the detailed nature of the problem in the accounts and the role that the director in question was supposed to play in relation to them.

Holland v. *Commissioners for Her Majesty's Revenue and Customs* is a case in point as regards the importance of paying close attention to the nature of the problem in the accounts.[3] When the case reached the Supreme Court it was decided on the ground that the individual in

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[1] Companies Act 2006, s. 830 and for public companies s. 831.
[2] Companies Act 2006, s. 836.
[3] [2010] UKSC 51, [2010] 1 W.L.R. 2793.

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question was not a de facto director, a conclusion which rendered other issues academic. For the point of immediate interest here, we have to consider the first instance decision.[4]

The problem in *Holland* was that the accounts which had been used to pay dividends failed to make provision for a higher rate tax liability. The applicable companies legislation required provisions to be made for liabilities, such provisions being defined as "any amount retained as reasonably necessary for the purpose of providing for any liability the nature of which is clearly defined and which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise".[5] In other words, and underscoring the fact that drawing up accounts is not an exact science, the legal framework required those responsible for the accounts to make a judgment call as to the "reasonably necessary" amount.

At first instance the court held that if said judgment as to the applicability of higher rate tax was justifiable based on a reasonably objective view of the facts that were known or reasonably ascertainable at the time when it was made, the fact that hindsight indicated otherwise did not render the dividend retrospectively unlawful. Applied to the facts, this meant that the defendant, who was considered to be a de facto director, was not liable for dividends paid out before the company received clear advice that the corporate structure was not effective to secure the favourable tax treatment. There was no appeal against this part of the decision.

It is a matter of obvious commonsense that a vital first step towards imposing personal liability on a director for unlawful dividends is that the dividends in question must actually have been unlawful. The first instance decision in *Holland* usefully explains the operation of this principle where the issue of unlawfulness turns on the decisions made by directors in the drawing up of the relevant accounts.

A different scenario is that in which, say, the finance director "cooks the books" so cleverly that the fraud is not detected by the other directors and only comes to light after dividends are paid. Another set of circumstances that may be outlined in that in which material errors creep into the accounts through mistakes made by subordinate staff and which, in spite of close scrutiny by the board (and the auditors), are not picked up until it is too late. In either set of circumstances, do honesty and reasonableness insulate the directors from liability in respect of dividend payments made on the basis of the inaccurate

[4] [2008] EWHC 2200 (Ch), [2008] 2 BCLC 613.

[5] Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409), sch. 7, para. 2; Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410), sch. 9, para. 2.

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accounts or are they factors that come into play only after liability is established as grounds for relief?

Dovey v. *Cory* stands as clear House of Lords authority that a director of a company who assents to the payment of dividends that, it later transpires, were unlawful because of a previously undetected fraud is not liable for breach of duty to the company if he relied on the judgment, information, and advice of others whose integrity, skill, and competence he had no reason for suspecting.[6] Yet in *Holland* Lord Hope in the Supreme Court opined (obiter) that *Dovey* v. *Cory* had been the end of the fault-based view, that the trend in the modern authorities was for strict liability subject to the possibility of relief, and that the more modern authorities represented the "better" view.

A decision of high standing cannot be disregarded merely because it is long in the tooth. Lord Hope linked the development of the stricter approach to the introduction by section 32 of the Companies Act 1907 (that is after *Dovey* v. *Cory*) of the power for the court to grant relief from liability if a director has acted honestly and reasonably and ought in fairness to be excused. According to his Lordship: "the whole point of introducing the right to claim relief under [now Companies Act 2006, s. 1157] was to enable the court to mitigate the potentially harsh effect of being held strictly liable".[7] There is, however, a slight problem with this claim that is immediately apparent from the wording of the section (which for all material purposes has remained consistent through various re-enactments).

The section empowers the court to grant relief from liability for "negligence, default, breach of duty or breach of trust". Since negligence liability is expressly mentioned, it appears to be too much to say that the "whole point" of the section's introduction was to mitigate the consequences of strict liability. The "whole point" argument rings true for the equivalent statutory relief in respect of trustees because that provision is differently worded in that the power to grant relief relates simply to breach of trust.[8] Notwithstanding that the 1907 companies legislation was intended to extend to directors a relief similar to that which the 1896 Act had already provided in respect of trustees,[9] the differences in statutory wording present a stubborn obstacle to the simple carrying across of the "whole point" analysis.

It would be wrong, however, to attach too much significance to a few words in an obiter remark that was made without the benefit of full argument on the point. Of more importance are the implications to be drawn from the suggestion that the introduction of discretionary relief

[6] [1901] A.C. 477, HL.
[7] At para. 46.
[8] First introduced as Judicial Trustees Act 1896, s. 3, now Trustee Act 1925, s. 61.
[9] D.G. Hemmant, *Companies Act, 1907* (London 1907), pp. 51–52.

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was intended to provide an alternative safety-valve that would relieve the pressure on the courts to fudge liability standards in order to avoid unjust results. That this was a motivation for the introduction of the statutory reliefs is a historically robust claim. Writing in the *Law Quarterly Review* in 1898, F.H. Maugham (a critic of the statutory changes which he regarded as "topsy-turvy legislation" that could well lead to anomalies) noted that an important part of the background to the statutory intervention was that the courts were striving to confine decisions relative to trustees within the narrowest limits in order to avoid injustice.[10] However, whilst it is undoubtedly wise in reviewing the older cases to take account of the subsequent introduction of the statutory relief, there is no compelling reason to assume that this must lead inexorably to the conclusion that a decision such as *Dovey* v. *Cory* is to be consigned to history as a stale leftover from a long-gone era of judicial fudge.

Much indeed has changed since *Dovey* v. *Cory* was decided. The standard of care and skill that is applied to directors has been significantly strengthened.[11] With the rise of corporate governance, expectations with respect to the functions that directors, including non-executive directors, should perform in the oversight of company accounts have become radically different from what they were a century ago. Non-executives nowadays cannot expect to get away with unquestioning reliance on executive directors and other officers.[12] Each of them has personal non-delegable responsibilities.[13] The bar is continually being raised. In particular, the importance of effective non-executive directors now features prominently in debates about how to improve governance arrangements in financial institutions so as to reduce the risk of a recurrence of financial turmoil.[14] All of which means that it is very likely that a fault-based claim against a modern-day John Cory, that is a director of a failed bank who was duped by those around him but who failed to do much by way of independent verification of the information supplied to him, would have a different outcome. Applying a fault-based standard does not mean letting a director off lightly.

The detailed statutory framework governing dividends and other distributions is another relatively modern development that has obvious relevance. One consequence of the statutory requirements for

[10] F.H. Maugham, 'Excusable Breaches of Trust' (1898) 14 L.Q.R. 159, 161.
[11] Companies Act 2006, s. 174.
[12] *Equitable Life Assurance Society v Bowley* [2003] EWHC 2263 (Comm), [2004] 1 BCLC 180, at para 41.
[13] *Re Barings plc and others (No 5)* [1999] 1 BCLC 433, 489, approved [2000] 1 BCLC 523 at 535–536 (para. 36).
[14] eg, HM Treasury: *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities – Final Recommendations* (November 2009) ("Walker Review").

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distributions to be justified by reference to proper accounts is that a dividend can be unlawful not only where it is not covered by available distributable profits but also where distributable profits are actually available but the accounts and reports are not in proper order or there is some other essentially technical irregularity.[15] The fact that a dividend may be unlawful in spite of the fact that it does not in substance involve a payment from capital or otherwise undistributable reserves merits close attention in thinking about associated liabilities.

As a general rule, our company law does not expect directors to be outright guarantors of the accuracy of information in company accounts. It is duty of the directors to prepare and publish accounts and reports.[16] Before giving final approval the directors must be satisfied that the accounts give a true and fair view.[17] Compliance with professional standards is prima facie evidence that the accounts present a true and fair view.[18] Accounts that are prepared in accordance with the relevant accounting standards do not fail to give a true and fair view if they fail to make provision for an unknown liability that could not reasonably have been discovered.[19] If actual defects are found later, the accounts or reports may have to be revised.[20] If the company is publicly-quoted, administrative sanctions for misleading the market may follow. These sanctions may be imposed on directors as well as the company itself, but liability is based on a failure to take reasonable care.[21] The company may be liable to compensate investors for losses suffered as a result of mistakes in published information but its directors are not themselves liable directly to investors.[22]

A company that incurs losses as a result of inaccuracies in its accounts or reports may sue its directors. In general the liability of the directors in these circumstances is considered to be fault-based. Whether this is an appropriate standard in this context arose for consideration during the review of company law that culminated in the Companies Act 2006. Concern that fault-based liability could leave directors over exposed and hence deter sensible people from taking up appointments as directors led Parliament to include a special protection in the Companies Act 2006 whereby in respect of directors' liability to their company for inaccuracies in financial reports, the applicable standard is now based on knowledge or recklessness rather

[15] *Precision Dippings Ltd* v. *Precision Dippings Marketing Ltd.* [1986] 1 Ch. 447, CA.
[16] Companies Act 2006, Part 15, chs. 4–7.
[17] Companies Act 2006, s. 393.
[18] *Macquarie Internationale Investments Ltd* v. *Glencore UK Ltd* [2010] EWCA Civ 697, para 51 per Jackson L.J.
[19] *Macquarie* at para. 55 per Jackson L.J..
[20] Companies Act 2006, ss. 454–457.
[21] Financial Services and Markets Act 2000, s. 91 and FSA, Disclosure Rules and Transparency Rules, DTR 1.3.4 and DTR 1A.3.2.
[22] Financial Services and Markets Act 2000, s. 90A and sch. 10A.

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than negligence.[23] Whilst this protection is only in respect of the reports, not the whole accounts, and was considered to be necessary because requirements to include forward-looking statements in reports give rise to special risks, that the legislature's move away from fault based liability in this complex and difficult field was in a direction that is more, rather than less, favourable to directors has considerable general significance.

For the court to apply a strict liability standard in respect of one particular type of loss that a company may suffer as a result of inaccurate accounts, namely, a loss reflecting the amounts improperly paid away as unlawful dividends, would go in the opposite direction. This high standard could be thought appropriate because this particular loss involves an infringement of corporate capital rules where special considerations apply. However, the issues are not clear cut, not least because, as noted above, an unlawful dividend should not be automatically equated to an unlawful return of capital.

Should an appropriate opportunity arise for a definitive ruling on the standard that governs directors' liability for unlawful dividends, it is to be hoped that the issues receive the wide-ranging and careful attention that they deserve. Whilst it is not for the courts to act on the many calls from academics and others for the rigid and mechanical approach in the statutory framework governing distributions to be scrapped in favour of the modern, solvency-based approach to distributions now in use in many jurisdictions outside Europe, that they are dealing with a set of laws that is widely considered to be outdated and which probably would have been abolished or streamlined in the Companies Act 2006 but for the impediment of certain restrictions in the Second Company Law Directive, is a relevant background fact.[24] The cases that are said to be part of the trend away from fault-based liability need to be carefully examined in order not to miss the contextual significance of judicial statements that in isolation may appear to support a strict standard but which were actually made in relation to directors who were dishonest or otherwise very clearly at fault.[25] Whether the possibility of granting relief from liability really is an adequate safety-valve that can, and should, be relied upon to prevent injustice also merits close scrutiny. A greater willingness on the part of the judiciary to grant such relief could solve some problems but it could also give rise to new ones, creating exactly the sort of uncertainty and unpredictability that Maugham warned against over a century ago.

[23] Companies Act 2006, s. 463.
[24] 77/91/EEC. E. Ferran, *Principles of Corporate Finance Law* (Oxford 2008) ch. 9 provides an account of the debate on reform of the legal capital rules.
[25] As was the case, for instance, in *Bairstow* v. *Queens Moat Houses plc* [2001] EWCA Civ 712, [2001] 2 BCLC 531.

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