Repaying an unlawfully paid dividend

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This is the Accepted Manuscript, the final version of this paper was published in Business Law Review

Grier, N. (2023) 'Repaying an unlawfully paid dividend'. *Business Law Review*, 44(4): pp.146-149. URL: https://kluwerlawonline.com/journalarticle/Business+Law+Review/44.4/BULA2023017

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Summary
It is well settled that directors are jointly and severally liable for an unlawfully paid dividend, being one that it is not paid out of distributable profits. Strict rules apply to the meaning of distributable profits and the authorisation of the payment of a dividend. What is not so clear is when a member may retain an unlawfully paid dividend. S.847 of the Companies Act 2006 indicates that a member must repay it if he knows that it is unlawfully paid, though it is not clear what constitutes "knowing" in this content, or what the position should be if a member does not immediately know if the payment is unlawful but subsequently discovers that it is. Case law is not especially helpful in dealing with this point. It is suggested that a solution to this gap in the law may be found in the precise wording of s.847, and that a member's liability to repay should be limited to a period of six months after payment (similar to an unfair preference).

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The sums that a company may pay out by way of dividends are according to s.830(2) of the Companies Act 2006 ("CA 2006") to be paid out of the company's distributable profits. Distributable profits are defined as "*its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not written off in a reduction or reorganisation of capital duly made.*"

If a company does not have a surplus of accumulated realised profits over its accumulated realised loss, it may not pay any dividend. There are further more stringent rules for plcs to prevent the payment of any dividend which causes the company's net assets to dip below the aggregate figure of its share capital and any other undistributable reserves.[1]

CA2006 has various complex rules relating to the ways of dealing with revaluation of assets leading to certain unrealised profits,[2] research and development expenditure[3] and how to treat payments of dividends in non-cash assets.[4] These rules all reflect the essential point that any payment to a member that is not made out of distributable profits must perforce be paid out of capital unless one of the permitted exceptions applies.

The whole point of the capital is that it is there to act as the creditors' buffer, a fund of last resort to reassure the creditors that there will be money to pay their bills. Members cannot dip their hands into the capital to extract their investment at will. They may only do so in accordance with specified rules, such as the rules for repurchase or redemption of shares. The capital also ought to remain in place unless it has been reduced in accordance with the provisions of reduction of capital in terms of s.641 of CA 2006, by a restructuring of the

[1] CA 2006 s.830(1).
[2] S.841.
[3] S.844.
[4] Ss.845, 846.

company, usually following a scheme of arrangement under Parts 26 and 26A of CA2006, or perhaps a successful s.994 petition which results in the buy-back of a member's shares. It is not permissible for a member to receive a payment out of capital except under very restricted circumstances.

In order for a dividend to be paid at all, the directors must be seen to have declared the dividend by board minute, in doing so having referred to the relevant accounts under s.836. Those accounts must be circulated to the members.[5] The members may then pass an ordinary resolution (or written resolution in a private company) to approve the level of dividend or reduce it, but not increase it.[6]

The directors' decision to declare the dividend is made on the basis of the most recent accounts (with special provisions for interim accounts or initial accounts).[7] If the company is audited, the auditor must provide a report on the accounts. If that report states that any qualifications to his report are material for determining whether or not a distribution may be made, this must be imparted to the members before the distribution is made.[8] If the material qualification is not imparted to the members when it should have been, and the distribution made anyway, the improper distribution cannot be retrospectively cured by an attempted ratification, since it is not permissible to ratify an illegal act.[9] Until it is declared, there is no obligation to pay the dividend.[10] A dividend is a debt due to the members only once it has been declared.[11]

Directors who negligently authorise a payment of a dividend which is improper are under common law jointly and severally liable for the sums paid on the grounds of the breach of their fiduciary duty.[12] A company does not need to be insolvent for this liability to arise. The line of authorities, as reviewed in *Burnden Holdings (UK) Limited (In Liquidation) v Gary John Fielding, Sally Anne Fielding*[13] by Zacaroli J., seems to suggest that although directors are strictly liable for an improper distribution, if they have taken professional advice and had no reason to think that the distribution was improper, and have not acted contrary to the requirements of s.172 of the Companies Act 2006 ("CA2006"), they may have the benefit of s.1157 which protects a director who acted reasonably and honestly with regard to all the circumstances.[14]

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[5] S.423.
[6] Private Company Model Articles reg.30(2); there are equivalent provisions for public companies.
[7] S.836.
[8] S.837.
[9] *Precision Dippings Ltd v Precision Dippings (Marketing) Ltd* [1986] Ch. 447.
[10] *Bond v. Barrow Hermatite Steel Co*. [1902] 1 Ch 353.
[11] *Re Severn and Wye and Severn Bridge Railway Co.* [1896] 1 Ch. 559.
[12] *Re Exchange Banking Co (Flitcroft's Case)* (1882) 21 Ch. D. 519 CA; *Bairstow v Queens Moat Houses Plc* [2002] B.C.C. 91.
[13] [2019] EWHC 1566 (Ch).
[14] As happened in *SSF Realisations Limited (In Liquidation) v Loch Fyne Oysters Limited* [2020] EWHC 3521 (Ch).

The authorisation of dividends by directors has recently come under scrutiny in *BTI 2014 LLC v Sequana SA and others*[15] where the question arose whether directors should have paid a dividend to a holding company, given that some years later the company went into insolvent liquidation. At the time of the distribution the company was solvent on both a cash-flow basis and a balance-sheet basis, but there was nevertheless a possibility in the future that it would be unable to meet in full a contingent liability for environmental costs. As this was only a possibility, it was held that the payment of the dividend was acceptable. This raises the wider issue of whether it is more important to pay dividends than to make adequate provisions for environmental costs: insolvency law perhaps has not fully caught up with the need to take account of environmental matters and is still content to socialise such costs.

Even though directors may be found liable for improper distributions, much of the time directors will be unable personally to repay those distributions. It therefore makes sense to reclaim improper distributions from the recipients of those distributions, the members. S.847 allows for this to take place, albeit under slightly ambiguous circumstances.

S.847 states as follows:

> *(1) This section applies where a distribution, or part of one, made by a company to one of its members is made in contravention of this Part (23).*
>
> *(2) If at the time of the distribution the member knows or has reasonable grounds for believing that it is so made, he is liable*
>
> > *(a) to repay it, (or that part of it as the case may be) to the company, or*
> > *(b) in the case of a distribution being made otherwise than in cash, to pay the company a sum equal to the value of the distribution (or part) at that time.*
>
> *(3) This is without prejudice to any obligation imposed apart from this section on a member of a company to repay a distribution unlawfully made to him.*

Members who receive distributions (or other payments that were in essence distributions even if disguised as something else) that they know are illegal or otherwise improper will be liable, as seen in *It's A Wrap (UK) Ltd (In Liquidation) v Gula*.[16]

In this case, Mr and Mrs Gula knew that there were no profits available for distribution. Nevertheless, following advice from their accountant, they took a payment from the company which was said to be their "salary". They were told that a payment in this manner would be more tax-efficient. After the company went into liquidation the liquidator, slightly unusually, chose to reclaim the payment under s.277 of Companies Act 1985, the then equivalent of s.847 of CA 2006. The Gulas' defence was that they did not appreciate that what they had done was unlawful, and so should not be liable. The judge at first instance held that the Gulas were not required to return the distribution, but the liquidator appealed.

[15] [2022] UKSC 25.
[16] [2006] EWCA Civ 544; [2006] 2 B.C.L.C. 634.

Arden L.J., as she was then, ruled that, given the requirement for UK compatibility with Articles 15 and 16 of the Second EC Directive on Company Law (77/91/EEC), in order to be liable under the then s.277 of CA 1985 (now s.847 of CA 2006), the recipient members only had to know of the facts that gave rise to the contravention. As part of this knowledge, the Gulas were deemed to be aware of the applicability of EU law, though it is open to question whether people in the Gulas' situation could have been expected to be know of the EU law or even be unaware of it.[17] Arden L.J. ruled that it was not necessary for the company (or liquidator as the case may be) to have to prove that the recipient members appreciated that distribution was a contravention if the members are already aware of the facts leading up to the distribution, namely that the company did not have any distributable profits. The state of mind of the recipients was not relevant. The fact that they received advice was irrelevant too: it was no defence. To put it more bluntly, they could not be allowed to keep the distribution merely because they believed that they had done nothing wrong and because they did not know the law, s.277 in particular. Lack of knowledge of the law was no defence. What mattered was that they knew perfectly well that the company had no distributable profits. The other judges agreed with Arden L.J..

Arden L.J did not dwell on the phrase "has reasonable grounds for believing" in s.847(2). Chadwick L.J. did not think that "has reasonable grounds for believing" was the same as constructive knowledge, in other words, knowledge that the recipient member is automatically deemed to have. He said "The knowledge which the legislature has sought to describe in s.277(1) of the 1985 Act is, I think, knowledge which the member has and knowledge which the member 'must be taken to have' or, perhaps, 'may reasonably be taken to have'."

This suggests that there is doubt as to what "reasonable grounds for believing" actually means. The phrase suggests something less than absolute knowledge – perhaps, to put it colloquially, "being pretty sure that the payment was a contravention". It is a curious phrase, because the recipient has to have a belief (a subjective matter) but that belief must be "reasonable", which suggests a degree of objectivity. Furthermore, it is a belief to the recipient's disadvantage. If he knows the payment was a contravention, he has to repay it. If he did not know that it was a contravention, it seems he may be allowed to keep it. If he does not have reasonable grounds for thinking it was a contravention, he may again keep it. But if he personally had no idea, or did not believe, that it was a contravention, but looking at the matter objectively he lacks reasonable grounds for thinking it is not a contravention, does he then have to return it? The answer to this is probably "yes", because otherwise there would have been no point in introducing the phrase "reasonable grounds for believing". For example, a recipient member might say that he did not know or believe that the payment was improper because he did not look at the company's accounts, or even if he did, not being an accountant, he did not understand them. It would not be reasonable to expect a member to be allowed to retain a dividend merely because he chose not to look at or understand the company's accounts.[18] It is

[17] For a discussion on this point, see Robins, *Knowledge, ignorance, and unlawful dividends*, Insolv. Int. 2007, 20(3), 33-36. Robins was the barrister who acted for the Gulas in the Appeal Court hearing.

[18] This point is touched on at 25 in *It's a Wrap*, albeit in the context of the wording of Article 16. Arden L J proves herself unsympathetic to the position of the shareholder who chooses not to look at his company's accounts.

submitted that this was probably what the draughtsman may have intended, but perhaps was not expressed with quite the clarity that might have been desirable. As this matter has not been explored further in the *It's A Wrap* case, or indeed anywhere else, it remains open to question.

In the above case, the Gulas' beliefs did not really matter, as the Gulas had admitted that they knew the company did not have distributable profits. This inevitably made them liable. Furthermore, although the matter was not discussed in this case, as the Gulas were directors, they could equally well have been liable for the dividend in their capacity as directors rather than members. In addition, the Gulas might have been able to claim against their accountant for his inaccurate advice. As for the conformity with the EU directive, it remains to be seen whether the Retained EU Law (Revocation and Reform) Bill currently going through Parliament will change this. It seems unlikely, as the Gula case has been followed for some years.[19]

Although the Gulas had to repay their distribution, the point of the provisions of s.847 is that if a member receiving an unlawful distribution can somehow prove that he genuinely did not know that there were no distributable profits available, he may be able to retain the distribution. Ignorance is, if not bliss, at least free from the requirement to reimburse the company. This section may have been drafted on the principle of making a member liable if he knows a distribution is improper, but the converse is also true, that he is not liable if he does not know of the impropriety.

The question of the innocent recipient of unlawful dividends was touched on in *Re Exchange Banking Co (Flitcroft's Case)*[20] but not specifically addressed with complete clarity. The directors were required to make good the loss to the company arising out of the payment of an improper dividend. In this case, the accounts as exhibited to the members bore little relation to the true financial state of the company. The members would not necessarily have known this when they approved the payment of the dividend recommended by the mendacious directors. There was no suggestion at the time that the recipient members should have to pay it back, and there was no equivalent of s.847 at the time. In theory the recipient members might have been in the happy position of having received a payment which should not have been made, finding that the directors had reimbursed the company with the dividends that should not have been paid, and then receiving another dividend arising from the directors' payments. History does not relate what did actually happen, but what is likely is that if any repayments were ever made by the directors, the liquidator would have applied the monies received to the company's creditors. It seems likely that the members just kept their dividends, as the case made no pronouncement on the need for the return of the dividends to the company.

This raises the question of whether the dividend payment could be seen as a form of unjustified enrichment which the recipients ought to return. Perhaps this could be what was meant by s.847(3) when it states "*This is without prejudice to any obligation imposed apart from this section on a member of a company to repay a distribution unlawfully made to him*." While this is a possibility, it is more likely, on the basis of Walker L.J.'s judgement in the case, *Bairstow*

[19] *Re Snelling House Ltd (In Liquidation)*, [2012] EWHC 440 (Ch).
[20] (1882) 21 Ch. D. 519 CA

v Queens Moat Houses Plc,[21] that what was intended by s.847(3) was some form of equitable contribution. He stated: "In *Moxham v Grant* [1900] 1 QB 88 this court considered that the principle of equitable contribution as between delinquent trustees (*Chillingworth v Chambers* [1896] 1 Ch 685) could apply as between company directors and shareholders who had received unlawful dividends with notice of the facts."[22] In *Moxham* the directors made an improper repayment of capital to the shareholders. The shareholders were well aware of the lack of judicial authorisation for the repayment. There should have been approval from the courts before any such reduction of capital. The approval was not obtained and following liquidation the directors were found liable for the unauthorised repayment. They in turn were allowed to claim from the shareholders who had knowingly received the repayment, aware that the proper procedures had not been followed. The shareholders were specifically indicated to be constructive trustees for the repayment. But the point here was the shareholders knew of the impropriety. That was not the case in the *Flitcroft* case.

In *Bairstow*, the question of repayment by members of improper distributions was again touched upon, and *Flitcroft's Case* closely analysed by Walker L.J.. No decision on the matter was ultimately made as the point had been not seriously pleaded in the course of the hearing. The matter was left open, and remains open to this day – a potential gap in the law. Walker L.J. was alert to the possibility of members receiving a windfall from both the dividend and the return of the dividend to the company from the directors, though under the circumstances in *Bairstow* it was evident that the directors in question would never be able to repay the company the improper dividends. Walker L.J. was also alert to the practical problem that the original recipients of improper dividends might well have sold their shares, that recovery from them might be difficult, or that other shareholders might have bought their shares hoping to benefit from any repayments made to Queen's Moat Houses plc. In any event, the body of shareholders at the time of the Appeal Court hearing was very different from that at the time of the improper payments.

Walker L.J. made no pronouncement on any repayment from the members, and indicated that it should be left for another day. The matter therefore remains unresolved. But the question still remains: on what grounds, if any, may members in receipt of a dividend which should never have been recommended in the first place, and which they did not know at the time of receipt of the dividend to be an unlawful dividend, be required to repay that dividend?

Payne in *Unjust Enrichment, Trusts and Recipient Liability for Unlawful Dividends*[23] argues that innocent recipients of improperly paid dividends are unjustly enriched and should be obliged to repay the dividend. An improperly paid dividend is not theirs to receive as it should never have been made, and there are no grounds for retention. To retain an improperly paid dividend is a form or unjustified enrichment. Unjust enrichment is a thicket from which few birds flee without losing feathers. The sticking point for unjust enrichment is the tricky matter of the innocent recipient who has no means of knowing that there was anything wrong with

[21] [2002] B.C.C. 91.
[22] *Bairstow v Queens Moat Houses Plc* [2002] B.C.C. 91 per Walker L.J. at 47
[23] (2003) 119 L.Q.R. 583

what he has received. Tham in *Unjust enrichment and unlawful dividends: a step too far?*[24] provides a trenchant critique of Payne's assertions and suggests that it is not realistic for an innocent recipient to have to justify his retention of the dividend when as far as he can see the directors, the company and anyone else who may have been involved have approved its payment: what more is the recipient supposed to do?

The reality, as ever, as with so many other gaps in the law, is that there has to be a test case to clarify the matter, and as the cost of such a case is generally greater than the value of the dividend, such matters are usually settled out of court and the matter remains unresolved.

Nevetheless, there is perhaps a solution to this matter. This is that s.847(2) states, "*If at the time of the distribution the member knows knows or has reasonable grounds for believing that it* (the payment in contravention of Part 23) *is so made, he is liable (a) to repay it, (or that part of it as the case may be) to the company*". In the cases discussed so far, the timing of the distribution or of the knowledge of the contravention was never considered. What the section does not say is this: "*If at the time of the distribution,* or at any time thereafter*, the member knows or has reasonable grounds for believing that it is so made, he is liable (a) to repay it, (or that part of it as the case may be) to the company*." If it had said that, the member would have had a duty to repay the dividend from the moment he became aware of the contravention of Part 23, even if that were some months after the payment. But it does not say this. It merely says that if at the time of the distribution the member knows of the contravention, he is liable to repay it. Can this be taken to mean that it is the timing of the distribution that is significant? If the member does not know of the contravention (or does not have reasonable grounds for thinking it a contravention), at the time he receives the distribution, is he free to retain the distribution? Was this what was actually meant by the wording of this section?

The problem is the word "time". The draughtsman did not use the word "date" or give any specific period. Although the word "time" can mean a time specific to a minute, it can also mean the general period surrounding an event. The word "time" in s.847(2) might, for example, mean a period of, say two or three months from the date of the distribution. It clearly could not mean any date before the date of payment of distribution. How long is "time" in this context? Might a suggestion be a period of up to six months, which is the same period as an unfair preference to an unconnected person under s.239 or s.243 of the Insolvency Act 1986? If the evidence of the unknown contravention emerged after six months, the company have would lost its right to reclaim the distribution from those who by then knew of the contravention. As with any time limit, this would create winners and losers, but it would at least give some certainty to the matter. In this case the wording was the same in CA 1985 as it is now, and indeed reflects the wording of s.44 of CA 1980. Presumably it had caused no difficulties, and so the wording was continued to the present day.

On the assumption that the draughtsman put in the words "If at the time of distribution" deliberately – since, after all, this section might have been drafted without those words - it would suggest that the wording was meant to limit liability to those aware of the contravention

[24] C.L.J. 2005, 64(1), 177-211

as the date of payment of improper dividend and for a limited period thereafter. It would narrow the number of recipients who might have to repay the dividend. It might, however, get round the practical difficulty hinted at by Walker L.J. when referring to the fact that the original recipient members (in the *Bairstow* case) may well have moved on, sold their shares, or otherwise proved untraceable. If the contravention only became apparent at a later date, the opportunity for reclaiming the payment would be too late. The Gulas would still have been caught, as they knew at the time they received their distribution that it was unlawful, but the shareholders in the *Bairstow* case who at the date of payment had no means of knowing that the accounts were bogus and the distribution unlawful, would have been able to keep their dividends. The question of whether or not they were constructive trustees for the improper dividend would not be relevant, since the real issue is the state of knowledge of the recipient of the dividend as at the time of payment of the dividend.

It is not possible to tell, over 40 years later, what exactly was in the draughtsman's mind when s.44 of CA 1980 was drafted. Is this interpretation what the draughtsman had in mind? It is unlikely we shall ever know. It is clear that the point of s.44 was to force knowing members to repay unlawful dividends, but equally to protect some "unknowing" shareholders receiving dividends. What is not so clear is whether the liability to repay is restricted to those who know on or for a period after the day of payment that the distribution is improper. Leaving aside the open question about the "reasonable grounds for believing", everyone else who does not know about the unlawfulness on the day of repayment (if this is correct), or only finds out about the unlawfulness at a much later date, may keep the dividend. It is true that those allowed to keep the dividend may (if they have not sold their shares) conceivably obtain a windfall if they are allowed to keep their dividend and the directors reimburse the company. On the other hand, the company is the one that has suffered, and if the directors repay the divident, it is returned to the position it should have been if the directors had never authorised the distribution. Furthermore, the innocent recipient of the dividends had committed no fraud nor had done anything else wrong. It was not their fault that they received the payment: it was the directors' fault.

Conclusion

It may be said that all this is perhaps making a muckle out of mickle: good standards of accounting should ensure that auditors do not allow directors to pay dividends out of capital. But the fact remains that companies' accounts are sometimes misleading, and auditors get it wrong. Auditors may be more worth suing than innocent recipients of dividends. Most of the time, in practice, certainly in smaller companies, the members who receive improper dividends will also be the directors and so liable in their capacity as directors. But there will always be some cases where deceitful management and incompetent auditing allow dividends to be paid when they should not have been. There appear to be no cases so far explicitly dealing with this point. It is suggested that the wording of s.847(2) be followed to the letter: only those who at the date of the receipt and with a short period thereafter (perhaps six months) of their dividend know or have reasonable grounds for believing (as explained above) that the distribution is in

contravention of Part 23 should have to repay it. Those who had no reason to know of its impropriety at the time of payment should be allowed to keep it, as may those who discover the impropriety after the permitted period. S.847(3) allows for the possibility of equitable compensation where directors have to repay the improper dividend but may reclaim it from members who were aware of the impropriety. The thorny question of unjustified enrichment can thankfully be avoided. Perhaps this apparent gap in the law may now be filled.