

Challenging Director Remuneration

What's in a label?

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On the menu...

- A reminder of some key principles.
- *Re Implement Consulting Ltd* [2019] EWHC 2855 (Ch).
- *Re Vining Sparks Ltd* [2019] EWHC 2885 (Ch).
- *Re Chalcot Trading Ltd* [2020] EWHC 1054 (Ch).
- Some conclusions.

A reminder...

A reminder of some key (legal) principles:

“The appointment of a person as a company director does not make that person an employee of the company. A director is the holder of an office. Nor does appointment as a company director of itself bring into being any contract between the director and the company. Many directors will have contracts of service running in parallel with their status as officers of the company. But they are distinct legal relationships.”

Ranson v Customer Systems plc [2012] EWCA Civ 841

A reminder of some key (legal) principles:

- Office-holder (service agreement?) / employee / worker / shareholder.
- Remuneration by way of fees (Reg 82, Table A (ordinary resolution)) / salary and other benefits.
- Loans to directors (s. 197 CA 2006, *Champagne Perrier-Jouet SA v HH Finch Ltd* [1982] 1 WLR 1359)
- Distributions (s. 830 et seq CA 2006) and unlawful returns of capital.

Re Implement Consulting Ltd

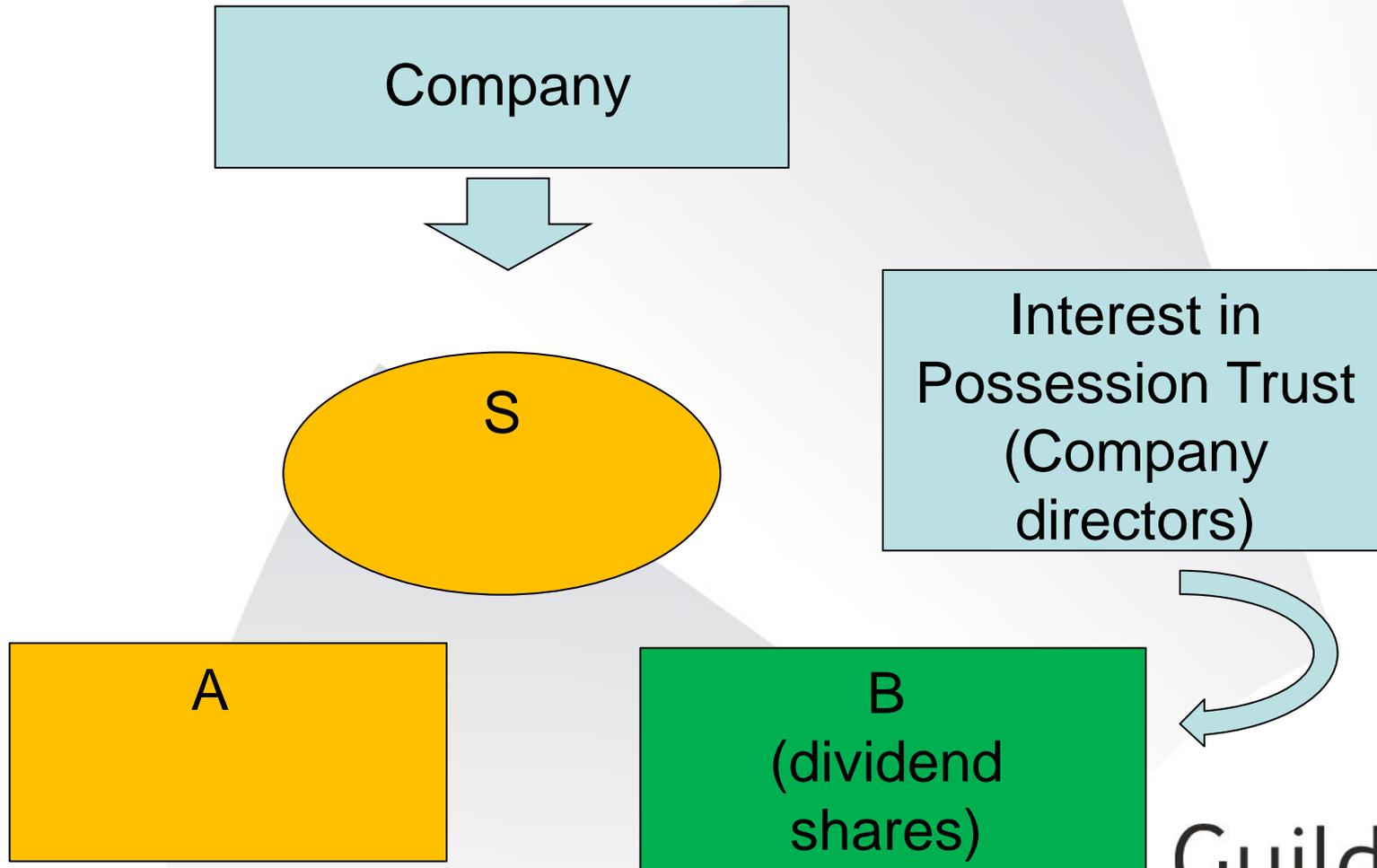


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Toone v Ross (Re Implement Consulting)

- *Toone v Ross (Re Implement Consulting Limited)* [2019] EWHC 2855 (Ch)
- ICC Judge Briggs
- Payments of circa £2.3m between October 2009 and June 2013.
- HMRC was the Company's primary creditor. Most of HMRC's debt related to unpaid tax on the EBT payments.

The scheme (in brief)



Arguments

- Were the payments to the EBT/IIP distributions which were *ultra vires* the Company?
- Were the payments made at a time when the interests of creditors should have been considered to be paramount due to the Company's insolvency?
- Was s.423 engaged?

Distributions

- Did the court have to accept the trust deed at face value? Or should the court look at the substance? How are the payments to be characterised?
- Pennycuik J in *Ridge Securities Limited v Inland Revenue* [1964] 1 WLR 479 (at 495):

*“A company can only lawfully deal with its assets in furtherance of its objects. The corporators may take assets out of the Company, by way of dividend or, with the leave of the court by way of reduction in capital, or in a winding up.... **They cannot take assets out of the company by way of voluntary disposition, however described, and if they attempt to do so, the disposition is ultra vires the company.**”* (emphasis added)

Re Lee: three stage test

- *Re Lee, Behrens and Co Ltd* [1932] 2 Ch 46:
 - (i) Is the transaction reasonably incidental to the company's business?
 - (ii) Is it a bona fide transaction?
 - (iii) Is it done for the benefit and to promote the prosperity of the Company?

Label or reality?

“The manufacture of a five-pronged implement for manual digging results in a fork even if the manufacturer, unfamiliar with the English language, insists that he intended to make and has made a spade”

Per Lord Templeman in *Street v Mountford* [1985] AC 809.

Re Implement at [61]:

“I reject the submission.....that the only basis of attacking the payments made to the trust is to allege that the trusts were a sham. It is not necessary to frame the trusts as shams in order to establish the true nature of the transaction.”

Application

- Money always ended up with the shareholding directors
- Money always came from the reserves of the Company
- Not paid for the benefit of non-shareholders employees
- No distinction made by the directors between the interests of the shareholders and the interests of the Company
- References in the evidence to “disguised dividends”

Therefore in substance the transactions were returns of capital which did not comply with the Companies Act and were unlawful.

Vining Sparks UK Ltd



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Vining Sparks – the Facts

- The company was a commission agent introducing securities transactions to its US-based parent.
- Following advice from Baxendale Walker (and others), an Employee Scheme was set up in 10/02.
- Structure involved: trust / sub-trust / loan to a Ltd co / loan to employee (family).
- Company closed in 2014; w-u order on 29/02/16, liquidators appointed 31/03/16.

Vining Sparks – the Claim

- Particulars of Claim alleged breach of ss. 172-176 CA 2006 (but at trial, this was narrowed to s. 172)
 - No allegation of breach of duty of care (s. 174).
 - No allegation of insolvency / interests of creditors.
 - No allegation of sham / lack of authorisation.
 - But, there was an allegation of dishonesty.
- Fraudulent trading (s. 213 IA 1986).

Vining Sparks – the Defence

- No breach of duty to promote the success of the company.
- Mr B (the relevant company director) acted honestly, relied on advice and was transparent with HMRC.
- The company's parent authorised / acquiesced / ratified the actions.
- Limitation / causation / s. 1157.

Vining Sparks – the Decision

“Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be.”

IRC v Westminster (Duke) [1936] A.C.1 (Lord Tomlin)

Vining Sparks – the Decision

Mr B. as a witness:

“an honest and helpful witness. He was serious, considered each question carefully and in my judgment sought to provide truthful answers. Insofar as there are issues concerning his recollection, I am satisfied this will be attributable to the memory problems mentioned.”

Vining Sparks – the Decision

- Mr B acted honestly, and relied upon (and believed) the advice (and although it was unwise not to obtain independent advice or HMRC clearance, that didn't mean it was a breach of duty) which wasn't obviously in error.
- The artificial features of the scheme did not mean the scheme was dishonest.
- Defences (*obiter*): if dishonesty had been established, acquiescence (etc..) and limitation would have failed.

Chalcot Trading Limited

Re Chalcot

- *Chalcot Trading Limited v Stoneham (Re Chalcot Trading Limited)* [2020] EWHC 1054 (Ch)
- Decision of Michael Green QC (sitting as a deputy).
- Decision is currently being appealed.

Facts

- Company (by the same director who entered into the transactions) argued that the tax avoidance scheme was in substance a distribution and therefore should be unwound.
- Company wanted to avoid the liability for tax on the scheme which would exist if the scheme was valid. HMRC had challenged the validity of the scheme.
- Scheme creation of 'E' and 'F' shares to avoid tax on payments to directors and reduce corporation tax. 'Rewards' to directors were paid after the directors took the option to subscribe for new shares (which were created by amendments to articles).
- The directors paid 1% 'to acquire shares and then received 100% of 'Rewards' by credits to a directors loan account. There could be a call on the shares if directors left the Company (but no calls had been made).

Issues

- Were the payments distributions or remuneration?
- If the payments were not unlawful distributions, then were the payments unlawful discounts or commissions (contrary to s.552-553 Companies Act 2006)?
- Should the 'E' and 'F' share agreements be set aside on grounds of mistake?

Characterising the payments

- Should the court ignore the substance and look to the label? Or was the issue whether there had been a genuine exercise of the power to award remuneration by the directors?
- Was the power ultra vires the Company? Court declines to follow *Re Lee* and the three tests when looking to see if a transaction is within the Company's corporate capacity i.e. (i) is the transaction reasonably incidental to the carrying on of the company's business; (ii) is it a bona fide transaction; (iii) is the transaction for the benefit and to promote the prosperity of the company?

Rejection of *Re Lee*

- Ultra vires doctrine “abolished” by s.39 CA 2006.
- Declines to follow *Toone (Re Implement)* (at [165]) by saying “*There does not seem to have been any consideration as to whether there was a genuine exercise of the power to award remuneration*”. Notes the differences between the cases and the inconsistent approach to the transaction from a Company/tax law perspective.
- *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] Ch 246 where Slade LJ stated that the *Re Lee* tests “...should in my opinion, now be recognised as being of no assistance, and indeed positively misleading, when the relevant question is whether a particular gratuitous transaction is within the company’s corporate capacity.”
- *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016: “The real test must, I think, be whether the transaction in question was a genuine exercise of the power [to award remuneration].”

Test adopted

- The test is whether there was a genuine exercise of the power to award remuneration. This is not a purely objective test.
- *“In deciding whether there was a genuine exercise of the power to award remuneration, particularly in a solvent company, the directors will be judged in the way that other commercial decisions are adjudicated upon; the Courts will generally not interfere in commercial decisions taken by directors and a wide “margin of appreciation” is allowed”*

Characterisation—application of the test

- Purpose of the scheme was to provide employment related remuneration whilst avoiding tax liabilities.
- Documentation reflected that the scheme was employment related.
- The accounts recorded the payments as remuneration.
- It was not determinative that there was no exchange of value (i.e. increasing share capital liability and not distributable reserves) or that the payments were calculated by reference to business profits and in accordance with shareholdings.
- The individuals at the time perceived the payments to be remuneration for services and not distributions.

Queries with decision

- Slade LJ went on to say (in *Rolled Steel*) (which is not quoted) “[T]o this extent the tests should, I think, be finally laid to rest, though they may well be helpful in considering whether or not in any given case directors have abused the powers vested in them by the company.”
- See also *MacPherson v European Strategic Bureau Ltd* [2002] BCC 39 which adopts the *Re Implement* approach in the Court of Appeal and the *Re Lee* test.
- S.39 CA 2006: “[T]he validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution”

Some concluding thoughts...

Conclusion

- Approach of ICCJ Briggs is closer to CoA (*McPherson*) than Michael Green QC's approach: *Implement* to be preferred?
- Initial analysis and identifying and then selecting the correct cause of action is likely to be critical.
- In the case of EBTs, difficult interplay between company law / insolvency law & tax law (e.g. the distinction between mitigation / avoidance / evasion).