Company Law: Back to Basics - Directors, Shareholders And Company Assets

[00:00:00.000] - Suzanne Kearney, Of Counsel

In today's episode we are discussing the recent Supreme Court decision in McCool v Honeywell and some of the company law issues arising from directors or shareholders buying assets from their company. I'm Suzanne Kearney, Of Counsel in the Corporate and M&A Department in Arthur Cox.

[00:00:17.790] - Tom Courtney, Partner

And I'm Tom Courtney, Partner here at Arthur Cox.

[00:00:21.310] - Suzanne Kearney, Of Counsel

Tom, today is more of a thematic episode, where we are going to discuss a range of legal issues that could potentially arise from a particular fact pattern, that is a director or shareholder buying assets from their company.

[00:00:33.910] - Tom Courtney, Partner

Yes Suzanne, the backdrop to today's podcast is prompted by the Supreme Court decision in McCool v Honeywell Control Systems Limited, which was handed down only a couple of weeks ago. In the course of the three majority and one dissenting judgment, the Supreme Court has revisited issues as basic as the Rule in Salomon and one of the consequences of the fact that a company is a separate legal person, namely that a company cannot be represented in court by a director and must instead be represented by a legal practitioner, known as the Rule in Battle v Irish Art Promotion Centre. It really is quite extraordinary that such basic principles would in 2024 still be matters of contention and result in a majority Supreme Court decision!

[00:01:22.040] - Suzanne Kearney, Of Counsel

Absolutely, Tom. The facts of this case were that a company called McCool Controls Engineering Limited sued the defendant for damages on the grounds that it excluded it from a major construction project, breaching what it alleges was an exclusive distribution agreement between the parties.

[00:01:38.510] - Suzanne Kearney, Of Counsel

As the company could not afford separate legal representation, Mr McCool wanted to represent the company but when confronted by the rule in Battle he resigned as chair, secretary, managing director and majority shareholder, and he arranged for the company to transfer its cause of action to him.

[00:01:54.740] - Suzanne Kearney, Of Counsel

If the assignment was valid this meant that he could litigate the dispute, because individuals are entitled by law to represent themselves – anotherwords. they need not retain a legal practitioner to represent them in court.This was not met with much enthusiasm by either the High Court or the Court of Appeal which rejected the validity of the assignment of the cause of action on three grounds. These were Firstly, that the assignment was not absolute and so did no comply with Section 28(6) of the Supreme Court of Judicature Act (Ireland) 1877 and Second, that the assignment savoured of champerty. It is the third reason, however, which is of particular interest to company lawyers - and that is that the assignment of the chose in action had sought to circumvent the strictures of the decision of the Supreme Court in Battle v Irish Art Promotion Centre in a manner which was abusive.

[00:02:44.830] - Tom Courtney, Partner

In what I think might have been a surprise decision, the Supreme Court upheld the validity of the assignment of the chose of action by the company to Mr McCool, albeit by a majority (Judges Woolfe, Murray and Hogan being the majority) and Mr. Justice Charlton dissenting.The majority decision for the purposes of the rule in Battle can be summarised this: 1) the policy underpinning the rule in Battle is that a company cannot be represented in Court other than by a practising solicitor or barrister, save that a director or shareholder may be heard in exceptional circumstances in order to avoid any injustice; 2) The rule in Battle is not a bulwark for the abuse of limited liability; it did not formulate any new principle of company law and merely declined to create a new exception to a long-established rule of general application i.e that a litigant cannot be represented in court other than by a legal practitioner; 3) The rule in Battle has no application to a situation where, following a valid assignment of a cause of action which complies, the plaintiff in the action is an individual and not a company. As I embark on writing the fifth edition of my book, I must confess that I relished reading the four judgements of our Supreme Court particularly delivered by such outstanding legal minds, on what are really, really basic issues in Irish company law.

[00:04:10.980] - Tom Courtney, Partner

One of the thoughts which occurred to me was, okay, so the assignment was not prohibited for being an abuse of process, or champerous provided that the legal rules around an assignment of a chose in action were complied with, but what about all the company law issues such an assignment throws up? While these were alluded to in a number of the Supreme Court judgements, particularly by Charlton J in his dissenting judgment, the company law issues were not addresseed as they were not before the Court,The assignment of non-cash assets to or from companies to or from their directors can be a minefield in terms of compliance with s 228, fiduciary duties, 238, substantial property transactions and, where the director is also a member of the company, the rules around making distributions if an asset is sold at an undervalue.

[00:05:01.350] - Suzanne Kearney, Of Counsel

It's great to hear that you're working on the fifth edition of your book, Tom. I don't suppose that you would give any indication as to when it might be published. So silence from Tom. I suppose it'll be published whenever it's published. I could not agree more, though, in the points you make in relation to the judgments, and I, too, was fascinated by the four Judges judgements. So now that it is established as being permissible for companies to assign shows in action to their members or directors, I suppose the starting point has to be what the consideration is for the transfer and whether, if less than the book value, the transfer is a disguised distribution. I know you've lots to say in this, Tom, so perhaps let's start at that point. Listeners of our previous episodes will be aware that a distribution can only be made from distributable of profits. So what is a disguised distribution and how might it arise?

[00:05:49.670] - Tom Courtney, Partner

Well, in most cases, a distribution by a company will be very obvious. The company will make a payment or transfer an asset to its members. A classic example is the payment of a dividend. In this context, the directors of the company will be fully aware that the company is making a distribution. They'll follow the necessary steps to ensure that the distribution is carried out in accordance with the Companies Act and the company's own constitution. In including establishing that the company has sufficient distributable profits, and then they'll document the transaction as such in board minutes and where necessary, shareholder resolutions. However, it's also possible for a distribution to arise where it's not labelled as such, and the company and indeed the recipient or recipients are not, in fact, aware that the transaction is a distribution. This occurs where there is a transfer of value from the company to or in favour of the company's shareholders. Disguised Distributions are still distributions, regardless of whether the parties intended them to be such, and therefore, they run the risk of being unlawful, where the statutory requirements for a distribution have not been complied with, including the all-important requirement of having sufficient distributable reserves.

[00:07:03.570] - Tom Courtney, Partner

Disguised distributions can often arise in the context of group reorganisations, where assets are being transferred between group companies, and the sale of an asset to a shareholder is also capable of being a distribution where the value of the assets exceeds the purchase price paid.

[00:07:20.150] - Suzanne Kearney, Of Counsel

And the value of the assets transferred is another aspect to discuss. So Tom, in your example, where the company sells an asset to a shareholder, is it the market value or the book value the asset that's relevant here?

[00:07:32.160] - Tom Courtney, Partner

That's the key question, Suzanne. Yes, Section 119(1) was a very welcome inclusion in the Companies Act 2014, and it applies for determining the amount of a distribution consisting of or including the

disposition by a company of a non-cash asset. So Section 119(1) provides in simple terms that if the company receives consideration and the consideration is the same as the book value of the assets, there is no deemed distribution to members. And to the extent that the consideration the company receives is less than the book value, the amount of the distribution will be the difference between what the company received and the book value of the asset. So if it shows an action has a book value of, say, €1,000 and it's transferred to a member for €1,000, there will be no distribution. If, however, it was transferred for less than €1,000, then the rules on distributions come into play.

[00:08:28.090] - Suzanne Kearney, Of Counsel

So a limited company must have distributable profits of at least the difference between what the company receives and the book value of the asset transferring. To the extent that a company does not have distributable profits, it cannot proceed unless the transaction is restructured. For example, the company receives more consideration in return for the asset or alternatively more distributable profits are created by, for example, reducing or varying the company capital by summary approval procedure or a high court order.

[00:08:55.550] - Tom Courtney, Partner

Another potential issue that comes to mind in the context of transferring a shows of action from a company to a director is Section 238 and substantial property transactions. Again, we recorded an entire episode on this topic, so I would encourage listeners to relisten to that episode for a more in-depth overview. By way of reminder, Section 238 regulates transactions in which a relevant person either acquires a non-cash asset of the requisite value from a company or where a company acquires such an asset from a relevant director. A relevant person can be a director of the company, a director of its holding company, or any persons who are connected with such directors.

[00:09:35.900] - Suzanne Kearney, Of Counsel

We should also note for our listeners that we discuss in detail what constitutes a connected person in our episode on Substantial Property Transactions. Tom I've often heard you describe the restriction under Section 238 as a two-way value, capturing circumstances where companies either acquire or dispose of assets from directors or a person connected with such a director. So, its relevant to the scenario that we are discussing today – where a director of a company might acquire assets from the company.

[00:10:04.550] - Tom Courtney, Partner

Yes, Suzanne and I have another sound bite which I probably mentioned already in the previous episode, but it's very relevant to the scenario we're discussing today and that is one of the greatest hazards to Section 238 is failing to recognise its application. Like a disguised distribution, parties can easily find themselves in contravention of Section 238 without any intent or malice. Section 238 should be a key item on any checklist involving involving the corporate transfer of assets.

[00:10:32.430] - Suzanne Kearney, Of Counsel

And similar to a distribution, falling within scope of Section 238 does not mean that the transaction cannot proceed. Rather, the transaction can proceed once the company obtains the necessary approvals in compliance with the Companies Act. In this case, approval of the members in the form of an ordinary resolution.

[00:10:48.950] - Tom Courtney, Partner

Finally, just to note that from a timing perspective, Section 238 provides that this ordinary resolution must be passed in advance of the transaction being entered into.

[00:10:59.710] - Suzanne Kearney, Of Counsel

The statutory obligation on directors to disclose their interest in contracts under Section 231 might also be relevant to our scenario. Tom – I've often heard you liken Section 231 to Section 238, in that both provisions seek to regulate self-dealing between companies and their directors. While Section 238 requires the members to approve of a substantial property transaction, Section 231 requires disclosure to be made by the director to the other directors.

[00:11:27.910] - Tom Courtney, Partner

Section 231(1) imposes a duty of disclosure on a director who is interested in 'a contract or proposed contract'. But not every contract must be disclosed! Section 231 is only concerned with contracts, the decision to enter into which is taken by the board of directors (or a committee of the board) of which the director interested in the contract is a member. The rationale is that the director with the interest is part of the mind of the company, the mind that decides whether or not it is in the company's interests to enter into that contract. Section 231 ensures that all other directors are aware that one of their number, has a personal interest in the contract. So, in the context of a director buying assets from (or indeed selling to) the company you can see why Section 231 would be relevant.

[00:12:18.590] - Suzanne Kearney, Of Counsel

Again, the potential application of Section 231 does not mean that the transaction cannot proceed. What it means is where a proposed transaction falls within Section 231, the director is required to disclose their interest in the proposed contract at a board meeting, and the declaration must be entered into the Book of Declarations and Interests, which is available for inspection by the officers and members of the company. Of course, while disclosure is required by Section 231, under Section 228 subsection 1(f), directors are obliged to avoid any conflict of interest between their duties to their company and their other, including personal interests, unless relieved of this by either the Constitution or a resolution in general meeting. I know Conflicts of Interest is a topic on which you were very interested, Tom. And indeed, you also have a

very comprehensive Article on Conflicts of Interest, which was published in the Irish Jurist couple of years ago.

[00:13:11.300] - Tom Courtney, Partner

That's right, Suzanne and as I point out in that article, it's very usual for company's constitutions to expressly relieve directors from their duty to avoid conflicts of interest when it comes to their contracting with their company. In fact, the optional provisions expressly relieve directors from the duty to avoid conflicts in the in the context of contracting with their LTDs. Of course, as I always stress, you must always check a particular company's constitution to ensure that either the optional provisions apply and have not been dissaplied, or if they have been dissaplied, that there is a bespoken alternative provided.

[00:13:48.140] - Suzanne Kearney, Of Counsel

I think no episode will be complete, Tom, without you reminding us to check the constitution to see whether the optional provisions apply and speaking of episodes, sadly, this is the final episode in our Back to Basics series with Tom, as is retiring as a Partner here in Arthur Cox at the end of this month. So Tom, what will you be doing next?

[00:14:06.180] - Tom Courtney, Partner

Well, first of all, let me say that it has been a real pleasure doing these podcasts with you, Suzanne, and it's really hard to believe that we've been doing them now for three years. As I mentioned, I am beginning to write the fifth edition of the Law of Companies. Now that I have more time, I intend to revisit a number of the core issues with a view to, I suppose, reimagining how best to explain the law. For example, the law on lifting the veil, Hogan J in the McCool decision described as being the judicial equivalent of seeking out the North-West Passage! I have other ideas for projects, too, in relation to the dissemination of company law to practitioners and company directors, which I'll announced through LinkedIn in the coming months but thanks again, Suzanne, and thanks to all our loyal listeners. Goodbye for now.

[00:14:55.490] - Suzanne Kearney, Of Counsel

Well, thanks again, Tom. The pleasure is mutual, and I will be looking out for your announcement on LinkedIn. We've received some really positive feedback in this series with almost 12,000 plays to date across SoundCloud, Spotify, and Apple podcasts. So from Tom and I, thank you to all of our listeners over the past three years. For my part, I'm delighted to say that the Back to Basics series will continue, and I'll be joined by my colleague, Aisling Carey, a very experienced professional support lawyer in Arthur Cox. And Aisling and I will return soon to discuss further topics of interest. In the meantime, thank you for listening, and goodbye.