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UK Court of Appeal: Creditors Can Seek to Reverse Lawful Dividend Payments

Ruling provides helpful reminder to directors, companies, and creditors that Section 423 of the Insolvency Act 1986 applies even outside of insolvency.

Background

The UK Court of Appeal has upheld a decision that a dividend payment by a subsidiary to its parent company may constitute a transaction at an undervalue within the meaning of Section 423 of the Insolvency Act 1986 (s. 423). The ruling brings welcome clarity about the wide remit of s. 423.

S. 423 is increasingly being viewed as a useful tool for actual or potential creditors to prevent a company from disposing of valuable assets. This is because a creditor (whether actual or potential) can bring such action directly against the debtor company, and in doing so, would *not* need to show any of the following facts:

- The creditor has a proprietary right in the asset being disposed of, or the company was subject to a contractual obligation not to dispose of the asset.
- The debtor was or is insolvent.
- The relevant transaction was undertaken dishonestly or for fraudulent purposes.

However, a creditor must demonstrate that the relevant transaction was undertaken for the purpose (but not necessarily the sole or dominant purpose) of putting assets beyond its reach or otherwise prejudicing its interests.

This *Client Alert* considers the appeal on the basis of the court's application of s. 423. The *Client Alert* [UK Court of Appeal: When to Trigger the Creditor Duty Shift](#) discusses the other aspect of the judgment, which saw the court tackling the question of when directors' fiduciary duty to have regard to the interests of creditors is triggered.

Case Facts

Arjo Wiggins Appleton Limited (AWA) paid two large dividends to its parent company, Sequana SA (Sequana), at a time when AWA had ceased trading and was subject to contingent liabilities in respect of indemnities for cleanup costs and damages arising out of river pollution in the United States. AWA set off the amount of the dividends against part of an inter-company debt that Sequana owed AWA.

The claimant (who through its parent was a potential creditor of AWA, in respect of the above-mentioned indemnities) challenged both dividends on the basis that:

- The dividends were paid in breach of the AWA directors' duty to have regard to the interests of AWA's creditors (which the court termed the "should not pay" claim).
- In any event, the payment of the dividends fell within s. 423.

At first instance, Justice Rose dismissed the "should not pay" claims but accepted the s. 423 claim. The claimant appealed against the dismissal of the "should not pay" claim, and AWA appealed against the High Court's decision that the second (so-called "May") dividend payment fell within the meaning of s. 423.

S. 423 Overview

S. 423 applies when a company enters into a transaction at an undervalue (including for no or inadequate consideration, or when providing a gift) in order to either:

- Put assets beyond the reach of a person who is making, or may at some time make, a claim against the company
- Prejudice the interests of such a person in relation to a claim that the person is making, or may make

The court may grant wide-ranging remedies designed to restore the company's position to what it would have been had the relevant transaction not been entered into, and/or to protect the interests of victims of the transaction.

Whether the purpose of a transaction has been to put assets beyond the reach of potential creditors will be a question of fact. The court will seek to determine the subjective intention of the person who transferred the assets (*i.e.*, what they sought to achieve). The specified purpose does not need to be the sole or dominant purpose, but it cannot merely be a consequence.

Ruling

Did the payment of dividends fall within the scope of s. 423?

The court considered two grounds of appeal by Sequana. The first was that a dividend is not "a transaction at an undervalue", and the second was that the dividend was not paid with the purpose of putting assets beyond the reach of creditors.

In dealing with the first ground, the court considered whether:

- A dividend is a "gift" within the meaning of s. 423
- A dividend is a "transaction for no consideration" within the meaning of s. 423
- A dividend payment is a "transaction" within the meaning of s. 423

The court held that the dividend payments were not gifts within the meaning of s. 423. Dividends are paid pursuant to the rights attached to shares, pursuant to the terms of issue or by the Articles of Association, and for which consideration was given by each shareholder, or original subscriber of the share. The court concluded that:

Dividends are both commercially and legally a return on the investment. It would be startling to categorise dividends as gifts made by a company to its shareholders.

However, the fact that dividends were paid in accordance with the rights attached to the shares did not mean that a company received consideration for the dividend payments. The court held that the terms of dividend payments (in particular, the fact that they are discretionary and paid using funds owned by the company, not its shareholders) do not provide for companies to receive any consideration. As such, the court concluded that the payments did constitute a “transaction for no consideration”.

As to whether dividend payments constitute a “transaction” within the meaning of s. 423, the court held that there was no policy reason to distinguish between gifts (which were within s. 423) and other unilateral transactions, such as the payment of dividends.

Sequana argued that the application of s. 423 to dividend payments would “cut across” the statutory regime in Part 23 of the Companies Act 2006, which determines the profits that a company may lawfully distribute to its shareholders. The court rejected this argument on the basis that Part 23 expressly allows for “any enactment” to restrict the amount or manner in which dividends are paid. The court also reasoned that:

... there is no conceptual difficulty in an otherwise lawful dividend being paid for the purpose of putting assets beyond the reach of actual or potential claimants, and there is no difficulty in envisaging a dividend being paid for that purpose. (para 62)

With regards to the second ground of appeal, the Court of Appeal agreed with Justice Rose’s decision at first instance that the evidence clearly showed that the May dividend was paid for the purpose of putting assets beyond the reach of a creditor, as the payment was made in order to wipe out the intercompany receivable owing by Sequana to AWA. As a result, AWA could be sold and Sequana could be free of any risk of having to fund the potential indemnity liability.

Remedies for breach of s. 423

At first instance, Justice Rose ordered Sequana to pay sums up to the value of the dividend plus interest. The court was reluctant to interfere with the High Court’s discretionary ruling, which had factored in uncertainties associated with the underlying liability.

However, the court did disagree with Justice Rose’s decision as to the start date for activating the higher rate of interest. The court instead agreed with Sequana that the appropriate start date ought properly to have been the date of commencement of the s. 423 proceedings.

Implications

As highlighted in [a prior Client Alert](#), the provision is likely to be of increasing interest to both existing and prospective creditors. Although cases involving disposals of assets frequently arise, this matter confirms that the payment of a dividend, even if made in accordance with the corporate statutory regime, can be reversed if its purpose was to put assets beyond the reach of those who might have a claim. Therefore when considering the payment of a dividend, the company and the recipient shareholder should assess the potential application of s. 423, particularly if the company is no longer trading and has actual or potential liabilities that exceed, or could potentially exceed, its assets.

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