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# Directors' concerns: Distributions and dividends

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## Distributions and dividends

It is a fundamental principle of company law that the property of a company belongs to itself and not to its shareholders. For that reason a company cannot simply pay or distribute its property to its shareholders. The Companies (Jersey) Law 1991 (the **Companies Law**) sets out requirements that must be satisfied before such a payment or distribution may be made.

When a company is considering making a payment, therefore, one of the important issues for a director to consider is whether or not the payment might be characterised as a distribution under the Companies Law. For the purposes of the law a 'distribution' is a payment or distribution by a company of its assets to its shareholders as shareholders, whether in cash or otherwise. The key point in this description is that the assets that the company is distributing are paid to shareholders because they are shareholders and not, for example, because they are creditors (like suppliers or employees). This is a question of fact and so this wording can cover not only payments by the company where the directors have specifically resolved to make a payment to shareholders, for example by paying a dividend, but also other payments, whatever the intention and whatever they are called, if, as a matter of fact, they are paid to a shareholder because he is a shareholder and not only for some other reason such as payment of a service fee or a debt.

In addition, the law will only regulate a distribution if:

- the distribution reduces the net assets of a company; or
- is in respect of shares which are required to be recognised as a liability in the accounts of the company (eg preference shares).

Any question as to whether a distribution reduces the net assets of the company is to be determined in accordance with generally accepted accounting principles adopted in the most recent accounts of the company (or proposed to be adopted in the case of the company's first accounts).

The emphasis on net assets being reduced should help the clarification of certain transactions. For example, the mere entry into of a guarantee in relation to the indebtedness of a shareholder should not normally reduce the net assets of the company if it is unlikely that the guarantee would be called. In such a case, under UK GAAP, the guarantee should not need to be recorded in the accounts of the company as a provision (ie as a liability) and therefore would not reduce the net assets of the company. If, however, when entering into the guarantee it is considered more likely than not that the guarantee will be called, then the guarantee should be recorded as a provision in the accounts of the company and this would therefore reduce the net assets of the company. In such a case, it would be necessary to treat the entry into of such a guarantee, which is recorded as a liability, as a distribution which should be made in accordance with the distribution procedures of the Companies Law.

Where a payment is to be made to a shareholder as shareholder and the law regulates the distribution (eg because the net assets of the company will be reduced), the law sets out a solvency test that must be applied with a view to protecting the company and people dealing with the company. The directors who approve the payment must satisfy themselves that making it, (for example, when paying a dividend), will not leave the company unable to pay its debts and that the company will continue to be able to meet its liabilities for a year after making the payment. Moreover, the company may not make the payment unless the directors have signed a statement to that effect in the form set out in the Companies Law. Provided that the directors can make the statement as to solvency, a company may make the payment from almost any account of the company. Since 2008 it has not been necessary for directors to consider, for the purposes of making a distribution, whether there are distributable profits and whether they are realised or unrealised. If a director makes the statement as to solvency without reasonable grounds, the director is guilty of an offence and so each director must make proper enquiries about the solvency of the company before approving the payment. If a distribution, such as a dividend, is not paid in accordance with the requirements of the Companies Law, a shareholder who receives it may also be obliged to repay the amount received to the company if the shareholder knew, or had reasonable grounds for believing, that the law had not been complied with.

In addition to the solvency test under the Companies Law, the directors must also have regard to their duties under that law and under customary law to act with a view to the best interests of the company. If a director authorises a payment that is a distribution for the purposes of the Companies Law, in breach of the director's duties and without considering the best interests of the company, such director may

become personally liable to repay to the company some or all of the payment made, even if the director is not a shareholder and receives no benefit from the payment.

Dividends and distributions come in a number of forms and different considerations apply to the different forms. Dividends may, for example, be paid or payable:

- as final dividends or as interim dividends;
- in cash or in kind;
- from time to time or according to a schedule as a preferential right; or, even,
- inadvertently, where an agreement provides for a payment the legal character of which is a distribution, whether or not it is identified as a dividend.

While the requirement for a declaration of solvency before a payment can be made applies to dividends of every sort, the Companies Law does not otherwise set out detailed corporate procedures or mechanisms for making these payments. Instead, the procedures that a company follows are usually set out either in its articles of association or have developed as a matter of common practice.

### **Final and Interim Dividends**

Final dividends are usually paid once a year and are calculated after the annual accounts have been drawn up. The usual procedure for payment of a final dividend is that, having made the necessary declaration of solvency, the directors recommend to the shareholders an amount. Payment of the dividend is then approved and declared by the shareholders. They may approve payment of a lower amount than has been recommended by the directors but not a higher amount. Once the shareholders approve the payment of the dividend it becomes a debt due by the company to the relevant shareholders from the date on which it is due to be paid.

The usual process for declaring an interim dividend is simpler than it is for a final dividend. Interim dividends may be paid at any time through the year and are calculated before the company's annual earnings have been determined. The solvency requirements set out in the Companies Law apply to interim dividends as much as to final dividends but the articles of association usually provide that they can be decided upon solely by the directors and, unlike final dividends, can be paid without shareholder approval. Also unlike final dividends, declaration of an interim dividend does not generally create a debt enforceable if the dividend is not paid because the directors can always rescind their resolution to pay the dividend at any time before it is actually paid. The law does not prescribe whether dividends should be declared as final dividends or paid as interim dividends but, despite the attractiveness for directors of the simpler process, it is not generally considered good practice for companies to attempt indefinitely to get around the need for a shareholder vote in relation to a final dividend by paying a series of interim dividends.

### **Cash and Kind**

As well as deciding whether a dividend should be paid as an interim dividend or as a final dividend, directors may have to consider whether the dividend should be paid in cash or, if the company's articles permit it, in kind by a transfer of an asset of the company to a shareholder. A dividend that is paid in kind is often referred to as a dividend *in specie*. Whether or not a dividend in kind is appropriate is likely to be determined by the circumstances in which it is to be declared. It can be helpful to pay a dividend in kind, for example, when a company is being wound up and has assets that the shareholders would prefer to receive directly. Before resolving to pay a dividend in kind, the directors must, of course, consider the solvency of the company but must also consider the provisions of the company's articles of association carefully in order to determine the procedure. In particular it is common for the articles of association of a Jersey company to provide that a dividend may only be paid in kind where the directors have recommended it and the dividend has been approved by the company in general meeting. Where the articles of association are in those terms, an interim dividend declared by the directors without shareholder approval would not be able to be paid in kind.

### **Preferential dividends**

Subject to the articles of association of the company, dividends may be recommended by the directors and declared at any time. It is not uncommon, however, for shares to have attached to them a right to receive a dividend in priority to any dividend payable on the ordinary shares. There are many possible variations in such rights but it is quite common for rights attaching to preference shares to specify a fixed

dividend, payable on specified dates and for the dividends to be cumulative so that if a dividend is not paid on its due date for any reason, the right of the shareholder to receive that sum is not extinguished but accumulates as a debt owed to the shareholder until it is paid. Whilst such rights may be devised so that they have characteristics similar to debt (and are, for that reason, often used in connection with venture capital investments) there can be no absolute right to be paid a dividend at a particular time. The usual rules applicable to making distributions and paying dividends continue to apply so that the requirements set out in the law, including the making of a solvency statement in relation to each payment, must be satisfied if the dividend is to be paid lawfully. One of the consequences of this is that although share rights can create an expectation of payment and have the effect of giving the directors an obligation to consider making the payment at the relevant time, they cannot provide for dividends to be paid automatically.

### **'Inadvertent' distributions**

As described earlier, the Companies Law identifies a payment, such as a dividend, as a distribution by reference to what is paid (company assets), to whom it is paid (a shareholder) and in what capacity (as shareholder). It then imposes requirements which must be satisfied if the payment is to be lawful. The effect of this is that although not every payment that is made by a company to a shareholder is a distribution, it is possible for a company to agree to make a payment that is, in fact, a form of distribution even though it appears to be only, for example, a contractual obligation like a debt or even a payment as part of a statutory procedure. If the true character of the payment is not recognised, the risk for both the directors and the recipient is that the proper procedure will not be followed with the consequence that the company may need to be reimbursed. In an English case the High Court confirmed that where a payment is properly characterised as a distribution, the statutory procedures apply and must be followed even if, as a matter of fact, the interests of creditors and others would not be prejudiced if the statutory requirements were not followed. The statutory procedures in Jersey are not the same as under English law but there is no reason why the principle that the relevant statutory procedures must be followed in all circumstances should not apply in Jersey as it does in England.

Circumstances in which a payment to a shareholder might, in fact, be a distribution for the purposes of the Companies Law, even though looking like something else may arise in many circumstances including, for example:

- an agreement by one subsidiary to sell an asset to a sister company at less than its market value. In this case, what looks like a straightforward sale of an asset may in fact be a distribution to the common parent of the parties of the amount of the undervalue which would require a solvency statement by the directors; or
- an agreement by a company to pay the cost of an accountant's report into that company, prepared for the benefit of a shareholder or to pay legal fees incurred by a shareholder in connection with acquiring additional shares. This looks like a payment for services supplied by the reporting accountant or the lawyers but it may also be a benefit for the shareholder as a shareholder and, if it is, it would be a distribution by the company, requiring a solvency statement by the directors.

### **Practical steps**

In view of the consequences for a company and for the directors personally if a payment that is a distribution for the purposes of the Companies Law is made unlawfully, there are a number of practical questions that a director should ask before approving a payment. These include:

- what is the character of the payment? Is it a payment to a shareholder as shareholder or is it made for some other reason?
- who benefits from the payment or the transaction? Does the payment or the transaction have the effect of benefitting (even indirectly) a shareholder as shareholder?

It should also be considered whether the payment:

- reduces the net assets of the company; or
- is in respect of shares which are recognised as a liability in the accounts of the company (eg preference shares).

If the answer to these questions is that the payment is a distribution for the purposes of the Companies Law, the directors must ensure that they have satisfied the requirements of the Companies Law for making distributions.

Where the character of a payment that is proposed to be made is recognised as a distribution and the directors intend that it should be a dividend, again there are practical things that should be thought about. These include:

- is it to be an interim dividend or a final dividend?
- how much should be recommended or approved for payment?
- is it to be paid in cash or in kind?
- is the company solvent and able to satisfy the requirements of the Companies Law? Is the payment to be made out of profits only or is it to be funded, as the law allows, from other sources? The question is sometimes raised as to whether a distribution that is funded from sources other than profits, even though legal, is properly a dividend or some other form of distribution. This is a question that may be important for the shareholders who receive the payment.
- what procedures and mechanisms do the company's articles of association prescribe for payment of a dividend of that type? Do they permit payment by BACS or is payment by cheque or warrant specified? What happens if a dividend payment is not cashed or collected?
- which shareholders are entitled to receive the dividend? Should a record date be set, fixing the shareholders eligible to receive the dividend by reference to those shareholders on the register at a particular date?
- what should be the date for payment of the dividend?

As the people responsible for the company, the directors owe their duties only to the company and must exercise their powers in its best interests. In doing so, however, they must also treat fairly anyone who is affected by the powers that they are exercising, including the shareholders. This difficult area of judgment is one that directors are particularly called upon to exercise in relation to any distribution of the company's property. With careful analysis of the nature of any payment being made and scrupulous attention to the procedures required by the law, it should be possible to avoid the traps but, if in doubt, a director should always take professional advice.

### **Court order ratifying a distribution made in contravention of the law.**

If a distribution is made in contravention of the law, it is possible to apply to the Royal Court for an order that the distribution is to be treated as if it had been made in accordance with the law. For example, the directors may have paid a dividend without the necessary solvency statement having been made and wish to apply for such a court order so that the position may be regularised.

The Royal Court may make such an order if it is satisfied that **certain solvency conditions are satisfied** and it does not consider that it would be contrary to the interests of justice.

### **Contacts**

A full list of contacts specialising in corporate law can be found [here](#).