**Restrictions on distributions**

This section deals with the legal restrictions on distributions by a company in the context of intra-group transfer of assets

**Read alongside:** Access the Companies Act 2006 (**‘CA 2006’**). Please read the sections referred to in this element as and when they are mentioned.

**Intra-group transfers**

Prior to the sale of a group company, group companies often carry out a **pre-sale re-organisation**. They may also carry out a **post-sale re-organisation** following an acquisition.  If the transaction has **split signing and completion** a re-organisation will often be implemented in the gap between signing and completion.  The buyer would need to be comfortable with the plan for the reorganisation and would require safeguards to be put in place in relation to its implementation.  That could include e.g., an indemnity from the seller for any loss or liability incurred by the buyer in connection with the reorganisation.

Group re-organisations can also take place for **tax reasons** or to increase **business efficiency**.

As part of a re-organisation, assets may be transferred from a subsidiary company to its parent company or from one subsidiary to another company within the same corporate group. These transfers gives rise to two key considerations.

* Consideration 1: the statutory restrictions on distributions in the CA 2006.
* Consideration 2: the directors of the transferring company need to be advised as to their statutory duties.

**Why control distributions?**

**Distributions** enable a company's shareholders to extract value from the company.

The CA 2006 distribution regime is in place to prevent a company's shareholders from extracting value from that company to the detriment of the company’s creditors.

You will remember from Business Law and Practice (‘**BLP**’) that shareholders rank below creditors on a company’s winding up. There is a risk to creditors that a company’s shareholders will authorise decisions made by the company which prejudice the creditors and unduly favour the shareholders.

The distribution regime, therefore, protects creditors by controlling the circumstances in which a distribution can lawfully be made.

**What is a “distribution”?**

What is a distribution? - s.829 CA 2006

Distribution means every description of distribution of a company's assets to its **members**, whether in **cash or otherwise**. Note that it is the purpose and substance of the transaction which matters, not the label given to it by the company.

What is the restriction? - s.830 CA 2006

A company may only make a distribution **out of profits available for the purpose** – it cannot lawfully make a distribution out of capital.

We will not consider cash dividends in this knowledge stream. Instead, we will focus on **non-cash distributions** ("**distributions in kind**") that may arise in an intra-group transfer.

**Types of non-cash distributions**

Where a company transfers an asset to one of its **shareholders** either as **a gift** or at an **undervalue\*,** this will constitute **a distribution in kind**.

Where an **asset is transferred between subsidiaries** (rather than from a subsidiary to its parent / shareholder) either as a **gift** or at **an undervalue\*,** this will constitute a deemed **distribution in kind** to the parent following the case of **Aveling Barford v Perion**.

In each of these cases, the transferring company is making a type of distribution. For the distribution to be lawful, the company must have sufficient profits available to cover the amount of the distribution.

(**Note:** \*‘Undervalue’ in this context means less than market value.)

**Example**

*Alt text – A company structure diagram shows Company A Ltd as owning 100% of the share capital in each of Company B Ltd and Company C Ltd.*

*Alt Text – on the structure diagram an arrow points from Company C to Company A showing with the label:* If Company C Ltd **transfers an asset at an undervalue** to its shareholder, Company A Ltd, this will be a distribution in kind

*Alt Text – on the structure diagram an arrow points from Company C Ltd to Company B Ltd showing with the label:* If Company C **Ltd transfers an asset at an undervalue** to Company B Ltd this will constitute a deemed distribution in kind

**Note:** Transfers between subsidiaries are called **deemed** distributions rather than distributions as the s.829 CA 2006 statutory definition of a distribution only refers to distributions to a company’s members.

**Motivation behind the “distribution”**

The legislation is aimed at making a transaction between a company and its shareholder, where that transaction is made in bad faith, unlawful.

If the directors genuinely believe (even if they are wrong) that the sale is at market value, the sale is a genuine commercial sale and is not, therefore a “distribution” under the CA 2006. That is the case even if, on an analysis of the facts, the sale falls within s.845 in being a “distribution of a company's assets to its members, whether in cash or otherwise” (s.829 CA 2006).

As Lord Hamilton said, in **Clydebank Football Club v Steedman 2002 SLT** 109,:“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 practice, this means directors should aim to make a reasonable determination of the market value of an asset to avoid the transfer being challenged by shareholders as being an unlawful distribution. If the transaction was a “good faith undervalue transaction” an aggrieved shareholder can still bring an action for negligence or breach of directors’ duties of skill and care but will not succeed on challenging the distribution as unlawful.

An asset transferred for **market value** will not (generally) constitute a distribution in kind as it is a commercial transaction, not a transfer of value out of the company.

As is discussed below, distributions need to be made out of profits available for the purpose.

**Book Value and Distributable profits**

In addition to considering the market value of the asset, to determine if there is a distribution, it is necessary to value the amount of the distribution by reference to the asset’s **book value**. The book value of an asset is the value of the asset after accounting for depreciation. It does not necessarily align with the asset’s market value.

The determination of whether a company has distributable profits, and the value of an such distributable profits is usually undertaken by accountants, whether the company’s financial team or external advisers. There is detailed technical guidance on this.

If a company has no distributable profits (or negative reserves) then, under s. 845(3) CA06, the amount by which the consideration received by the company for the transferred asset exceeds book value can be taken into account in determining the amount of distributable profits.

**Example:**

A Company has negative distributable profits of -£500.

The Company makes a deemed distribution of machinery to its sister company for £2,000. The book value of the machinery is £1,250.

The £750 by which the consideration exceeds the book value will be included in the distributable profits therefore the Company will be considered to have distributable profits of £250 at the time of the transfer.

**Assessing whether a distribution is lawful**

# Establish whether this is a distribution?(s.829 CA 2006)

1. If the answer to (1) is yes, a) does the transferring company have distributable profits?

A distribution can **only be lawful** if the transferring company has distributable profits **at the time of the transfer** (1 pence would be sufficient to satisfy this initial condition).

If there are no distributable profits, the distribution **will be unlawful**.

1. b) What is the value of the amount of the distribution?

In determining the amount of the it is necessary to value the amount of the distribution by reference to the asset’s **book value,** not its market value.

If the transfer is **at or above ‘book value’** (provided that the company has distributable profits per question (2)) is valued at nil and it **will be lawful**.

If the transfer is at **less than book value,** (including when the market value is below the book value) then the distribution will be an amount equal to the shortfall, and the company will need sufficient distributable profits to cover this shortfall. If it has enough distributable profits, the distribution **will be lawful**. If it does not, the distribution **will be unlawful**.

**Consequences of an unlawful distribution**

* An unlawful distribution **cannot be ratified** by a company’s shareholders.
* The directors who authorised the unlawful distribution will be **liable, jointly and severally,** to repay the company.
* If the shareholders receiving the distribution knew, or had reasonable grounds for believing, that the distribution was being paid in contravention of s.830 CA 2006, they will be liable to repay the company a sum equal to the amount of the distribution.
* **In practice** if an historic unlawful distribution is identified, it is unlikely that the money will be recovered by way of a direct payment from the shareholders. It is more likely that a new lawful dividend will be declared and approved and instead of being paid, will be set off against the money owed by the shareholder to the company.
* Deemed distributions are governed by the statutory rules on distributions under CA 2006. Accordingly, the statutory provisions on the consequences of an unlawful distribution will apply.
* If the deemed distribution is unlawful and the recipient acquired the property with knowledge of the facts, then the recipient will hold the asset as a **constructive trustee.** This means that the recipient could be liable to return the asset to the transferring company.

**Directors’ duties and group companies**

1. You will recall from studying BLP, that the principle of **separate legal personality** applies to each group company. In addition, you will remember that the common law directors’ duties were codified under CA 2006.
2. The general rule is that where decisions are made within a group of companies, the directors of each company within the group should act primarily with the success of that company in mind and not have regard to the success and demands of other group companies. This means that the board of each company must consider the benefit of each proposed transaction **to that company**, rather than just to the group as a whole.
3. However, the mere fact that, in a particular transaction, the directors of a company looked to the success of the group as a whole, will not of itself mean that they have acted in breach of their directors’ duties. Provided that an ‘intelligent and honest man’ in the position of the directors would have **reasonably believed** the transaction to be in the **interests of their company** this will be sufficient **(Charterbridge Corporation Limited v Lloyds Bank Ltd** (1970)).
4. Finally, the shareholders can ratify certain breaches of directors’ duties by passing an ordinary resolution. You considered this in BLP.

Ostensibly, the directors of a transferring company will be breaching their duty to promote the success of that company if they arrange for the company to transfer its assets at an undervalue. There are two potential outcomes:

**Directors’ duties and intra-group transfers**

Ostensibly, the directors of a transferring company will be breaching their duty to **promote the success** of that company if they arrange for the company to transfer its assets at an undervalue.

There are two potential outcomes:

* Provided the transferring company is **solvent** and has sufficient distributable profits to cover the amount of the undervalue so that the distribution is **lawful**, then the shareholders can **ratify** the breach by passing an ordinary resolution to approve the transfer of assets.
* If the transferring company is **insolvent** or it does not have sufficient distributable profits to cover the amount of the undervalue so that the distribution is **unlawful,** then the shareholders cannot ratify the distribution. The directors have breached their duties and they may be held personally liable to repay to the company the unlawful amount.

**Summary**

* A transfer of assets at an undervalue by a company to its parent or to a sister company will constitute a distribution in kind, or (in the latter case) a deemed distribution in kind.
* A company can only lawfully make a distribution/ deemed distribution in kind if it has at least 1 pence of distributable profits at the time of the transfer and, if the asset is transferred below its book value, it has sufficient distributable profits equal to the difference between the book value and the amount by which the asset is transferred for less than its book value.
* Generally, the directors of each company within a group of companies must act in the interests of that company. On the face of it, the directors of a company will be breaching their directors’ duties if they authorise the company to transfer assets at an undervalue.
* It is possible for the shareholders of a company to ratify an intra-group transfer at an undervalue provided that the transferring company is solvent and had sufficient distributable profits to cover the amount of the distribution.
* If the distribution is unlawful, it cannot be ratified by the shareholders. The directors who authorised the distribution will be personally liable to repay the company.