## Shareholders Extracting Assets from Privately Owned Companies

To what extent can shareholders of a privately owned company extract assets from the company and thereby remove them from potential exposure to the company's creditors? Motivation to do so will be high where directors foresee a material decline in the company's trading prospects or the company becomes exposed to contingent liabilities. Where that motivation exists, directors may plan to shelter the company's assets by removing them from the company by payment of a dividend. Alternatively, the directors may approve the sale of the assets to an affiliate on friendly terms. To what extent are directors safe to do so?

### Directors' Personal Liability

At least three relatively recent company law cases illustrate directors' personal liability where they prefer a shareholder's interests over the company's interests by zealously removing assets of a company in favour of the shareholder. In particular they demonstrate the need for directors to take into account the company's contingent liabilities prior to approving action that will deny the company the ability to meet them. Directors will be equally liable where removal of the company's assets is by way of a dividend or by way of a sale to a related party at less than their market value.

### The Directors Dilemma

Directors face the dilemma of meeting expectations of the shareholders to receive dividends from the company whilst preserving company funds for working capital and capex purposes. Shareholders will naturally enough place their own desires ahead of the interests of the creditors and directors are perennially tasked with balancing these competing interests.

In the case of closely held companies a director's self interest will often take paramounce. In such cases, directors chance personal liability claims against them either by a disgruntled creditor or by a liquidator in the event the company subsequently enters liquidation.

### When are Directors able to Declare a Dividend?

Directors may authorise a dividend only where the company remains solvent after the dividend has been paid. This begs the question how solvency is measured and in particular how it is measured where the company has an outstanding claim against it or circumstances suggest the threat of one. It is here that the directors' position is most grave.

### Transfers at an Undervalue

The same considerations apply to asset transfers. Where the assets are transferred to a third party, giving advantage to the third party serves no purpose and market value upon the transfer is presumed. The opposite applies where assets are transferred to a related party. Here, directors' pricing of the transaction inevitably faces scrutiny. Directors are well advised upon any related party transactions to obtain independent valuations to support their pricing.

### Solvency is a Two Fold Test

A company's solvency is determined on a two-fold basis. Firstly, under the liquidity limb, the company must be able to meet its debts as they fall due. Secondly, under the balance sheet limb, the value of the company's assets must be greater than its liabilities.

Reliance upon the company's most recent financial statements on its own is not sufficient.  Those financial statements will not record any claims made (or threatened) against the company which, pending a judgment or agreed settlement amount, remain contingent.  Company law expressly requires directors to take into account all other circumstances that they know affect, or ought to know may affect the value of the company's assets and the amount of its liabilities, including contingent liabilities.

### Contingent Liabilities

Might steps be taken to shelter assets prior to the contingency occurring in the case of contingent liabilities?

The key point here is that by making a payment or distribution that exhausts the company's funds, the company's ability to pay creditors is lost.  If there is a better than even likelihood that a contingent liability will hatch, directors will almost certainly become personally liable for it where they have stripped the company of funds to meet it. Essentially, the boundary line is earmarked by the degree of probability of the liability arising; directors may proceed with impunity only where they assess that probability as low. Remember though, the director's assessment of that probability will always be tested with the benefit of hindsight and hindsight is seldom to your advantage.

### To the Extent

Distributions to shareholders will only be claw backed and expose directors to personal liability to the extent that solvency is breached.  If a distribution of a lesser amount would leave the company solvent, the lesser amount remains available for distribution.

### Tax Considerations

Where revenue account assets are transferred, tax rules treat the sale as having been made at market value. This may or may not trigger a tax liability for the company.  In any event, a trap to watch out for is assets that are subject to the Brightline test (residential property, or shares in land rich companies).  The point to remember is that although the transfer from the company may itself be outside the brightline period, the transfer will establish a new acquisition date for the brightline test for the recipient.

**Peter Speakman**
*Principal*

Telephone: 09 973 0577
Mobile: 021 854 642
Email: peter@speakmanlaw.co.nz