of freeing itself from the deadlock and enabling it to function independently and this was echoed in the judgment of O'Connor LJ where he observed that the answer 'embraces avoiding liquidation, preserving its goodwill and the advantages of an established business'. Croom-Johnson LJ found the larger purpose in the reorganisation of the whole group. My Lords, I confess that I have not found the concept of a 'larger purpose' easy to grasp, but if the paragraph is to be given any meaning that does not in effect provide a blank cheque for avoiding the effective application of s 151 in every case, the concept must be narrower than that for which the appellants contend.

The matter can, perhaps, most easily be tested by reference to s 153(1)(a) where the same formula is used. Here the words are 'or the giving of the assistance for that purpose' (ie the acquisition of shares) 'is but an incidental part of some larger purpose of the company'. The words 'larger purpose' must here have the same meaning as the same words in sub-s (2)(a). In applying sub-s (1)(a) one has, therefore, to look for some larger purpose in the giving of financial assistance than the mere purpose of the acquisition of the shares and to ask whether the giving of assistance is a mere incident of that purpose. My Lords, 'purpose' is, in some contexts, a word of wide content but in construing it in the context of the fasciculus of sections regulating the provision of finance by a company in connection with the purchase of its own shares there has always to be borne in mind the mischief against which s 151 is aimed. In particular, if the section is not, effectively, to be deprived of any useful application, it is important to distinguish between a purpose and the reason why a purpose is formed. The ultimate reason for forming the purpose of financing an acquisition may, and in most cases probably will, be more important to those making the decision than the immediate transaction itself. But 'larger' is not the same thing as 'more important' nor is 'reason' the same as 'purpose'. If one postulates the case of a bidder for control of a public company financing his bid from the company's own funds—the obvious mischief at which the section is aimed—the **(p. 534)** immediate purpose which it is sought to achieve is that of completing the purchase and vesting control of the company in the bidder. The reasons why that course is considered desirable may be many and varied. The company may have fallen on hard times so that a change of management is considered necessary to avert disaster. It may merely be thought, and no doubt would be thought by the purchaser and the directors whom he nominates once he has control, that the business of the company will be more profitable under his management than it was heretofore. These may be excellent reasons but they cannot, in my judgment, constitute a 'larger purpose' of which the provision of assistance is merely an incident. The purpose and the only purpose of the financial assistance is and remains that of enabling the shares to be acquired and the financial or commercial advantages flowing from the acquisition, whilst they may form the reason for forming the purpose of providing assistance, are a by-product of it rather than an independent purpose of which the assistance can properly be considered to be an incident. Now of course in the instant case the reason why the reorganisation was conceived in the first place was the damage being occasioned to the company and its shareholders by reason of the management deadlock, and the deadlock was the reason for the decision that the business should be split in two, so that the two branches could be conducted independently. What prompted the particular method adopted for carrying out the split was the commercial desirability of keeping Brady in being as a corporate entity. That involved, in effect, Jack buying out Bob's interest in Brady and it was, presumably, the fact that he did not have free funds to do this from his own resources that dictated that Brady's own assets should be used for the purpose. No doubt the acquisition of control by Jack was considered, at any rate by Jack and Robert [Jack's nephew], who were and are Brady's directors, to be beneficial to Brady. Indeed your Lordships have been told that the business has thriven under independent management. But this is merely the result, and no doubt the intended result, of Jack's assumption of control and however one analyses the transaction the only purpose that can be discerned in the redemption of loan stock is the payment in tangible form of the price payable to enable the Brady shares to be acquired and ultimately vested in Jack or a company controlled by him. The scheme of reorganisation was framed and designed to give Jack and Robert control of Brady for the best of reasons, but to say that the 'larger purpose' of Brady's financial assistance is to be found in the scheme of reorganisation itself is to say only that the larger purpose was the acquisition of the Brady shares on their behalf. For my part, I do not think that a larger purpose can be found in the benefits considered to be likely to flow or the disadvantages considered to be likely to be avoided by the acquisition which it was the purpose of the assistance to facilitate. The acquisition was not a mere incident of the scheme devised to break the deadlock. It was the essence of the scheme itself and the object which the scheme set out to achieve. In my judgment therefore, sub-s (2)(a) of s 153 is not satisfied and if the matter rested there the appeal ought to fail on that ground.

[His Lordship went on to hold that, since the transaction involved a private company, an order for specific performance could be made, the parties being directed to follow the 'whitewash' procedure in CA 1985 ss 155–158.[21]]

LORDS KEITH OF KINKEL, HAVERS, TEMPLEMAN and GRIFFITHS concurred.

➤ Notes

1. This was regarded a very restrictive interpretation of statutory provisions which, it had been widely believed, were intended not only to clarify the former law but also to make it possible for many routine business transactions—some of them of long-standing—to go ahead without the fear that they might be illegal because they incidentally involved a breach of the financial assistance rule. This uncertainty is very costly—it has been estimated that well over £20 million a year is spent on obtaining legal advice in an endeavour to ensure that **(p. 535)** proposed transactions do not fall foul of 'financial assistance' prohibitions. In consequence, there has been a demand ever since *Brady*for further reform of the law. That has been given, at least to some extent, by CA 2006. *Brady*, being concerned with a private company, would now not be caught by the prohibition at all. But the uncertainty in interpreting the 'purpose' exceptions, as illustrated by *Brady*, unfortunately remains in full. The reason given is that, at least for public companies, the UK must keep in place a provision sufficiently strong to meet the requirements of the Second EU Company Law Directive. In the government's view, none of the proposed changes in the wording of CA 2006 s 678(4)(a) sufficed to meet the Directive's requirements *and* clarify the 'purpose' exception.

2. Note the comments on 'purpose' by Toulson LJ in *Anglo Petroleum Ltd v TFB (Mortgages) Ltd* **[10.07]**.

3. Despite this gloomy assessment of the uncertainties in the application of the section, there are instances where the 'principal purpose' test has been relied upon to exempt transactions from being classed as 'financial assistance' notwithstanding the company's knowledge that its moneys would be used to fund the acquisition of shares in the company or its holding company, although only as part of a larger scheme or purpose: see, for example, *Re Uniq plc* [2011] EWHC 749 (Ch). Here a restructuring scheme was devised to provide a solution to the imminent insolvency threatened by large pension fund deficits. Inter-group transactions provided funds which would be used to purchase shares in the target company and thus provide a necessary injection of capital. In these circumstances, David Richards J held that 'notwithstanding that it is known and intended that it [the funds] will be used by Newco to pay up the new shares. Even if that could properly be regarded as a purpose of the loans and payment, I would be satisfied that the principal purpose was to obtain the release and that they were made in good faith in the interests of the relevant companies, so falling within [CA 2006] s.678(2).'

4. Recall, too, that the prohibition now applies only to public companies. This was material in *Paros plc v Worldlink Group plc* [2012] EWHC 394 (Comm), where a public company entered into a payment obligation (a 'break fee') which prima facie infringed the prohibition on financial assistance (as described later), but where the obligation would only arise on fulfilment of a condition precedent that the public company be re-registered as a private company. In such circumstances the court held there was no infringement of CA 2006 s 678. Jonathan Hirst QC, sitting as a Deputy High Court judge, held:

> 72 In my judgment, … the break fee … did amount to the giving of unlawful financial assistance contrary to s.151 [of CA 1985, now see CA 2006 s 678]. It is clear that s.151 applies to cases where a person is proposing to acquire shares in the company, just as much as where he is actually acquiring them. Here Paros was proposing to buy the issued shares in Worldlink. It would clearly have constituted unlawful financial assistance for Worldlink to agree to pay Paros's fees and costs incurred in connection with the acquisition whilst Worldlink was a public company. [Although the] break fee was only payable in the event that the acquisition fell through, [it provided for] Worldlink to bear all ParOS' and its advisers' agreed fees and costs. … it was plainly intended to ensure that, if Worldlink withdrew from the negotiations before it

was re-registered as a private company, ParOS was certain to recover a minimum contribution towards its expenses. As such the fee was 'smoothing the path to the acquisition of the shares' … The break fee was not a mere inducement to enter into the transaction (if relevant) … it amounted to 'other financial assistance' and that it materially reduced the net assets of Worldlink, given that they were negative at the time.

73 On the other hand, the undertaking to pay Paros' fees and costs after it re-registered as a private company does not in my judgment infringe s.151. The commitment was subject to a condition precedent that Worldlink re-registered. Unless and until it did so, there was no obligation to pay ParOS' fees and expenses. If Paros did re-register, the financial assistance would not be caught by s.151 because it does not apply to private companies. I think it is taking s.151 too far to hold that **(p. 536)** because the conditional promise was given at a time when Worldlink was still a public company, it is unlawful.[[22]] There is support for this conclusion at the highest level: see *Brady v. Brady* **[10.08]** where the House of Lords granted an order for specific performance of an agreement to give financial assistance where there was a means by which the appellants could perform the contract lawfully by using the 'whitewashing procedure'. The parties were to be presumed to intend that the contract was to be performed in the lawful rather than the unlawful manner: per Lord Oliver of Aylmerton at p. 783D. Here the position is a fortiori. The obligation to pay Paros' fees and costs only arose if the company re-registered as a private company, when it would become lawful.

Consequences when a transaction breaches the prohibition

The only statutory sanction for breaching the financial assistance prohibition is that an offence is committed by the company and by every officer of the company who is in default (being an offence that can lead to a prison term): CA 2006 s 680. Note that criminal liability is imposed on the company itself, even though the provisions are allegedly designed to *protect* the company against disposal of its assets.

In practice the civil consequences are usually even more important, but for a time they seemed more troubling. The difficulty arose from the wording of the section (which has not changed in successive re-enactments): instead of making it illegal for the purchaser to *accept* financial assistance, CA 2006 s 678 makes it illegal *for the company*(or its subsidiary) to *give* financial assistance. This suggested to some judges that the object was not to protect the company, but to punish it, and for a while the consequences of illegality were analysed in that rather counter-intuitive way.[23]

A transaction which infringes CA 2006 s 678 is illegal and unenforceable by either party.

[10.09] Re Hill and Tyler Ltd (In Administration) [2004] EWHC 1261, [2005] 1 BCLC 41 (Chancery Division)

The facts are immaterial.

RICHARD SHELDON QC: The argument can be broken down into three questions: (1) Is a contract involving the provision of financial assistance in contravention of s 151 [CA 2006 s 678], even where the whitewash procedure is available but not properly complied with, void and unenforceable as a matter of statutory interpretation of s 151? (2) If not, under the common law, is such a contract illegal as to its formation? (3) If not, is such a contract illegal as to its performance?

I consider first whether every contract which constitutes financial assistance within s 151 is rendered void and unenforceable as a matter of statutory interpretation. In*Chitty on Contracts* (29th edn) paras 16-141 to 16-146 the following is stated (citations omitted):

> 'Unenforceability by statute … arises where a statute itself on its true construction deprives one or both of the parties of their civil remedies under the contract in addition to, or instead of, imposing a penalty upon them. If the statute does so, it is irrelevant whether the parties meant to break the law

> or not …' (para 16-141) 'where the statute is silent as to the civil rights of the parties but penalises the making or performance of the contract, the courts consider **(p. 537)** whether the Act, on its true construction, is intended to avoid contracts of the class to which the particular contract belongs or whether it merely prohibits the doing of some particular act … it is important to note that where a contract or its performance is implicated with breach of statute this does not entail that the contract is avoided. Where the Act does not expressly deprive the plaintiff of his civil remedies under the contract the appropriate question to ask is whether, having regard to the Act and the evils against which it was intended to guard and the circumstances in which the contract was made and to be performed, it would in fact be against public policy to enforce it.' (para 16-145)
>
> 'If, on the true construction of the statute, "the contract be rendered illegal, it can make no difference, in point of law, whether the statute which makes it so has in mind the protection of the revenue or any other object. The sole question is whether the statute means to prohibit the contract". If, on the other hand, the object of the statute is the protection of the public from possible injury or fraud, or is the promotion of some object of public policy, the inference is that contracts made in contravention of its provisions are prohibited.' (para 16-146)

Applying these principles, and having regard to the mischief to which s 151 is directed, I consider that contracts which are entered into in breach of s 151 are rendered illegal by that section. The section provides that it is 'not lawful' for a company to give financial assistance directly or indirectly for the purpose of the acquisition of its own shares. It seems to me to follow that contracts which are entered into in contravention of that section are illegal. In consequence, such contracts are void and unenforceable. Although the consequences on an innocent party may be harsh, it is well recognised that the courts will not lend their assistance to transactions which are rendered unlawful by statute.

Notes

1. In *Anglo Petroleum Ltd v TFB (Mortgages) Ltd* **[10.07]**, Toulson LJ made the following comments on illegality:

54 There are different ways in which a statute may give rise to an argument that a contract was illegal in its formation and therefore unenforceable. They are (1) that its formation was prohibited by statute, (2) that it was a contract to do an act prohibited by statute or (3) that … it was entered into for the purpose of doing an act prohibited by statute. Mr Martin argued that the Credit Agreement was unlawful on grounds 2 and 3. Since I agree with the judge that the use of the funds borrowed by APL from TFB did not contravene s 151, it is not strictly necessary to decide whether the credit transactions would have been unlawful if the use of the funds had contravened the section. … [but, had the transactions been in breach of s 151 …]

83 It is hard to see how public policy would be served by invalidating a contract which is not unlawful in its terms and which a reasonable person in the position of TFB would have seen as an ordinary, innocuous commercial transaction. It is also hard to see how public policy would be served by stretching the principle that ignorance of the law is no excuse so as to attribute to the party seeking to enforce the contract an unrealistic knowledge that the other party intended to act illegally. …

84 In the present case it was reasonable for TFB to regard the loan as an ordinary commercial loan made in the course of its business. There is no good reason why public policy should have required TFB to investigate whether the proposed use of the loan would amount to a breach of s 151, and the law would be out of touch with reality if it deemed TFB to have knowledge that the proposed use would be a breach. Even if Mr Martin were right in his argument about the effect of the section, this would have been far from obvious to a lawyer, let alone to a party in the position of TFB. Moreover, as Mr Todd pointed out, even if s 151 was potentially engaged, it would not necessarily follow that it would be breached, because if APL had itself been aware of a problem it would have had the possibility of using the whitewash procedure.

(p. 538) 85 Even if the use of the funds had involved a breach of s 151, the judge was right to hold that the

Credit Agreement, the Security Agreement and the Guarantee were not illegal. The agreements did not necessitate any breach of the law, and it was not the purpose of TFB in entering into them to procure or assist the commission of conduct which would be a breach of the law. In the circumstances, it would not be just to equate TFB's knowledge of APL's intended use of the loan with knowledge of its alleged illegality, nor would it be just to draw an inference of a shared unlawful design if a reasonable person in the position of TFB would have seen it as an ordinary commercial transaction.

2. An otherwise unenforceable obligation to pay a break fee was rendered enforceable in *Paros plc v Worldlink Group plc* (see Note 4 following *Brady v Brady* **[10.08]**, p 535), per Jonathan Hirst QC:

80 It seems to me that the correct analysis is that illegality renders a contract unenforceable rather than void, if by void is meant that the agreement was never made. It is clear that property can pass under an illegal contract, and in some circumstances a Court will enforce a contract which involves an element of illegality. If the contract was truly void, in the sense that it is to be treated as never having existed, it is difficult to see how that could occur. The distinction between void and unenforceable is in any event narrow. The Shorter Oxford Dictionary defines 'void' as 'having no legal force, not binding in law; (legally) invalid, ineffective Freq. in *null and void*'. The essence of a contractual obligation is that it is enforceable. If it is not, then it is ineffective as a contract.

81 In any event, whether the obligation to pay a break fee is to be regarded as at 25 February 2009 as void or unenforceable, or both, should to make no real difference. On 4 March 2009, the parties varied the HoT in a significant way. Their objective intention was clearly that clause 5.1 should apply in full to the arrangement as varied. The break clause ceased to be unlawful under s.151. It is to be treated as either reinstated or rendered enforceable. There is no longer any reason why the Court needs, as a matter of public policy, to decline to enforce the break fee obligation. After all the parties would have been entirely free to tear up the HoT and to conclude a new contract. It is irrational to say that they could not achieve the same result by varying the HoT.

Although a company that is party to a transaction which infringes CA 2006 s 678 cannot enforce the illegal contract, it is not prevented by law from suing others who have participated in the wrongdoing, for example in an action for damages for conspiracy.

[10.10] Belmont Finance Corpn Ltd v Williams Furniture Ltd [1979] Ch 250 (Court of Appeal)

It was alleged that four of the defendants, with the connivance of two of the three directors of the plaintiff company, had sold its property worth £60,000 for a price of £500,000 and that the four had then used the money to purchase all the issued shares in the plaintiff. The company claimed damages for conspiracy against the defendants. It was held that the company could sue, despite the fact that it had been itself a party to the transaction which infringed the statute.

BUCKLEY LJ: In the course of the argument in this court counsel for the first and second defendants conceded that the plaintiff company is entitled in this appeal to succeed on the conspiracy point, unless it is debarred from doing so on the ground that it was a party to the conspiracy, which was the ground that was relied upon by the judge.

The plaintiff company points out that the agreement was resolved on by a board of which the seventh and eighth defendants constituted the majority, and that they were the two directors who countersigned the plaintiff company's seal on the agreement, and that they are sued as two of the conspirators. It is conceded by Mr Miller [counsel] for the plaintiff company that a company may **(p. 539)** be held to be a participant in a criminal conspiracy, and that the illegality attending a conspiracy cannot relieve the company on the ground that such an agreement may be ultra vires; but he says that to establish a conspiracy to which the company was a party, having as its object the doing of an illegal act, it must be shown that the company must be treated as knowing all the facts relevant to the illegality; he relies on *R v Churchill*[24] … But I feel impelled to ask: can the plaintiff company sensibly be regarded as a party to the conspiracy, and in law ought it to be regarded as a party to the conspiracy?

Section 54 of CA 1948 [CA 2006 s 678] is designed for the protection of the relevant company whose shares are dealt with in breach of the section; that was so held in *Wallersteiner v Moir*.[25]

In the present case the object of the alleged conspiracy was to deprive the plaintiff company of over £400,000-worth of its assets, assuming always, of course, that it succeeds in establishing that allegation. The plaintiff company was the party at which the conspiracy was aimed. It seems to me that it would be very strange that it should also be one of the conspirators. The majority of the board which committed the company to carry out the project consisted of two of the alleged conspirators.

The judge said that the plaintiff company was a vital party to the agreement, and it could not be said that the other parties were conspirators but not the plaintiff company. With deference to the judge, who I think probably had very much less reference to authority in the course of the argument before him than we have had in this court, that view seems to me to be too simplistic a view, and not to probe far enough into the true circumstances of the case.

On the footing that the directors of the plaintiff company who were present at the board meeting on 11 October 1963 knew that the sale was at an inflated value, and that such value was inflated for the purpose of enabling the third, fourth, fifth and sixth defendants to buy the share capital of the plaintiff company, those directors must be taken to have known that the transaction was illegal under s 54.

It may emerge at a trial that the facts are not as alleged in the statement of claim, but if the allegations in the statement of claim are made good, the directors of the plaintiff company must then have known that the transaction was an illegal transaction.

But in my view such knowledge should not be imputed to the company, for the essence of the arrangement was to deprive the company improperly of a larger part of its assets. As I have said, the company was a victim of the conspiracy. I think it would be irrational to treat the directors, who were allegedly parties to the conspiracy, notionally as having transmitted this knowledge to the company; and indeed it is a well-recognised exception from the general rule that a principal is affected by notice received by his agent that, if the agent is acting in fraud of his principal and the matter of which he has notice is relevant to the fraud, that knowledge is not to be imputed to the principal.

So in my opinion the plaintiff company should not be regarded as a party to the conspiracy, on the ground of lack of the necessary guilty knowledge.

GOFF LJ: [In] support of what Buckley LJ has said, I would wish to cite two short passages from *Wallersteiner v Moir*; the first passage is in the judgment of Lord Denning MR where he said:

> In *Essex Aero Ltd v Cross*,[26] Harman LJ said: ‘the section was not enacted for the company’s protection, but for that of its creditors; … the company … cannot enforce it.’ I do not agree. I think the section was passed so as to protect the company from having its assets misused. If it is broken, there is a civil remedy by way of an action for damages.

Scarman LJ spoke to the same effect and said:

> There was, on these facts, a breach of duty by Dr Wallersteiner as a director. The companies were, also, in breach of the section. But the maxim ‘potior est conditio defendentis’ is of no avail to Dr Wallersteiner, for the section must have been enacted to protect company funds and the interests of shareholders as well as creditors. I do not agree with the dictum of **(p. 540)** Harman LJ in *Essex Aero Ltd v Cross* … to the effect that the section was enacted not for the company’s protection but

for that of its creditors.

ORR LJ delivered a concurring opinion.

A company that is party to a transaction which infringes CA 2006 s 678 may bring an action against its directors and other implicated third parties for recovery of its misapplied property, on the grounds of breach of trust or constructive trust.

[10.11] Selangor United Rubber Estates Ltd v Cradock (No 3) [1968] 1 WLR 1555 (Chancery Division)

The facts are immaterial.

UNGOED-THOMAS J: Does [this] principle, however, prevent an action succeeding for breach of trust in doing what is illegal?

In *Steen v Law*[27] directors of a company, incorporated in New South Wales, lent the company's funds which the directors had to give financial assistance to purchase the company's shares. The liquidator of the company claimed that there had thus been a breach of a New South Wales section, which, so far as material, was in the terms of s 54 [CA 2006 s 678]; and that the directors had thereby committed a breach of their fiduciary duty to the company and should reimburse the company the sums so illegally applied. It was not contended that the directors were absolved from accounting by reason of the illegality of the loan by the company. Such illegality was clearly before the Privy Council and, if available against such a claim, provided a complete answer to it. Yet the point was neither taken by the defendants nor by the Privy Council; and it seems to me for the very good reason that the company was not relying for its claim on the unlawful loan and the relationship of creditor and debtor thereby created, but upon the misapplication by the directors of the company's moneys by way of the unlawful loan. That is the position with regard to the plaintiff company's claim in our case. It was founding its claim, as in our case, not on a wrong done by it as a party to the unlawful loan, but as a wrong done to it by parties owing a fiduciary duty to it. The courts were being invited, as in our case, not to aid illegality but to condemn it. If this were not so, the courts would give redress to companies against directors for misapplication and breach of fiduciary duty which did not involve the company in illegality, but no redress if they were so serious as to involve the company in illegality.

I appreciate that, in the ordinary case of a claim by a beneficiary against a trustee for an illegal breach of trust, the beneficiary is not a party to the illegality; but that, when directors act for a company in an illegal transaction with a stranger, the company is itself a party to that transaction and therefore to the illegality. [[28]] The company, therefore, could not rely on that transaction as 'the source of civil rights' and, therefore, for example, it could not successfully sue the stranger with regard to rights which it was claimed that the transaction conferred … [But in] a claim based on an illegal breach of trust the claimant does not rely on a right conferred or created by that breach. On the contrary, he relies on a right breached by the breach, as the very words 'breach of trust' indicate. It is only on the footing that there is a breach of trust that the defence of illegality becomes relevant. So it is assumed, for present purposes, that there is a breach of trust against the plaintiff company by those who are directors and by those who are claimed to be constructive trustees. The constructive trustees are, it is true, parties with the plaintiff company itself to the transaction which is illegal. The plaintiff company's claim, however, for breach of trust is not made by it as a party to that transaction, or in reliance on any right which that transaction is alleged to confer, but against the directors and constructive trustees for perpetrating that transaction and making the plaintiff **(p. 541)** company party to it in breach of trust owing to the plaintiff company. The breach of trust includes the making of the plaintiff a party to the illegal transaction. So it seems to me clear on analysis that the plaintiff company is not precluded from relying on breach of trust by a party to an illegal transaction, to which the plaintiff itself is a party, when the breach includes the making of the plaintiff a party to that very transaction. Those who proved to be constructive trustees, sharing the responsibility with the directors for the breach of trust, share the liability too.

> The result is that the plaintiff company in this case would not, by reason of illegality, be prevented from being reimbursed money paid by it unlawfully under a transaction to which it is a party. But this does not mean that this would nullify the ordinary operation of illegality with regard to companies and parties outside the company, and not being or treated as being a trustee to it. But it would prevent such operation shielding those whose position or conduct makes them responsible as owing a fiduciary duty or as constructive trustee …

➢ Questions

1. In the light of the reasoning in *Belmont* **[10.10]**, will a company ever have the *mens rea* necessary for it to be convicted under CA 2006 ss 678, 680?

2. Tortuous plc lends £5,000 to Smith for the purpose of a purchase by Smith of Tortuous shares. Can it recover £5,000 or any sum from Smith: (i) as repayment of the loan when due; (ii) as damages on the basis of *Belmont*; or (iii) on the ground that Smith is liable to it as a constructive trustee, following *Selangor*?

3. In *Armour Hick Northern Ltd v Armour Trust Ltd* [1980] 1 WLR 1520, A Ltd was a subsidiary of B Ltd. B owed £93,000 to X, the owner of 7,000 shares in B. Y and Z wished to buy these shares, but X was unwilling to sell them unless the debt was first repaid. A accordingly paid off the debt out of its own funds. Y and Z then used their own money to buy the shares. Would there in your opinion be an infringement of CA 1985 s 151 on these facts (the 1985 Act being, for relevant purposes, in the same form as CA 2006, but applying also to private companies)?

Dividend distributions

Permitted distributions

Pre-1980 position

Before 1980, there were no general rules in the Companies Acts regulating the distribution of dividends to the members of a company, although there were specific bans on using the share premium account and the capital redemption reserve for this purpose. The only legal constraint was a broad prohibition established by the cases that dividends should not be paid out of 'capital'. Most of these cases were decided in the late Victorian period, and reflected concepts of bookkeeping which were regarded as odd even then by some contemporary critics. In fact, for the greater part of the past century the standards of propriety in relation to distributions have been set by the accountancy profession and not by the law at all; and these standards have increased progressively over time. This continues to be so, even though we now have formal statutory rules about the payment of dividends in CA 2006 ss 829ff (repeating for the most part the CA 1985 provisions). These rules implement in part the Second EU Company Law Directive and also incorporate some recommendations made by the Jenkins Committee in 1962 and the Company Law Review more recently.

The current Act, CA 2006, makes separate rules for private companies, public companies and investment companies (defined in s 833).

(p. 542) The first and primary rule, applicable to all companies, is that a company may not make a '*distribution*' to any of its members except out of profits which are available for that purpose (s 830(1)). 'Distribution' is defined exceptionally widely in s 829, to mean 'every description of distribution of a company's assets to its members, whether in cash or otherwise, subject to [specified] exceptions', being issues of bonus shares, reductions of capital, share redemptions or repurchases, and distributions on winding up.

This rule may be thought to correspond in its effect to the common law principle laid down in *Re Exchange Banking Co, Flitcroft's Case* **[10.13]**, that dividends could not be paid from 'capital'; but when taken with other sections of the Act its consequences are altogether different from the position at common law. This may be illustrated by the following older common law cases:

(i) *Lee v Neuchatel Asphalte Co* (1889) 41 Ch D 1: a company could pay dividends out of its current trading profits without making provision for the depreciation of its fixed assets.
(ii) *Verner v General and Commercial Investment Trust* [1894] 2 Ch 239: a dividend could be paid from current trading profits without making good earlier losses in fixed capital.
(iii) *Ammonia Soda Co Ltd v Chamberlain* [1918] 1 Ch 266: a company could pay dividends out of current trading profits without making good past revenue losses.
(iv) *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] Ch 353: a surplus resulting from the increase in the overall book value of a company's assets could be treated as a distributable profit even though it had not been realised by sale.[29]

In short, at common law, the current year's profit and loss account only was looked at, and the profits for that particular year reckoned by taking it in isolation; money lost in earlier years of trading, and *a fortiori* capital losses, did not have to be brought into account. And it was not necessary for profits to be realised profits before they were regarded as distributable—although of course, as a practical matter, the company had to have available or be able to raise the cash necessary to pay the dividend when declared.

Current position

As noted previously, the primary rule is that a company may not make a distribution to any of its members except out of profits which are available for the purpose (CA 2006 s 830(1)). Under Pt 23 of CA 2006 (re-enacting changes made from 1980), however, 'profits' available for distribution by a company are to be 'its 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' (s 830(2)).

The two major changes introduced by this formulation are:

(i) it is now necessary to look not at the current year's trading figures in isolation, but at the net overall position of the company, taking into account its *accumulated*surpluses and losses over the years up to date; and
(ii) the figures used in the calculation of profits must be those for the company's *realised*[30] profits and losses: mere 'revaluation surpluses'—the 'paper profits' relied on in the *Dimbula Valley* case (see the previous point (iv))—cannot be brought into account in reckoning profits.

As a result, the current approach involves a change to what is sometimes called the 'balance sheet surplus' approach: the company's cumulative position, involving past years as well as the **(p. 543)** current year, has to be considered, and dividends can be paid only if justified by the picture as a whole.

Special rules apply to *public* companies and to *investment* companies:

(i) A *public company* must ensure that its net assets (aggregate assets less aggregate liabilities) after the distribution does not fall below the value of its share capital and undistributable reserves,[31] and its 'undistributable reserves' are defined so as to require public companies to allow for any excess of *unrealised* losses over unrealised profits on the capital account—that is, provision must be made for any unrealised revaluation deficit (s 831).
(ii) An *investment company* (defined in s 833) must draw a distinction between its revenue (trading) profits and its capital profits, and it may make a distribution only out of the accumulated, realised revenue profits (ie not including even realised capital profits, and taking into account realised revenue profits and both realised and unrealised revenue losses), and it may make such a distribution provided that its assets are not thereby reduced to less than one-and-a-half times its aggregate liabilities to creditors (s 832).

Requirement to pay dividends

There is no rule that all profits must be distributed (until, of course, the company is wound up), and there has been no English case in which a shareholder has succeeded in an action brought to compel a company to pay a dividend. Indeed, in *Burland v Earle* [1902] AC 83, the Privy Council made it clear that this was a matter where the court would not interfere. By contrast, in the well-known US case *Dodge v Ford Motor Co* 170 NW 668 (1919), Ford was ordered to pay a substantial dividend to its shareholders when the directors would have preferred to spend the company's trading surplus on increasing the wages and improving the work conditions of its employees, reducing prices to its customers and similar altruistic objects.

However, in *Re a Company* (1988) 4 BCLC 506, Harman J did not rule out the possibility that failure to pay a dividend might, in a particular case, be a ground for ordering the winding up of a company on the just and equitable ground ('Compulsory winding up on the "just and equitable" ground', pp 795ff) if it had pursued a restrictive dividend policy and denied the shareholders a return on their investment which they were reasonably entitled to expect. In *Re Sam Weller & Sons Ltd* [1990] Ch 682, Peter Gibson J held that such a policy might also justify relief on the ground of 'unfairly prejudicial conduct' (then CA 1985 s 459, now CA 2006 s 994). This section has since been amended so as to put it beyond doubt that the view of Peter Gibson J could be followed where this was justified on the facts (see 'Use of CA 2006 s 994 to protect non-member interests', pp 692ff).

Payment of a dividend

No dividend is payable on a company's shares, even on the preference shares, until the company has 'declared' (or decided to pay) a dividend. Authority to make the decision is usually determined in the articles and the entitlements, as between shareholders, are determined by the class rights attached to the shares. In *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1986] Ch 447, CA, it was held that the statutory procedure prescribed for the declaration of a dividend (involving, inter alia, an auditors' report on the accounts[32]) was **(p. 544)** mandatory and that a departure from it could not be rectified by a subsequent resolution of the shareholders.

Once the dividend is payable, it is a debt owed by the company to the member, and is subject to all the usual rules on debts (limitation periods, etc). Unless the articles provide otherwise, distributions must be in cash (*Wood v Odessa Waterworks Co* (1889) 42 Ch D 636).

Distributions in kind

If a distribution in kind is made, then the valuation rules in CA 2006 ss 845–846 apply.

CA 2006 s 845 is intended to remove the doubts that arose after *Aveling Barford* **[10.14]**, which concerned a property sale at a considerable undervalue by a company that had no distributable profits. The contract was held to be void as an unauthorised return of capital. That case left it unclear whether intra-group transfers of assets could be conducted by reference to the asset's book value rather than its market value (which will frequently be higher than the book value, and which would require expensive formal valuation). A transfer at book value may have an element of undervalue, and would therefore constitute a distribution requiring the company to have distributable profits sufficient to cover the difference in value. As a result, companies often abandoned their plans or structured them in more complex ways. CA 2006 s 845 does not disturb the position in the *Aveling Barford* case if the company does not have distributable profits: then the transaction will be an unlawful distribution; it does, however, clarify the position where a company has an appropriate level of available distributable profits, and it then permits asset transfers at book value.

➢ Notes

1. *Clydebank Football Club Ltd v Steedman* 2002 SLT 109: a transaction which is genuinely conceived of and effected as an exchange for value is not a distribution despite being for less than the amount of a professional valuation. Similarly, see the Supreme Court's decision in *Property Progress Co Ltd v Moore* **[10.15]**.

2. With small companies where the business affairs are conducted with little formality, the courts may have to distinguish between payments that can be justified as directors' remuneration and payments that amount to an unauthorised distribution of assets, either because there were no realised profits available or because the statutory procedure has not been followed. See, for example, *Re Halt Garage (1964) Ltd* **[5.03]**. Also see

'Disguised returns of capital', pp 548ff.

Consequences of an unauthorised distribution

There are no criminal consequences. The statutory civil consequences are set out in CA 2006 s 847, which provides that a member who 'knows or has reasonable grounds for believing' that the distribution contravenes the statutory requirements is obliged to repay the sum (or the value of the asset) received in contravention. This remedy is without prejudice to general remedies available at law. Nevertheless, its usefulness may be rather limited. Except in relation to small private companies, it is unlikely that members will have the necessary knowledge that any distributions are unauthorised. The common law equivalent is similar (see **[10.12]**), although earlier cases suggest the added advantage of a better remedy by way of constructive trust of the distribution (although that now seems doubtful[33]): *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1986] Ch 447; *Allied Carpets plc v Nethercott* [2001] BCLC 81.

(p. 545) *Statutory and general law remedies against the members.*

[10.12] It's a Wrap (UK) Ltd (In Liquidation) v Gula [2006] EWCA Civ 544, [2006] BCLC 634 (Court of Appeal)

This case concerned the statutory liability under CA 1985 s 277(1) [CA 2006 s 847] of an insolvent company's directors and shareholders to repay certain dividends that had been paid out in contravention of CA 1985 Pt VIII [CA 2006 ss 630ff].

> ARDEN LJ:
>
> 1 This appeal raises a short point of law. [CA 1985 s 277(1)] provides a statutory remedy against a shareholder for recovery of an unlawful distribution paid to him if he knew or had reasonable grounds to believe that it was made in contravention of the Act. I will call the first kind of knowledge actual knowledge, and the second kind of knowledge constructive knowledge [but see CHADWICK LJ later]. The question that we have to decide is this: if a company brings a claim against a shareholder under this section, is the actual or constructive knowledge that the section requires actual or constructive knowledge of:
>
> **(i)** the relevant facts constituting the contravention, or
> **(ii)** those facts and in addition the fact that the Act was contravened?
>
> 2 The deputy judge held … that the second of these alternatives was correct. In my judgment, the deputy judge was wrong on this question of law. I reach my conclusions by the following steps:
>
> **(A)** s 277(1) has to be interpreted in conformity with Art.16 of the second EC directive on company law … which it is designed to implement;
> **(B)** Art.16 has to be read in the context of the rules on distributions in Art.15 of the second directive and the general principles of Community law;
> **(C)** the provisions of ss 263–276 of the Act [CA 2006 ss 830ff] are designed to implement Art.15 of the second directive;
> **(D)** on its true interpretation, Art.16 means that a shareholder is liable to return a distribution if he knows or could not have been unaware that it was paid in circumstances which amount to a contravention of the restrictions on distributions in the second directive, whether or not he knew of those restrictions;
> **(E)** accordingly s 277 must be interpreted as meaning that the shareholder cannot claim that he is not liable to return a distribution because he did not know of the restrictions in the Act on the making of distributions. He will be liable if he knew or ought reasonably to have known of the facts which mean that the distribution contravened the requirements of the Act.
>
> … As to remedies against shareholders who receive dividends not lawfully made, the general law of the United Kingdom was, arguably at least, not to exactly the same effect as Art.16. … Liability under the