THE LIMITS OF LIMITED LIABILITY

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For individuals operating "through" an English company limited by shares, great comfort is often derived from knowing that the principle of "limited liability" stands between him/her and the creditors or potential creditors of the company. Indeed, it is understandably easier to take entrepreneurial risks when the downside is limited to what you, as an investor, have chosen to contribute to the company. If the risk pays off, nobody will be left out of pocket. If it does not, and the company faces insolvency, the company's counterparties can usually be assumed to have known that they were dealing with a limited liability company and considered the risks involved.

One entity that does not get to choose or consider its "customers" is HMRC. Companies build up tax debts through the ordinary operation of a business, even a loss-making one, for instance, can incur liabilities for PAYE and VAT. In general, there is very little that HMRC can do to stop a company carrying on business, and if the company goes into insolvency owing HMRC significant sums, that is not usually a risk HMRC has had the opportunity to consider.

There are various provisions in the tax code that allow HMRC to seek to protect themselves to some extent. For instance, transferring PAYE liabilities from employer to employees (SI 2003/2682, rr.72 and r.81) or demanding security as a condition of trading (VATA 1994, Sch 11, para 4). A trend that has become more apparent in recent years, however, is the use by liquidators (directly or through litigation funders) of company law mechanisms for pursuing persons who were involved with an insolvent company to recover the losses of that company. It is the latter which are the subject-matter of the present article.

These mechanisms do not involve piercing the corporate veil, but, rather, rely on allegations that one or more individuals involved with the company have not complied with company law obligations and, as a result, have incurred a liability to the company for losses suffered. For instance, it might be alleged that a director was in breach of his/her duties as a director, in allowing the company to enter into a tax avoidance arrangement, without making provision for the potential tax liabilities, if the scheme failed and that he should reimburse the company for losses suffered as a result. Once the director gets over the initial shock of seeing that there are limits to limited liability, he/she will find that the underlying legal issues are complex, both in terms of the basis for making such a claim and the potential responses and defences.

The following areas are explored in this article:

(1) Piercing the corporate veil.

(2) Recovery of unlawful dividends.

(3) Breach of directors' duties.

(4) Other grounds of potential liability

(1) Piercing the corporate veil

Piercing the corporate veil means disregarding the separate personality of the company (*Prest v. Petrodel Resources Ltd* [2013] UKSC 34, §16). This might happen where the corporate veil is being abused to evade or frustrate the law:

> "[35] I conclude that there is a limited principle of English law which applies when a person is under an existing legal obligation or liability or subject to an existing legal restriction which he deliberately evades or whose enforcement he deliberately frustrates by interposing a company under his control. The court may then pierce the corporate veil for the purpose, and only for the purpose, of depriving the company or its controller of the advantage that they would otherwise have obtained

> by the company's separate legal personality. The principle is properly described as a limited one, because in almost every case where the test is satisfied, the facts will in practice disclose a legal relationship between the company and its controller which will make it unnecessary to pierce the corporate veil. Like Munby J in *Ben Hashem*, I consider that if it is not necessary to pierce the corporate veil, it is not appropriate to do so, because on that footing there is no public policy imperative which justifies that course. I therefore disagree with the Court of Appeal in *VTB Capital* who suggested otherwise at para 79. For all of these reasons, the principle has been recognised far more often than it has been applied. But the recognition of a small residual category of cases where the abuse of the corporate veil to evade or frustrate the law can be addressed only by disregarding the legal personality of the company is, I believe, consistent with authority and with long-standing principles of legal policy."

The limited nature of this exception is illustrated by *Hurstwood Properties (A) Ltd v. Rossendale BC* [2021] UKSC 16, which concerned a business rates avoidance scheme. Under that scheme, the registered owner of an unoccupied property granted a short lease to an SPV such that it was intended to become the 'owner' and liable for the tax. The SPV was then dissolved or put into liquidation at which point it was argued that either an exemption for companies in winding up applies (liquidation version) or that, upon dissolution, the lease and liability automatically transferred to the Crown as bona vacantia.

One argument for the local authorities was that the use of the SPV was an abuse of its separate corporate personality and the corporate veil could be pierced. The Supreme Court held that, even ignoring the fact that the registered owners were not shareholders of the SPVs (so it was not clear what piercing

the veil would achieve), the corporate veil could not be pierced so as to visit the liability of the company onto its shareholder:

> "[72] Even if there is an "evasion principle" which may in "a small residual category of cases" (per Lord Sumption) justify holding a company liable for breach of an obligation owed by its controlling shareholder, we are not ourselves convinced that there is any real scope for applying such a principle in the opposite direction so as hold a person who owns or controls a company liable for breach of an obligation which has only ever been undertaken by the company itself…"

On the facts, however, the tax avoidance scheme failed because the SPVs did not became "owners" upon a proper construction of the legislation because they did not become entitled to possession of the demised property – the landlord remained the owner and liable for the rates.

It follows that in situations where a company becomes insolvent owing tax debts, piercing the corporate veil ranks highly for legal concepts with vivid, attention-grabbing names, but low for chances of being seen in real life.

(2) Recovery of unlawful dividends

The inverse of the limited liability of persons acting through companies is that there are important restrictions on how and when assets may be taken out of companies, so as to protect creditors from the dissipation of assets that would otherwise be used to pay their debts.

These restrictions include the principle that distributions may only be paid out of profits available for the purpose (CA 2006, s.830) and must be justified by relevant accounts (last annual accounts, interim accounts or initial accounts) (s.836).

This makes it important to know what is and is not a "distribution". In this respect, distribution is not limited to

transactions purporting to be dividends but, equally, does not include every situation in which there is a transfer of value out of a company.

The general principle arising out of the case law is that it is necessary to inquire into the true purpose and substance of the impugned transaction. In some cases, it will be obvious on an objective appraisal that the payment is simply a transfer of value to a shareholder qua shareholder and a distribution, but in others, for instance a sale at undervalue, it will be necessary to consider subjective intentions:

> "[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." (*Progress Property Company Ltd v. Moorgarth Group Ltd* [2010] UKSC 55)

In *Re Implement Consulting Limited [2019] EWHC 2855 (Ch), payments into an employee benefits trust (EBT) were reclassified as unlawful dividends:*

> "[7] In my judgment although the payments of the Company's capital were made to the Respondents via a trust or interest in possession fund, they were in substance distributions. Due to a failure to comply with the statutory code they constitute unlawful distributions and are void. Later payments totalling £70,000 made to the shareholders in 2013 also constituted unlawful distributions. One shareholder and employee, Mr Flanagan, received £30,000 in expenses in March 2013. Such payments were made at a time when the Company was insolvent, and in breach of directors' duties."

It was important in that case, however, that each of the beneficiaries was also a shareholder and the payments were calculated by dividing the capital paid out of the company to match the number of shares each of them held.

Where an unlawful distribution is identified, the recipient is liable to repay it, if they knew or had reasonable grounds for believing that it was unlawful (CA 2006, s.847). This test has been held to require knowledge of the facts that make the distribution unlawful, not knowledge of the law (*Re It's A Wrap* (UK) Ltd [2006] EWCA Civ 544, §50), although it is difficult to see how someone can know a dividend is unlawful without having some understanding of the law. It is suggested that the decision in *Tooth v. HMRC* [2021] UKSC 17 on the meaning of deliberate (which requires an intention to mislead) points in a different direction. The "reasonable grounds for believing" test would, however, cast the net wider.

If the recipient had actual knowledge that the distribution was unlawful, there may also be a constructive trust of the amount received, in favour of the company, to the extent that

it can be traced (Precision Dipping Ltd v. Precision Dippings Marketing Ltd [1986] Ch 447, Dillon LJ).

The limits on this basis of liability depend upon the reason why the distribution was unlawful. For instance, if the dividend is unlawful because it is in excess of the distributable reserves, it is only unlawful to the extent of the excess (*Re Marini Ltd [2003] EWHC 334).*

(3) Breach of directors' duties

A number of duties owed by directors may become relevant in the context of an insolvent company with tax debts:

(1) Duty to act within powers/for the purposes for which they are conferred (CA 2006, s.171). In order to fall foul of this duty, the improper purpose must be the primary purpose (or, perhaps, a but-for cause) (*BTI 2014 LLC v. Sequana SA* [2019] EWCA Civ 112, §233).
(2) Duty to promote the success of the company (s.172). In *Re Vining Sparks UK Ltd* [2019] EWHC 2885 (Ch), it was held that contributions to an EBT tax scheme were not dishonest, in the sense that they were made otherwise than with a view to promoting the success of the company.
(3) Duty to exercise independent judgment (s.173).
(4) Duty to exercise reasonable care, skill and diligence (s.174).
(5) Duty to avoid conflicts of interest (s.175).
(6) Duty not to accept benefits from third parties (s.176).
(7) Duty to declare interest in proposed transaction or arrangement (s.177).

There is also a duty to consider the interests of creditors, but this is only triggered if the company is or is likely to become insolvent (*Sequana SA,* §220). This can catch dividends that are otherwise lawful if they leave the company unable to pay debts when due:

> "[224]...The problem facing his submission is that, even in the case of an insolvent company, Part 23 does not

> occupy the whole field. An example will show this. The latest accounts of a company show distributable profits and the directors propose to pay a dividend that does not exceed those profits. There has been no diminution in the value of the company's assets since the date of the accounts nor have the total liabilities increased since that date. The payment of a dividend would not therefore represent a return of capital. However, the dividend would exhaust the company's cash resources and, let it be assumed, the company would be unable to raise cash from other sources after the dividend was paid. Payment of the dividend would therefore leave the company unable to pay its debts as and when they fell due. The company would be insolvent on a cash-flow basis, but not on a balance sheet basis. Part 23 would not prohibit the payment of the dividend, but the creditors' interests duty established by the authorities would do so. It would be a breach of duty by the directors to pay the dividend, and it would not be open to ratification by the shareholders." (*BTI 2014 LLC v. Sequana SA* [2019] EWCA Civ 112)

It is not just persons who are formally appointed as directors who are subject to these responsibilities – so are *de facto directors, i.e. persons who act as directors, even though not formally appointed:*

> "[39]...All one can say, as a generality, is that all the relevant factors must be taken into account. But it is possible to obtain some guidance by looking at the purpose of the section. As Millett J said in *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180, 182, the liability is imposed on those who were in a position to prevent damage to creditors by taking proper steps to protect their interests. As he put it, those who assume to act as directors and who thereby exercise the powers and discharge the functions of a director, whether validly appointed or not,

> must accept the responsibilities of the office. So one must look at what the person actually did to see whether he assumed those responsibilities in relation to the subject company." (*HMRC v. Holland* [2010] UKSC 51)

A common instance where liquidators seek to find breaches of one or more duties is where assets of the company are distributed on the basis of accounts that do not make provision for potential tax debts.

> "[95] I comment that from this date, to enter into an arrangement which sought to achieve a distribution of assets, without regard to the requirements of statute, and without making proper provision for creditors was, itself a breach of duties which directors owe to a company: *MacPherson v European Stategic Bureau* [2000] 2 BCLC 683 paragraph 48. Having reached the conclusion above, the expenses paid to Mr Flanagan in March 2013 constituted a breach of duties. The Company was not bound, at the date of the expense payment, to make the payment. The Company owed a duty to its creditors to keep its property inviolate and available for the repayment of its debts." (*Re Implement Consulting Limited* [2019] EWHC 2855 (Ch), ICCJ Briggs)

A provision is required to be made if the tax liability is more likely than not to exist (*HMRC v. Holland* [2008] EWHC 2200 (Ch), Mark Cawson QC, §§196 - 199). One judges this by references to a reasonably objective view of the facts as known or reasonably ascertainable by those taking the decision to pay the dividend.

The consequence of a breach of directors' duty is usually that the director is required to restore moneys wrongfully paid out – for instance, to compensate the company for the sum that was paid out by way of unlawful distribution.

There is, however, a discretion to excuse a director for breaching his/her duties:

"(1) If in proceedings for negligence, default, breach of duty or breach of trust against—

(a) an officer of a company, or

(b) a person employed by a company as auditor (whether he is or is not an officer of the company),

it appears to the court hearing the case that the officer or person is or may be liable but that he acted honestly and reasonably, and that having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused, the court may relieve him, either wholly or in part, from his liability on such terms as it thinks fit." (CA 2006, s.1157(1))

In this respect, conduct can be reasonable, even if it amounted to a lack of reasonable care:

"[225] In *Re D'Jan of London Limited* (supra) at 564, Hoffman LJ pointed out that the wording of Section 727 itself contemplates that conduct may be reasonable for the purposes of Section 727, despite amounting to lack of reasonable care at common law.

[226] By extension, it seems to me that it would be at least possible for conduct to be held to be "reasonable" for the purposes of Section 727, even though the conduct complained of was of a failure to make provision, when, on a reasonable objective view, provision ought to have been made for HRCT." (*HMRC v Holland* [2008] EWHC 2200 (Ch), Mark Cawson QC)

It may also be particularly relevant to consider the extent to which the distribution could lawfully have been made:

"[413] While I do not accept that the discretion in s.1157

> is fettered such that the court can never relieve a director from liability in circumstances where he or she is the recipient of the unlawful dividend, even where the company subsequently goes into liquidation so that the retention of the dividend can be said to be at the expense of creditors, I nevertheless accept that the fact that a director received an unlawful dividend at the expense of creditors is a powerful factor against granting relief. Whether that factor is enough to preclude relief being granted will depend upon matters such as the causal link between the dividend and prejudice to creditors, the length of time between the dividend and the action being commenced and whether the director retains the benefit of the dividend.
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> [414] Of particular relevance, therefore, is the extent to which the Distribution could lawfully have been made in the circumstances existing at the time (this being recognised as a potentially relevant factor by Robert Walker LJ in *Bairstow v Queens Moat Houses plc* [2002] BCC 91, at [36], and by HHJ Seymour in Marini)." (*Burnden Holdings (UK) Ltd v. Hunt* [2019] EWHC 1566 (Ch), Zacaroli J)

This principle is often of significance in EBT cases, where the contributions to the trust were made at a time when the company had sufficient funds to have declared dividends, but, by the time the tax consequences have been determined, was insolvent.

Reliance on professional advice in respect of the tax consequences is also often a significant factor in demonstrating reasonableness.

By way of example, relief was granted when relying on professional advice regarding tax up until the point when

leading Counsel advised that the scheme did not work in *HMRC v. Holland* (High Court, §§236 – 269), but was refused in Re Loquitur where there was no genuine belief that the scheme would work.

It is also important to remember that, although controlled by the liquidator, it is the company who has the right to bring a claim against the directors and it may be that the alleged breaches were ratified by the company (acting through its shareholders) at the time. This is often referred to as the "Duomatic principle", but that principle does not apply if the company is insolvent or likely to become insolvent at the time (*Burnden Holdings (UK) Ltd*, §402).

(4) Other grounds of potential liability

Apart from the above, liquidators will often consider whether a number of other grounds for recouping the company's losses are available. These include:

(1) Transactions at undervalue within two years before the onset of insolvency (IA 1986, s.238 onwards).

(2) Transactions at undervalue at any time for the purpose of prejudicing creditors (IA 1986, s.423).

It was held in *Sequana SA* that a dividend is a transaction within the scope of s.423. Furthermore, although a dividend is not a gift, it is for no consideration. On the other hand, employee remuneration packages are not generally regarded as transactions at undervalue.

In order to fall within s.423, the purpose of prejudicing creditors need only be a purpose, but must be more than a mere consequence.

(3) Unlawful preference of a creditor (IA 1986, s.239) – the preference must be influenced by the purpose of putting that person in a better position, but this is presumed if the person is connected with the company.

(4) Wrongful trading (trading when the person ought to have

known there was no reasonable prospect of avoiding insolvent liquidation) (IA 1986, s.214).

(5) Fraudulent trading (trading with the intent to defraud creditors or any other fraudulent effect) (IA s.213).

When faced with claims based on such grounds, the potential defences depend very much on the facts. The court has a discretion as to the remedy to grant, subject to not granting any remedy (IA, s.212, *HMRC v. Holland*, §§49 – 51) and this may be used in a similar way to the discretion to excuse directors from breaching their duties. Equally, and in every case, it is important to consider limitation periods for any claim, although these raise complex issues of their own.

Conclusion

It can be a seductive thought for persons involved with companies that have built up significant tax debts to simply let the company fall into insolvent liquidation and "walk away" in reliance on the principle of limited liability. Increasingly, the reality is that at some point such persons receive a tap on the shoulder from the liquidator (or a litigation funder who has purchased claims from the liquidator), that will quickly disabuse them of this notion.

The nature of negotiations with such liquidators/litigation funders is not similar to negotiation with HMRC. HMRC are bound by their litigation and settlement strategy and usually see no scope to split the difference or do a deal. Liquidators/litigation funders, however, are generally entirely commercial in their outlook. At the end of the day, they are interested in how much they believe they can claim, the strength of the claim and how much the proposed defendant can afford to pay. They are often very interested in doing deals, but getting the best deal depends upon proper strategy and understanding of the defendant's position.

A final point to mention in respect of company insolvency is the prospect of directors' disqualification. For some, the possibility of being barred from acting as a director for a number of years is something that can be lived with, but for others it can be a fundamental point that guides their whole approach to the potential insolvency of their company. Once again, proper strategy and understanding of the individual's legal position is essential, but identifying the risk in the first place (rather than, for instance, simply diving in with a liquidation) is key to being able to seek to manage it.