MCTEAR WILLIAMS WOOD

business rescue & insolvency

briefing sheet

unlawful dividends and overdrawn directors' loan accounts

introduction

Until the Companies Act 2006 came into force on 1 October 2007 directors' overdrawn loan accounts above £5,000 were unlawful. Since then directors' overdrawn loan accounts are lawful below £10,000 and above this amount if fully disclosed to and approved by a resolution of shareholders. However, in SME companies these formalities are often not followed and although unlawful overdrawn loan accounts are voidable (effectively making it repayable on demand) as long as there is no loss to the company overdrawn loan accounts are considered normal and routine.

Often director/shareholder overdrawn loan accounts operate in conjunction with declaring dividends. Rather than paying wages/salary typically directors will draw sums in "lieu of wages/salary" over the year and at the year end a dividend is declared and posted to the directors' loan accounts bringing the balance down to nil. As long as the balance is extinguished within nine months of the financial year no S455 (formerly S419) tax arises and for annual drawings/dividends up to £88,000 per annum tax/national insurance is saved.

The problem comes if the "music stops", the company ceases to have distributable reserves or become insolvent. Sure enough any directors' overdrawn loan accounts appear as bold as brass on the balance sheet but it is no longer lawful to declare a dividend and "put the loan account right". In effect the directors have foregone wages/salary, worked for nothing and owe the company a substantial debt exactly at the same time their principal source of income has or is in danger of drying up. An invidious position.

the law

In brief the law on dividends to shareholders is set out in the Companies Act 2006 and in a company's Articles of Association. The provisions usually include:

- A company may only pay dividend distributions from distributable reserves (i.e. retained profits).
- Profits available for distribution will normally be by reference to the last annual accounts but where such accounts are either not available or do not show distributable reserves properly prepared management accounts or interim accounts may be used.
- The power to declare dividends generally lies with the shareholders at a general meeting but cannot exceed the amount recommended for payment by the directors. The directors are usually authorised to pay interim dividends which are subsequently approved by shareholders at an AGM.
- The directors owe a fiduciary duty to act in the best interests of the company. Therefore before recommending a dividend directors should consider the company's future cashflow requirements (looking ahead at least 12 months).

the remedies

A shareholder who knows or has reasonable grounds to believe that a dividend has been declared/paid when there are insufficient distributable reserves is liable to repay it together with interest pursuant to Section 847 of the Company Act 2006. Where there is substantial

continued overleaf

unlawful dividends and overdrawn directors' loan accounts

continued

share capital, share premium or revaluation reserves this situation could arise long before a company becomes insolvent. The time limit for such a claim is normally six years from payment but for directors in receipt of dividends this could be 12 years. Other remedies include:

- Where a dividend is paid after a company becomes insolvent it may be recoverable by an Administrator or Liquidator as a transaction at an under value pursuant to Section 238 of the Insolvency Act 1986. Essentially this is an easier claim to make than under Section 847 of the Company Act 2006 because an insolvency practitioner simply has to show that the company was insolvent at the time of the payment and not that the shareholder knew or had reasonable grounds to believe there were no distributable reserves.
- If the dividend is declared when the company is solvent but paid or credited to a loan account when the company is insolvent it can also be pursued by an Administrator or a Liquidator as a preference pursuant to Section 239 of the Insolvency Act 1986 if within two years of the date of administration/liquidation.
- As regards to unlawful loan accounts rather than the simple recovery of a debt the remedy against any person who is or has been an officer of the company is a claim for misfeasance under Section 212 of the Insolvency Act 1986. As this is a claim by the Liquidator a director cannot set off any sums the company owes to him/her and would have to rely on a defence that he/she has acted honestly and reasonably.

how you can help clients

If a company faces insolvency or there are doubts about its ability to continue as a going concern the following simple steps taken in time may significantly improve your client's position in the event of an insolvency:

- Obtain shareholder approval for any loans to directors above £10,000 to make them lawful.
- Ensure your clients do not continue to unwittingly build up loan accounts based on your advice given when the company was solvent.
- Consider paying directors by way of wages/salary rather than through monthly drawings and dividends. Directors are entitled to reasonable remuneration just like any other employee. Minute the reasons for doing this.
- In the event of any insolvency if the directors are employees then statutory pay in lieu of notice, redundancy, arrears of wages/holiday pay claims up to £400 per week will usually be paid by the Redundancy Payments Service. For a director with over 10 years service this could be worth over £10,000 but he/she will have to show the necessary employee/employer relationship. This will be easier if directors/shareholders have a contract of employment or service contract, are paid as other employees through the payroll with any PAYE/NIC deducted at least up to the National Insurance limit in normal times and are paid at a proper market rate for at least 12 weeks prior to an insolvency.

If in doubt please feel free to discuss your client's situation with us if necessary on a no name basis.

Call our business rescue and insolvency hotline on 0800 085 5070 or visit www.mw-w.com