PRACTICAL IMPLICATIONS FOR COMPANIES AND OFFICEHOLDERS

Revisiting over 150 years of case law, the High Court has resolved a question on which both the courts and textbooks had given conflicting answers: is a director's liability for payment of a dividend which is unlawful as a result of incorrect accounts fault-based or strict? Going against what appeared to be the established wisdom, the High Court has recently concluded that liability is fault-based – directors will only be liable where they knew of the facts which constituted an unlawful dividend, although it is unnecessary for the claimant company or insolvency officeholder to prove that the directors knew that those facts made the dividend unlawful.

Where directors are unaware of the relevant facts, the High Court has held that the directors will not be liable provided that they had taken reasonable care to secure the preparation of accounts and calculation of distributable profits which would support the amount of the dividend, including by relying on appropriately skilled professionals.

For companies and (more likely) insolvency officeholders bringing claims against the directors of a company, the practical impact is likely to be twofold:
They will likely have to gather and deploy evidence not only in relation to the inaccuracy of the relevant accounts but also the directors' knowledge of the facts which gave rise to those inaccuracies (for example, that an asset was wrongly valued). Together with the difficulties often experienced by insolvency officeholders in piecing together the documentary and other records of a company, the evidential requirements may increase the costs of unlawful dividend claims.

A claimant's focus may shift towards the professionals, likely auditors, on whom directors relied when preparing the relevant accounts. In recent years, auditors have faced increased regulatory scrutiny upon high-profile insolvencies but the extent of their liability to the company, if any, is largely untested in the case law.

THE STATUTORY FRAMEWORK

Part 23 of the Companies Act 2006 (the "Act") restricts when a company can make a distribution, including by way of cash dividend. Distributions must only be made out of distributable profits, which are assessed by reference to the company's accounts. Section 836 of the Act determines whether the company should have regard to its last annual accounts, interim accounts or initial accounts.

Whichever accounts are used, they must have been properly prepared in accordance with the Act. Most importantly, the accounts must give a true and fair view (section 393) and be prepared in accordance with applicable accounting frameworks, whether UK GAAP or IAS.

Where a distribution is made other than in accordance with Part 23 of the Act, it is unlawful. Section 847 of the Act provides a statutory right of repayment exercisable by the company against shareholders who knew or had reasonable grounds to believe that the distribution was unlawful.
However, the Act is silent as to the consequences for directors. The common law plugs this gap, as do the general duties of directors under Part 10 of the Act. Previously, there have been conflicting views as to the basis for imposing liability on directors. On the one hand, where a distribution was unlawful it was argued that its payment was outside the company’s powers so that the directors were strictly liable for misapplying the company’s assets. Others argued that this was too onerous and that directors should only be liable where they had been at fault, for example acting negligently.

THE FACTS IN BURNDEN

These conflicting approaches have now been considered in detail by the High Court in *Burnden Holdings (UK) Ltd v Fielding* [2019] EWHC 1566 (Ch).

In 2007, Burnden had demerged so as to separate its energy consulting business into a separate corporate group. The demerger responded to a cash crisis arising out of unsuccessful litigation and involved the distribution of shares in Burnden’s subsidiary, Vital, to Burnden’s shareholders. The majority shareholders were Mr and Mrs Fielding, who were also Burnden’s directors. The distribution was made by reference to interim accounts.

Burnden subsequently became insolvent, entering administration in 2008 and liquidation in 2009.

Burnden's liquidator claimed that the interim accounts did not comply with the requirements of the Companies Act 1985, which are materially identical to the requirements under the Act. In particular, the liquidator contended that certain assets of Burnden had been given too high a value (including by inappropriate use of book value) and that others had been misdescribed so that it was impossible to make a reasonable judgment as to their value. As a consequence the distribution was unlawful and the directors were personally liable for distributing Burnden’s assets in breach of the Act - whether they knew about the alleged shortcomings in the preparation of the accounts or not.

Alternatively, the liquidator argued that the effect of the distribution was to make Burnden insolvent and that the directors failed properly to act in the best interests of the company, having particular regard to the interests of creditors given the effect of the transaction.

**STRICT OR FAULT-BASED LIABILITY?**

Giving the judgment of the High Court, Mr Justice Zacaroli (who before being appointed a judge practised as an specialist insolvency lawyer) dismissed the liquidator's claim.

Zacaroli J reviewed the case law underpinning this area, including recent Court of Appeal and Supreme Court authority which had suggested, albeit without deciding the point, that directors should be strictly liable where they misapply a company’s assets by making an unlawful distribution. Strict liability was justified in some cases because, even if found liable, directors could seek relief from liability (i.e. effectively be excused) under section 1157 of the Act, provided that the directors had acted honestly and reasonably.
Set against these recent authorities was case law decided before 1901, where directors had been treated in the same way as trustees who paid away assets in breach of trust but claimants were nevertheless required to prove that the trustee had acted with fault.

The judge concluded that the position reached by 1901 was correct and not impacted by the recent consideration of the issue in the appellate courts. Accordingly:

- Directors are to be treated as if they are trustees in relation to the company's funds.

- If directors knew the facts which constituted an unlawful distribution, they will be liable to reconstitute the company's assets irrespective of whether they knew that the distribution was itself unlawful.

- If directors were unaware of the facts which rendered the distribution unlawful, then provided that they had taken reasonable care to secure the preparation of accounts, they would not be liable if it turned out that there were in fact insufficient profits for that purpose.

- Directors are entitled to rely upon the opinion of others, including management and lawyers, as to the accuracy of statements appearing in the company's accounts. Directors could not be expected themselves to have the same level of expertise as professional advisors in a specialist area. Directors are entitled to rely on the judgment of others whom they appoint to carry out specialist financial roles within a company.

The judge found that Mr and Mrs Fielding did not know the facts that rendered the distribution unlawful and that they had reasonably placed reliance on others. They were not at fault. Mr and Mrs Fielding had relied on Burnden's finance director, as well as external accountants and lawyers, to advise in relation to the preparation and accuracy of the accounts supporting the distribution. The finance director and external advisors had all been provided with appropriate information in relation to the financial position of Burnden and, in those circumstances, it was reasonable for Mr and Mrs Fielding to conclude that the interim accounts resulting from this advice were prepared in accordance with the Act.

Mr and Mrs Fielding were also not liable for breach of their duty to act in Burnden's best interests – applying the recent guidance of the Court of Appeal in *BTI 2014 LLC v Sequana*, Mr and Mrs Fielding did not owe a duty to consider the interests of creditors because Burnden was not made insolvent by the distribution and, even if it was insolvent, Mr and Mrs Fielding did not know this. It was not enough for the liquidator to prove that Mr and Mrs Fielding knew that Burnden had cashflow difficulties. The liquidator instead had to prove that Mr and Mrs Fielding knew or ought to have known that Burnden was more likely than not to become insolvent; this knowledge was not established and the liquidator had not argued that they ought to have known.
PRACTICAL CONSEQUENCES

Subject to any appeal, the High Court's decision has provided clarity on the need to establish fault when bringing a claim against directors in relation to an unlawful distribution. The decision should give significant comfort to directors, who might otherwise face the prospect of liability in relation to a distribution even where they were unaware of any problem with the distribution and had relied on apparently competent professionals. This may in turn lead to directors taking a less conservative approach to distributions.

The most important practical consequence of the decision is likely to be that insolvency officeholders bringing claims against directors will be required to prove fault on the part of the directors, which may involve detailed consideration of the books and records of the company and of the extent to which directors were scrutinising, and entitled to rely on, the work of others including external professional advisers. This may lead to an increase in costs for officeholders pursuing a claim and a change to the burden of proof – where liability was strict, once the distribution had been shown to be unlawful it was for the directors to seek relief from liability under section 1157 of the Act on the basis that they had acted honestly and reasonably and ought fairly to be excused.

More generally, where a director's defence is that he or she relied on external professional advice, officeholders may wish to consider whether the company has any claim against the company's advisors. The nature of any liability owed by professional advisors is very different to the liability of directors – whereas a director's liability stems from the need to restore assets to the company (potentially, all of a distribution infected by unlawfulness), professional advisers will generally only be liable if they have breached a contractual duty or a duty of care and that breach has caused recoverable damages. Where officeholders do not target professional advisers, it is possible that they will nevertheless become embroiled in proceedings, for example because the directors bring a contribution claim. This may have knock-on consequences – for example, potentially professional advisors may be more reluctant to comply with an officeholder's requests for voluntary disclosure (prior to seeking an order under section 236 of the Insolvency Act 1986) if there is increased potential for subsequent claims.

Even following the judgment in Burnden, there remain outstanding issues. For example, it is unclear whether the test for making directors liable differs depending on whether a director is also a shareholder who received a pro rata share of the distribution. Certain of the older authorities had suggested that there could be a difference, at least in certain circumstances. It is further unclear whether a director's failure to take reasonable care to ensure proper preparation of the accounts is characterised as a breach of fiduciary duty (as opposed to a breach merely of a duty of care), which could affect the availability of certain remedies and the position of third parties that were accessories to the breach. Finally, there remains debate about whether, if the directors are at fault, the entire dividend is unlawful or is only unlawful to the extent that the distribution exceeded the company's distributable profits, properly calculated. All of these issues will have to await a subsequent case.
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