Defending Directors facing Liquidator claims following HMRC investigations

In this Newsletter, following recent cases, we examine the circumstances in which directors are increasingly being pursued personally by a Liquidator where their company has participated in tax avoidance schemes.

Unlawful dividends

One of the most common claims brought by a Liquidator where the company has participated in tax avoidance schemes is for recovery of unlawful dividends. This is on the basis that there were insufficient distributable reserves at the time that the dividend was declared and, in addition, the company failed to follow the correct procedure in declaring the dividend i.e. calling a meeting of shareholders and passing the necessary resolution.

Critically the basis of any claim will depend upon the financial information available to the director at the time the dividend was declared, whether that be the statutory accounts or up to date management accounts. But quite often directors are paid regular dividends as a form of remuneration, usually at the suggestion of the company’s accountant with a “tidying up exercise” at the end of the financial year to coincide with finalisation of the accounts.

Herein lies the difficulty because, first of all, unless the director is being provided with up to date financial information, and is satisfied as to its accuracy, how can a director truly say the dividend is lawful? Recently the Courts got round this by suggesting that the receipt of dividends (and directors’ loans) were really remuneration in a different name (see Global Corporate Limited v Hale (2017)).

This case was an absolute godsend for errant directors who could now argue why they should not be penalised by not receiving remuneration for their hard work?

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Unfortunately the pendulum has swung back in favour of the Liquidators with the subsequent decision of Toone and Murphy v Robbins (2018) which declared Global v Hale to be wrong (and was subsequently overturned). The starting point for that decision is that a director is considered to be a trustee of the company and therefore owes it a fiduciary duty, which includes not earning any unauthorised profit at the expense of the company.

What the Toone decision decided was that on a practical level this meant that unless a director’s remuneration has been authorised...
by the company, in accordance with its Articles of Association (for example by way of service contract or resolution authorising payment) then a director is not entitled to draw remuneration.

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Toone made clear that dividends are dividends! In other words accountants will advise directors to receive dividends in order to obtain certain tax benefits. It would therefore be wrong to later re-classify them as remuneration having retained the tax benefit. Moreover it is even more difficult for directors to retrospectively claim remuneration at a time when a company is at risk of insolvency.

So what lessons can be learnt from the Toone decision for any accountant asked to advise directors on how best to remunerate themselves?

- Up to date financial information for every dividend;
- Passing of resolutions declaring dividends;
- Passing of resolutions approving remuneration; and
- Service contracts.

Misfeasance
There has been much discussion about the consequences to directors participating in employee benefit trust schemes (EBTs) and, in doing so whether this amounts to misfeasance.

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Of course not all schemes will fall foul of the legislation but where they do, such as in the Glasgow Rangers case, then a Liquidator will consider pursuing a claim. At its simplest the claim will be that by failing to set aside money to pay tax, the directors have caused loss to at least one creditor i.e. HMRC, but more likely the general body of creditors if as a consequence of HMRC raising assessments or APNs, the company is forced to enter into liquidation.

Ultimately the claim will rest on two things. The first is the time of participation. The Glasgow Rangers case in particular was extremely high profile in 2011. Any director participating in schemes after that date is going to be hard pressed to explain why they entered into an EBT.

Assuming the scheme in question was entered into prior to 2011, the next issue is whether the director can claim to have acted on professional advice bearing in mind the test for misfeasance is whether the director exercised reasonable care, skill and diligence based on his own knowledge and that of a reasonable director.

If the director acted upon professional advice, it will be more difficult for a Liquidator to show a breach of duty. If however the director acted in the knowledge that such a scheme may be challenged and took no precautions to protect the company’s position, such as establishing a reserve account then the prospects of a claim will be greater. Again bear in mind that scheme introducers often highlight the risks involved, and even the legal opinion attached to the scheme is heavily caveated. Again the question needs to be asked whether the director took independent advice as that would enhance his position.

Transactions defrauding creditors
Oddly there is no requirement to prove fraud notwithstanding the title to these claims. Essentially the argument is that monies belonging to the company were transferred for little or no consideration and that the substantial purpose of the transaction was to prejudice the interests of a creditor or a group of creditors by putting those monies out of the creditors’ reach. So the argument regarding tax avoidance schemes is simply that monies have been paid to EBTs that should otherwise have been paid to HMRC i.e. in order to avoid certain tax liabilities. It is important to note that a Liquidator does not need to demonstrate that the dominant purpose was to put monies out of reach, but simply a substantial reason (see Hashemi v HMRC).

Limitation
Directors also need to be aware that there are no limitation issues for such claims on the basis that the operation of EBTs and/or misfeasance amounts to the misappropriation of trust assets (see Burnden v Fielding (2018)).
So what potential defences are there available to a director?

- **Unjust enrichment**
  This is the argument that the failure to pay for services provided to the company would deprive the director of the services he has provided and unjustly enrich the company. As a result if a proportion of the monies received could be seen as reasonable remuneration for those services, then this amount will not be recoverable. That is particularly where there are service contracts and/or resolutions. However is this still correct in light of the Toone decision?

- **Acting honestly and reasonably**
  Section 1157 Companies Act 2006 essentially allows a director to throw himself at the mercy of the Court by pleading that he acted honestly and reasonably and ought therefore to be excused from any liability. This is particularly where he relied upon professional advice. But this has to be weighed against whether the directors were fully aware of the risks they were taking, particularly bearing in mind the political environment surrounding EBT structures.

- **Ratification**
  It used to be thought that directors could belatedly ratify their actions, such as drawing remuneration where they could demonstrate there was shareholder approval at the time. But it is impossible to ratify unlawful dividends (because its trust property) or where to do so conflicts with a director’s duty to creditors where the company is facing insolvency (i.e. depriving the company of a claim against the directors).

**Consider also disqualification as per the case of BIS v Akbar (2017)**

The entering into of an EBT which involved the purchase of gold bullion for the director at a time when creditors remained unpaid was held to be misfeasant.

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Finally

Given HMRC’s entitlement to pursue directors personally for non payment of PAYE, National Insurance, etc then any practitioners advising directors ought to consider negotiating tri-partite agreements with HMRC.

Contact

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