'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

general law attaches where the shareholder knew or ought to have known that the distribution was unlawful. …

The following are some of the differences between the two types of liability, that is, liability under s 277(1) and liability under the general law. First, s 277(1) only applies where the distribution contravenes the Act, and thus it does not apply where the distribution for instance violates a provision of the general law or the company's constitution. Secondly, there is no defence in s 277(1) for the member who acts on advice. The member is instead left to sue the person who gave him inaccurate advice (if he can). By contrast, under the general law a shareholder may be able to claim that he did not have the requisite knowledge where he acted on advice. As a constructive trustee he would be able to claim that he was entitled in appropriate circumstances to relief under s 61 of the Trustee Act 1925 (see the definition of 'trustee' in s 68(7) of that Act). (I would add, however, that there is **(p. 546)** no inquiry under the general law into the question whether the shareholder was aware of the law's requirements regarding the payment of dividends.) In sum, the remedy under Art.16 is more absolute and stringent than that available under the general law. That is no doubt because it has been tailor made to facilitate the recovery of unlawful distributions whereas the remedy under the general law is an adaptation of the law of constructive trusteeship. However, the need for some form of actual or constructive knowledge on the part of the shareholder is common to both forms of remedy.

… The underlying rationale for this rule [on distributions] is that capital constitutes the security for creditors. A distribution that is not paid out of profits available for distribution is paid out of the reserves that must remain available for the payment of debts. The claims of shareholders rank behind those of creditors. It is a factor to be borne in mind that any defence given to shareholders who receive a distribution paid in contravention of this Act detracts from the protection available to creditors. One of the objects of the second directive was to give protection to creditors by harmonising restrictions on the profits which may be used for the payment of distributions. …

SEDLEY LJ delivered a concurring judgment.

CHADWICK LJ delivered a concurring judgment, but differed from ARDEN LJ on one point (which was not material on the facts): … I take the view that it is unnecessary, on the facts of this case, to decide what meaning should be given to the words 'has reasonable grounds for believing that'. Those words, plainly, do enable the second (or knowledge) condition in s 277(1) to be established without proof of actual knowledge. But, to my mind, it is by no means self-evident that they are to be equated with 'constructive knowledge' if by that expression is meant knowledge which a person would have but for his negligence. I do not think that the composite phrase 'knows or has reasonable grounds for believing' has the same meaning as 'knows or ought to know'.

General law remedies against the directors: directors who pay dividends improperly are liable to compensate the company personally for the money so paid away (regardless of whether it was paid to the director).

[10.13] Re Exchange Banking Co, Flitcroft's Case (1882) 21 Ch D 519 (Court of Appeal)

At common law, dividends could not be paid from capital. The directors had for several years made it appear that the company had made profits, when in fact it had not, by laying before the shareholders reports and balance sheets in which debts known to be bad were entered as assets. On the faith of these reports, the shareholders had passed resolutions declaring dividends, which the directors had paid. In the winding up of the company the liquidator successfully applied to have the directors who had been responsible on each occasion made accountable to the company for the sums wrongly paid away.

JESSEL MR: A limited company by its memorandum of association declares that its capital is to be applied for the purposes of the business. It cannot reduce its capital except in the manner and with the safeguards provided by statute, and looking at the Act … it clearly is against the intention of the legislature that any portion of the capital should be returned to the shareholders without the statutory conditions being

complied with. A limited company cannot in any other way make a return of capital, the sanction of a general meeting can give no validity to such a proceeding, and even the sanction of every shareholder cannot bring within the powers of the company an act which is not within its powers. If, therefore, the shareholders had all been present at the meetings, and had all known the facts, and had all concurred in declaring the dividends, the payment of the dividends would not be actually sanctioned. One reason is this—there is a statement that the capital shall be applied for the purposes of the business, and on the faith of that statement, which is sometimes said to be an implied contract with creditors, people dealing with the company give it credit. **(p. 547)** The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, I may say, gives credit to that capital, gives credit to the company on faith of the representation that the capital shall be applied only for the purposes of the business, and he has therefore a right to say that the corporation shall keep its capital and not return it to the shareholders, though it may be a right which he cannot enforce otherwise than by a winding-up order. It follows then that if directors who are quasi trustees for the company improperly pay away the assets to the shareholders, they are liable to replace them. It is no answer to say that the shareholders could not compel them to do so. I am of opinion that the company could in its corporate capacity compel them to do so, even if there were no winding up …

COTTON LJ: It was contended that though the directors might be ordered to repay what they had themselves retained, they ought not to be ordered to refund what they had paid to the other shareholders. But directors are in the position of trustees, and are liable not only for what they put into their own pockets, but for what they in breach of trust pay to others …

BRETT LJ delivered a concurring judgment.

This liability is in addition to the liability imposed on directors who pay dividends improperly *to themselves*: they will hold these receipts on constructive trust for the company, according to normal fiduciary principles (see *JJ Harrison (Properties) Ltd v Harrison* **[7.36]**).

➢ Notes

1. This obligation to repay illegal dividends is imposed on the directors who authorised the excessive payment regardless of whether the company is solvent or insolvent when it claims repayment. See *Bairstow v Queens Moat Houses plc* [2001] EWCA Civ 712, [2002] BCLC 91. The Supreme Court, in *Revenue and Customs Commissioners v Holland* **[7.02]**, concluded that this obligation is a form of 'strict liability', subject to the court's discretion to grant relief under CA 1985 s 727 [CA 2006 s 1157].

2. In *Allied Carpets Group plc v Nethercott* [2001] BCLC 81 it was held that the object of the remedy is restitution of what was wrongfully paid out by the company, not compensation for the loss the company has suffered. Therefore where the dividend was unlawful because the accounts were erroneous, it is irrelevant that the dividends might have been lawful if the accounts had been drawn up correctly. In *Revenue and Customs Commissioners v Holland* **[7.02]**, Lord Hope held that, while the obligation is restitutionary in nature, it is nonetheless within the trial judge's discretion under IA 1986 s 212 'to limit the award to what was required to make up the deficiency of a particular creditor where the claim was made by a party other than the liquidator'. Thus, 'it was open to the deputy judge to limit the amount that Mr Holland [the defendant] should pay to what HMRC [the only creditor] had lost from his unlawful conduct'.

3. In *Re Marini Ltd* [2003] EWHC 334 (Ch), [2004] BCLC 172, the court did not accept that, because the dividend had been paid on the advice of the company's accountant, the directors should qualify for relief under CA 1985 s 727 [CA 2006 s 1157]. Although they agreed that the directors had acted reasonably and honestly on their accountant's advice, the honesty of their actions did not allow them to enjoy a benefit at the expense of the company's creditors.

➢ Questions

1. According to *Re Exchange Banking Co, Flitcroft's Case* **[10.13]**, the fact that the illegal distribution was approved by the shareholders does not cure the defect, nor does it ratify the directors' acts so as to absolve them from liability. *Could* a shareholder resolution fail to achieve the former goal but succeed on the latter?

 2. What knowledge does a *shareholder* need to have, and of what, to be fixed with liability to repay unauthorised distributions?

3. What knowledge does a *director* need to have, and of what, to be fixed with liability to repay unauthorised distributions?

4. Can a director be excused from liability? See *Dovey v Corey* [1901] AC 477 and CA 2006 s 1157. Can a shareholder be excused from liability?

5. Can an auditor be made liable for unauthorised distributions?

Capitalisations and bonus shares

A profitable company that does not distribute all its profits as dividends will accumulate reserves (retained earnings). The shares will in consequence have a market value which is greater than their nominal value. There will be a similar situation when a company's fixed assets appreciate in value as a result of inflation or of a movement in their market value. Suppose, for example, that a company with a nominal capital of 10,000 £1 shares, all issued and fully paid, has accumulated profits of £90,000. Instead of paying out this surplus to its shareholders as dividends it may resolve to 'capitalise' these reserves by issuing a further 90,000 shares, so that nine new shares are allotted to the holder of each existing share, and treating the new shares as fully paid because the £90,000 is appropriated to meet the issue price. No cash changes hands at all. The formal result will be that the reserve has become capital and ceases to be available for distribution as dividend, the company's issued share capital has risen from £10,000 to £100,000, each shareholder now has ten times as many shares as before, and the market value of each share will have fallen back from something like £10 to £1.[34] (Of course, other factors influence the market price of shares, apart from their 'asset backing', but this in simplified terms will be what happens.)

A capitalisation issue is not a 'distribution' of profits or assets for the purposes of the statutory restrictions in CA 2006 ss 829ff (see s 829(2)(a)). It follows that profits which are not distributable (eg because they are unrealised profits) may be capitalised and issued to members as bonus shares provided the articles are so worded as to permit this.[35] Note, however, that in *EIC Services Ltd v Phipps* [2004] EWCA Civ 1069, [2005] 1 WLR 1377, an issue of bonus shares was declared void for mistake because the underlying ordinary shares were totally unpaid and no resolution allowing the issue was ever passed.

➢ Questions

1. What might be the advantages to (i) the company, (ii) its shareholders, of making an issue of bonus shares?

2. Are the shareholders better off in any real sense as a result? Is the expression 'bonus shares' misleading?

Disguised returns of capital

The rules noted previously provide various mechanisms for controlling what are seen as unacceptable disposals of the company's property. However, they do not seem to touch the ability of small companies to pay away their assets to their members in the form of directors' fees or employees' salaries, or, in corporate groups, for

subsidiaries to pay large fees to holding companies for 'group services' or other notional (or real) benefits. There is no rule that directors' fees (see **[5.03]**), still less employees' wages or business expenses, must be paid out of profits.

(p. 549) But it is also true, as we saw earlier, that directors cannot make gifts out of the company's assets unless (i) in furtherance of the company's objects, or (ii) out of distributable profits (and even then subject to certain limitations): see 'Corporate gifts', pp 134ff. This rule provides a further avenue for restraining unacceptable distributions of the company's assets, although it catches only the most blatant of abuses.

The possibility of recovery of the company's assets from *third party recipients* is limited. The abolition of the doctrine of *ultra vires* by the Companies Act 1989 deprived the courts of the most potent of their traditional weapons when dealing with allegations that corporate property has been misapplied. Of course, vastly expanded objects clauses and changes in judicial analyses of their impact meant that the occasions on which the doctrine could be successfully invoked were always destined to become rather fewer—particularly after the Court of Appeal's ruling in the *Rolled Steel* case **[3.04]** and **[3.17]**; but the doctrine did serve to deal with the most blatant cases of misappropriation such as *International Sales and Agencies Ltd v Marcus* [1982] 3 All ER 551, QB.

With the demise of the *ultra vires* doctrine, the courts needed to have recourse to other rules and remedies in such cases. As *Rolled Steel* itself shows, it may be possible to show that *directors* have behaved unconstitutionally, exceeded their authority, abused their powers or acted in breach of their fiduciary duties, with the consequence that they may be liable to make compensation to the company, and in addition (or alternatively) the relevant transaction may be declared void or voidable and both they and any third person who has received corporate assets with knowledge of the circumstances will be liable to reimburse the company (*Selangor United Rubber Estates Ltd v Cradock (No 3)* **[10.11]**). If the third party has dealt in good faith, for value and without notice of the irregularity, the company's remedy against that person will, of course, be lost; but very often the person will be an 'insider' or party to the wrong-doing and not able to plead this defence. There is also the possibility that a formal or informal ratification of the irregular act will be alleged to have occurred. But some breaches of directors' duty are not capable of ratification (*Cook v Deeks* **[7.22]**, *Kinsela v Russell Kinsela Pty Ltd* **[7.08]**); and where the act involves breach of statutory prohibitions (eg a prohibited distribution (s 830) or a breach of the 'financial assistance' prohibition (s 678)), it will not be capable of ratification at all. So the courts are still relatively well equipped to deal with cases of wrongful depletion of corporate assets.

The following cases illustrate a possible approach to these issues, perhaps linked as a matter of underlying principle with the 'maintenance of capital' doctrine. So, in *Re Halt Garage (1964) Ltd* **[5.03]**, Oliver J struck down a payment of remuneration to an inactive director as 'not genuine' and a 'dressed-up return of capital' to her. While the basis of this reasoning is open to question (not least because as a shareholder she held only one £1 share), it has since been adopted and applied by Hoffmann J in *Aveling Barford Ltd v Perion Ltd* **[10.14]**, where again the 'dressed-up return of capital' argument was somewhat shaky because the beneficiary of the asset-stripping, although totally lacking in merit, was not strictly a shareholder. The Supreme Court has perhaps provided much needed clarification in this area in *Progress Property Co Ltd v Moore***[10.15]**, where the court adopted an 'arm's length approach' in determining whether an undervalue transaction between the company and its member was genuine or not.

Matters are simpler when the company is insolvent or approaching insolvency. There are now a number of statutory provisions which may be invoked when corporate assets have been plundered or imperilled in the run-up to liquidation. These include preferences (IA 1986 s 239), transactions at an undervalue (IA 1986 ss 238 and 423), floating charges subject to avoidance (IA 1986 s 245), fraudulent and wrongful trading (IA 1986 ss 231 and 214) and misfeasance proceedings (IA 1986 s 212).[36] In the light of these statutory developments in the UK, it is unlikely that a new common law remedy will develop based on a duty owed by directors to creditors (see 'Directors' "duties" to creditors', pp 325ff).

(p. 550) ***A sale at an undervalue made by a company to one of its shareholders (or to another company controlled by the shareholder) may be open to challenge on the ground that it is not a genuine sale but a disguised return of capital.***

[10.14] Aveling Barford Ltd v Perion Ltd [1989] BCLC 626 (Chancery Division)

Aveling Barford and Perion were both owned and controlled by Lee. Aveling Barford, which was not at the material time insolvent but was not in a position to make any distribution to its shareholders, owned a sports ground which had planning permission for residential development. In October 1986 its directors resolved to sell this property to Perion for £350,000 when they knew that it had recently been valued at £650,000, but no binding contract was entered into at that stage. A later valuation put it at £1.15 million and Perion was subsequently offered £1.4 million. There was some evidence of an agreement reached in January 1987 that a further payment of £400,000 was to be paid to Aveling Barford by Perion if it resold the property within a year for more than £800,000. The property was conveyed to Perion for £350,000 in February 1987 and resold by it for £1.52 million the following August. Aveling Barford was subsequently put into liquidation and successfully sued in this action to have Perion declared a constructive trustee of the proceeds of the sale.

HOFFMANN J: Counsel for the defendants said that even if the 10 January contract was a rewriting of history in the summer of 1987, when it was plain that Perion would be reselling for more than £800,000, it was reasonable for the parties retrospectively to affirm the sale at £750,000, which would have been a proper sum to fix as the value in February 1987. I do not agree. If the February sale was, as I think, a breach of duty and liable to be set aside at the time, Dr Lee or Mr Chapman [solicitor to all the parties] on his behalf had no right to confirm it retrospectively as a sale at £750,000 at a time when they knew the value to be over £1,400,000. It was the duty of the directors to set aside the February sale and obtain the full value of the land for Aveling Barford. On any view, therefore, the sale was a breach of fiduciary duty by Dr Lee. Perion, through Dr Lee and Mr Chapman, knew all the facts which made it a breach of duty and was therefore accountable as a constructive trustee.

In the alternative, counsel for the defendant submitted that whether or not the sale to Perion was a breach of fiduciary duty by Dr Lee, it cannot be challenged by the company because it was unanimously approved by the shareholders. This approval was both informal and formal. Informal approval was given at the time of sale by virtue of the fact that Dr Lee owned or controlled the entire issued share capital. Formally, a sale at £750,000 was approved when the 1987 accounts were adopted at the company's annual general meeting. For the purposes of this motion I shall assume that shareholder consent was given in both these ways.

The general rule is that any act which falls within the express or implied powers of a company conferred by its memorandum of association, whether or not a breach of duty on the part of the directors, will be binding on the company if it is approved or subsequently ratified by the shareholders: see *Rolled Steel Products (Holdings) Ltd v British Steel Corpn* **[3.04]** and **[3.17]**. But this rule is subject to exceptions created by the general law and one such exception is that a company cannot without the leave of the court or the adoption of a special procedure return its capital to its shareholders. It follows that a transaction which amounts to an unauthorised return of capital is ultra vires and cannot be validated by shareholder ratification or approval. Whether or not the transaction is a distribution to shareholders does not depend exclusively on what the parties choose to call it. The court looks at the substance rather than the outward appearance. [His Lordship referred to *Re Halt Garage (1964) Ltd* **[5.03]** and an earlier case, *Ridge Securities Ltd v IRC* [1964] 1 All ER 275, [1964] 1 WLR 479, and continued:]

So it seems to me in this case that looking at the matter objectively, the sale to Perion was not a genuine exercise of the company's power under its memorandum to sell its assets. It was a sale at a gross undervalue for the purpose of enabling a profit to be realised by an entity controlled and put forward by its sole beneficial shareholder. This was as much a dressed-up distribution as the payment of excessive interest in *Ridge Securities* or excessive remuneration in *Halt Garage*. **(p. 551)** The company had at the time no distributable reserves and the sale was therefore ultra vires and incapable of validation by the approval or ratification of the shareholder. The fact that the distribution was to Perion rather than to Dr Lee or his other entities which actually held the shares in Aveling Barford is in my judgment irrelevant …

Counsel for the defendants says that this was an act within the terms of the memorandum. It may have been a sale at an undervalue, but it was certainly a sale: a conveyance in exchange for a payment in money. It was not a sham. The terms of the transaction were in no way different from those appearing on the face of the documents. The purpose for which it was done was therefore irrelevant. Counsel submits that the test for the genuineness of the transaction proposed by Oliver J in*Re Halt Garage* admits by the back

door all the questions about the motives, state of mind and knowledge of the company's directors which the Court of Appeal appeared to have expelled by the front door in the *Rolled Steel* case.

It is clear however that Slade LJ [in *Rolled Steel*] excepted from his general principle cases which he described as involving a 'fraud on creditors'. As an example of such a case, he cited *Re Halt Garage*. Counsel for the defendants said that frauds on creditors meant transactions entered into when the company was insolvent. In this case Aveling Barford was not at the relevant time insolvent. But I do not think that the phrase was intended to have such a narrow meaning. The rule that capital may not be returned to shareholders is a rule for the protection of creditors and the evasion of the rule falls within what I think Slade LJ had in mind when he spoke of a fraud on creditors. There is certainly nothing in his judgment to suggest that he disapproved of the actual decisions in *Re Halt Garage* or *Ridge Securities*. As for the transaction not being a sham, I accept that it was in law a sale. The false dressing it wore was that of a sale at arms' length or at market value. It was the fact that it was known and intended to be a sale at an undervalue which made it an unlawful distribution.

It follows that in my judgment even on the view of the facts most favourable to Perion, it has no arguable defence …

➢ Question

In *Re Halt Garage (1964) Ltd* **[5.03]**, referred to earlier, the issued capital of the company was two £1 shares, of which Mrs Charlesworth held one. Was the judge right to describe the overpayment of £20 per week as a disguised 'return of capital' to her?

➢ Notes

1. Although in *Aveling Barford* Hoffmann J several times described the transaction as *ultra vires* (and accordingly unratifiable), his remarks will continue to be valid and relevant despite the abolition of the *ultra vires* doctrine because of his ruling that the transaction was illegal as an unauthorised return of capital.

2. In declining to make a distinction between Lee and his company Perion, Hoffmann J was 'lifting the veil', in circumstances somewhat similar to cases like *Jones v Lipman* (Notes following *Gilford Motor Co Ltd v Horne* **[2.17]**, p 66).

3. This case was cited with approval by Harman J in *Barclays Bank plc v British and Commonwealth Holdings plc* [1996] 1 BCLC 1. Here B & C plc had issued redeemable preference shares to C and had undertaken to redeem them on a certain date. If B & C plc failed to do so (which would be unavoidable if it had no distributable profits or was insolvent), T Ltd promised to buy the shares from C, and B & C plc promised to indemnify T against the cost of doing so. The arrangement was held to be unlawful. Harman J said (at 17): 'as it seems to me it must … be unlawful to make an agreement expressed to impose a liability to make a gratuitous payment, that is, one not for the advancement of a company's business nor made out of distributable profits, at a future date when in the event the company has no distributable profits'.

(p. 552) 4. However defensible the *Aveling Barford* decision may be on the merits, it caused concern in commercial circles because it created uncertainty as to when payments by a company to its members in other such circumstances might also infringe ss 829 and 830 of the Act. CA 2006 might usefully have clarified the position and made it clear that the rules apply only to distributions to members in their capacity as members, but this was not done and the uncertainty therefore remains. Alternative protection is provided by other provisions of company law and insolvency law that apply on similar facts.

In determining whether an undervalue transaction constitutes a disguised return of capital, the court will look to the substance, not the form, of the transaction, characterising it as a matter of law, and regardless of its form or the label attached to it by the parties.

[10.15] Progress Property Co Ltd v Moore [2010] UKSC 55 (Supreme Court)

The whole of the issued share capital of company (Y), a subsidiary of the appellant company (P), was sold to the respondent company (M). All three companies were indirectly controlled by the same holding company. The sale price was calculated on the basis of Y's open market value, subtracting liabilities for creditors and a further sum in respect of an indemnity believed to have been given by P for a repairing liability. It transpired that P had no such indemnity liability to be released from and that there was therefore no justification for the reduction in Y's value. P alleged that the transaction had been at a gross undervalue, and was therefore automatically a disguised return of capital. The Supreme Court disagreed, upholding the Court of Appeal and the High Court.

LORD WALKER:

A question of characterisation

24 The essential issue then, is how the sale by PPC [claimant] of its shareholding in YMS [Y Ltd] is to be characterised. That is how it was put by Sir Owen Dixon CJ in *Davis Investments Pty Ltd v Comr of Stamp Duties (New South Wales)* (1958) 100 CLR 392, 406 (a case about a company reorganisation effected at book value in which the High Court of Australia were divided on what was ultimately an issue of construction on a stamp duty statute). The same expression was used by Buxton LJ in *MacPherson v European Strategic Bureau Ltd* [2000] 2 BCLC 683, para 59. The deputy judge did not ask himself (or answer) that precise question. But he did [2008] EWHC 2577 (Ch) at [39]–[41] roundly reject the submission made on behalf of PPC that there is an unlawful return of capital 'whenever the company has entered into a transaction with a shareholder which results in a transfer of value not covered by distributable profits, and regardless of the purpose of the transaction'. A relentlessly objective rule of that sort would be oppressive and unworkable. It would tend to cast doubt on any transaction between a company and a shareholder, even if negotiated at arm's length and in perfect good faith, whenever the company proved, with hindsight, to have got significantly the worse of the transaction.

25 In the Court of Appeal Mummery LJ developed the deputy judge's line of thought into a more rounded conclusion, at para 30:

> 'In this case the deputy judge noted that it had been accepted by PPC that the sale was entered into in the belief on the part of the director Mr Moore that the agreed price was at market value. In those circumstances there was no knowledge or intention that the shares should be disposed of at an undervalue. There was no reason to doubt the genuineness of the transaction as a commercial sale of the YMS1 shares. This was so, even though it appeared that the sale price was calculated on the basis of the value of the properties that was misunderstood by all concerned.'

(p. 553) 26 In seeking to undermine that conclusion Mr Collings QC (for PPC) argued strenuously that an objective approach is called for. The same general line is taken in a recent article by Dr Eva Micheler commenting on the Court of Appeal's decision, 'Disguised Returns of Capital—An Arm's Length Approach' [2010] CLJ 151. This interesting article refers to a number of cases not cited to this court or to the courts below, and argues for what the author calls an arm's length approach.

27 If there were a stark choice between a subjective and an objective approach, the least unsatisfactory choice would be to opt for the latter. But in cases of this sort the court's real task is to inquire into the true purpose and substance of the impugned transaction. That calls for an investigation of all the relevant facts, which sometimes include the state of mind of the human beings who are orchestrating the corporate activity.

28 Sometimes their states of mind are totally irrelevant. A distribution described as a dividend but actually paid out of capital is unlawful, however technical the error and however well-meaning the directors who paid it. The same is true of a payment which is on analysis the equivalent of a dividend, such as the unusual cases (mentioned by Dr Micheler) of *In re Walters' Deed of Guarantee* [1933] Ch 321 (claim by guarantor of preference dividends) and *British and Commonwealth Holdings plc v Barclays Bank plc* [1996] 1 WLR 1 (claim for damages for contractual breach of scheme for redemption of shares). Where there is a challenge to the propriety of a director's remuneration the test is objective (*In re Halt Garage* **[5.03]**), but probably subject in practice to what has been called, in a recent Scottish case, a 'margin of appreciation': *Clydebank Football Club Ltd v Steedman* 2002 SLT 109, para 76 (discussed further below). If a controlling shareholder simply treats a company as his own property, as the domineering master-builder did in *In re George Newman & Co Ltd* [1895] 1 Ch 674, his state of mind (and that of his fellow directors) is irrelevant. It does not matter whether they were consciously in breach of duty, or just woefully ignorant of their duties. What they do is enough by itself to establish the unlawful character of the transaction.

29 The participants' subjective intentions are however sometimes relevant, and a distribution disguised as an arm's length commercial transaction is the paradigm example. If a company sells to a shareholder at a low value assets which are difficult to value precisely, but which are potentially very valuable, the transaction may call for close scrutiny, and the company's financial position, and the actual motives and intentions of the directors, will be highly relevant. There may be questions to be asked as to whether the company was under financial pressure compelling it to sell at an inopportune time, as to what advice was taken, how the market was tested, and how the terms of the deal were negotiated. If the conclusion is that it was a genuine arm's length transaction then it will stand, even if it may, with hindsight, appear to have been a bad bargain. If it was an improper attempt to extract value by the pretence of an arm's length sale, it will be held unlawful. But either conclusion will depend on a realistic assessment of all the relevant facts, not simply a retrospective valuation exercise in isolation from all other inquiries.

30 Pretence is often a badge of a bad conscience. Any attempt to dress up a transaction as something different from what it is is likely to provoke suspicion. In the*Aveling Barford* case **[10.14]** there were suspicious factors, such as Dr Lee's surprising evidence that he was ignorant of the Humberts' valuation, and the dubious authenticity of the 'overage' document. But in the end the disparity between the valuations and the sale price of the land was sufficient, by itself, to satisfy Hoffmann J that the transaction could not stand.

31 The right approach is in my opinion well illustrated by the careful judgment of Lord Hamilton in *Clydebank Football Club Ltd v Steedman* 2002 SLT 109. It is an example of the problems which can arise with football clubs owned by limited companies, where some small shareholders see the club as essentially a community enterprise, and other more commercially-minded shareholders are concerned with what they see as underused premises ripe for profitable redevelopment. The facts are complicated, and the main issue was on section 320 of the Companies Act 1985 (approval by company in general meeting of acquisition of non-cash asset by director or connected person). But the judge also dealt with a claim under section 263 (unlawful distribution). He held that the sale of the club's derelict ground at Kilbowie Park, and another site originally purchased under an abortive plan for a new ground, was a genuine arm's-length sale even though effected at a price **(p. 554)** £165,000 less than the value as eventually determined by the court after hearing expert evidence. Lord Hamilton said, at para 76:

> 'It is also clear, in my view, that a mere arithmetical difference between the consideration given for the asset or assets and the figure or figures at which it or they are in subsequent proceedings valued retrospectively will not of itself mean that there has been a distribution. If the transaction is genuinely conceived of and effected as an exchange for value and the difference ultimately found does not reflect a payment "manifestly beyond any possible justifiable reward for that in respect of which allegedly it is paid", does not give rise to an exchange "at a gross undervalue" and is not otherwise unreasonably large, there will not to any extent be a "dressed up return of capital". In assessing the adequacy of the consideration, a margin of appreciation may properly be allowed.'

The words quoted by Lord Hamilton are from *In re Halt Garage* **[5.03]** and the *Aveling Barford* case **[10.14]**.

32 Lord Hamilton said, at para 79:

> 'It is plain, in my view, that directors are liable only if it is established that in effecting the unlawful distribution they were in breach of their fiduciary duties (or possibly of contractual obligations, though that does not arise in the present case). Whether or not they were so in breach will involve consideration not only of whether or not the directors knew at the time that what they were doing was unlawful but also of their state of knowledge at that time of the material facts. In reviewing the then authorities Vaughan Williams J in *In re Kingston Cotton Mill Co (No 2)* **[8.02]**, 347: "In no one of [the cases cited] can I find that directors were held liable unless the payments were made with actual knowledge that the funds of the company were being mis-appropriated or with knowledge of the facts that established the misappropriation." Although this case went to the Court of Appeal, this aspect of the decision was not quarrelled with (see [1896] 2 Ch 279).'

I agree with both those passages.

33 In this case there are concurrent findings that the sale of YMS1 to Moorgarth was a genuine commercial sale. The contrary was not pleaded or put to Mr Moore in cross-examination. I would dismiss this appeal.

LORD MANCE:

Like Lord Walker, I would not go so far as Mr McGhee QC for Moorgarth in his submission that the ultimate test is always one of the directors' (subjective) motives in effecting the transaction. The courts will not second-guess companies with regard to the appropriateness or wisdom of the terms of any transaction: see eg *In re Halt Garage* **[5.03]**. But there may come a point at which, looking at all the relevant factors, an agreement cannot be regarded as involving in substance anything other than a return or distribution of capital, whatever the label attached to it by its parties. I do not regard *Aveling Barford Ltd v Perion Ltd* **[10.14]** as inconsistent with this. The facts in that case made it possible to speak of knowledge and intention to sell at an undervalue, but that does not mean that such knowledge or intention are always necessary factors. In the present case, it is however unnecessary in my view to go further into such areas.

Also see *Ilife News & Media Ltd v Revenue and Customs Commissioners* [2012] UKFTT 696 (First Tier Tribunal (Tax Chamber)). In this case, it was held that licence fees paid in excess of market value were not, in light of all circumstances, unlawful distributions.

➢ Questions

1. What are the principal objectives of the capital maintenance rules—creditor protection against removal of a preferential capital 'buffer', or company/shareholder protection against asset-stripping?

(p. 555) 2. Do the current rules provide effective protection, either for creditors or for shareholders?

3. What are the advantages and disadvantages in adopting 'solvency declarations' as a simple hurdle to these types of transactions?

4. The Second EU Company Law Directive (77/91/EEC) was nominated for review as part of the EU Company Law Action Plan announced in May 2003, but until then many of the identified problems will necessarily remain on the statute books. What are the principal problems for which solutions might be found?

5. When might it be appropriate to take into account subjective elements such as the mental state of mind of directors of a company involved in an undervalue transaction? When and how should this line be drawn so as

to prevent inappropriate judicial activism in 'second-guessing companies with regard to the appropriateness or wisdom of the terms of any transaction' (per Lord Mance, *Progress Property Co Ltd v Moore*, **[10.15]**)?

Further Reading

ARMOUR, J, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?' (2000) 63 MLR 355.
Find This Resource

CLEMENTELLI, F, '(Under)valuing the Rules on Capital Maintenance' [2012] *International Company and Commercial Law Review* 191.
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DAVENPORT, B, 'What Did *Russell v Northern Bank Development Corporation Ltd* Decide?' (1993) 109 LQR 533.
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HO, LC, 'Financial Assistance after *Chaston* and *MT Realisations*: Deepsix and Double Think' [2003] *Journal of International Banking Law and Regulation* 424.
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MICHELER, E, 'Disguised Returns of Capital—An Arm's Length Approach' [2010] CLJ 151.
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NIRANJAN, V and NARAVANE, S, 'A Reassessment of Fundamental Dividend Principles' [2009] *International Company and Commercial Law Review* 88.
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PAYNE, J, 'Unjust Enrichment, Trusts and Recipient Liability for Unlawful Dividends' (2003) 119 LQR 583.
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PROCTOR, C, 'Financial Assistance: New Proposals and New Perspectives?' (2007) 28 *Company Lawyer* 3.
Find This Resource

THAM, CH, 'Unjust Enrichment and Unlawful Dividends: A Step Too Far' [2005] CLJ 177.
Find This Resource

Notes:

[1] A limited statutory exception allowing companies to issue redeemable *preference* shares had existed since 1929. Now redeemable shares can be of any class.

[2] Also revisit some of the further reading from Chapter 9: see especially J Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?' (2000) 63 MLR 355; J Rickford et al, 'Reforming Capital?' (2004) 15 *European Business Law Review* 919; J Armour, 'Legal Capital: An Outdated Concept?' (2006) 7*European Business Organization Law Review* 5; E Ferran, 'Creditors' Interests and "Core" Company Law?' (1999)