Dipping into the Company's Purse: A Review of Directors' Loan Transactions

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Introduction:

For the first time ever, Section 31 of the Companies Act 1990 introduced a prohibition on directors' loans. In practice, there is no issue with a director making a loan to a company, but there is a general prohibition on a director taking a loan from a company. The purpose of this prohibition is to ensure that company directors are not treating company funds as their own personal bank and borrowing money, with the intention that it is written-off against future earnings (which may or may not arise). According to Niamh Brennan, Academic Director of the UCD Centre for Corporate Governance, noting that some company directors viewed their firms as extensions of their private lives:

> *"Some people are very cavalier about these things and it wouldn't be a surprise that … [during an economic crisis] individuals might be tempted to access company funds for their own use."*[1]

This type of unauthorised borrowing is more commonly a feature of private companies in Ireland, where the separation of ownership and management is often more theoretical than factual. Furthermore, such loans are likely to be in contravention of directors' fiduciary obligations to the company, as the key issue is whether the granting of such a loan is in the best interests of the company, or whether such funds could be better utilised in the pursuit of a company's objectives and in the discharge of its lawful debts. According to MacCann[2]:

> *"… on occasion the directors may be tempted to advance all or part of the company's monies to themselves to finance their own private activities. By so acting they place themselves in a position of conflict of interest and duty, regardless of whether they intend to ultimately repay the company."*[3]

Similar, Paul Appleby (former Director of Corporate Enforcement) noted that the provisions are designed to:

> *"prevent directors from abusing their position and from adversely affecting the interests of a company's shareholders or creditors."*[4]

Section 31 designated that prohibited directors' loans are an offence. According to McGrath[5], criminal prosecutions are the means by which the public identify corporate crimes as wrongs against society and, ultimately, reinforce the common sense of right and wrong. As such, this provision was specifically aimed at tackling this type of white-collar crime in Irish companies. According to Gethings[6]:

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[1] See: Directors take out €134m in illegal personal loans - Independent.ie

[2] MacCann, Lyndon, *"Directors Remuneration and Loans – Part II"*, Irish Law Times 1991, 9, 276-280.

[3] Ibid at p. 276.

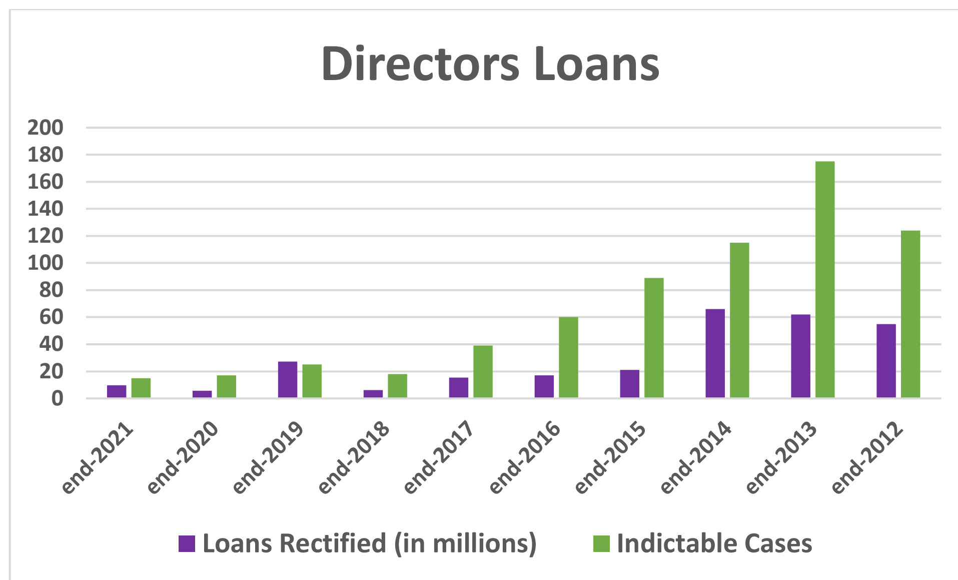
[4] See: https://www.irishtimes.com/business/many-loans-to-directors-illegal-1.361483

[5] McGrath, Joe, *"Confront our Continuing Failure to Prosecute Respectable Wrongdoers"*, (2010) Criminal Law Online Service 112.

[6] Gettings, Caoimhe, *Company Corporate Enforcement "Omnishambles" Or Alternative Regulatory Mechanism: An Objective Analysis of the ODCE,* Irish Law Times 2018, 36(19), 294-300.

> *"While there is a general global sentiment of frustration regarding white-collar crime, it is arguable that it is particularly acute in Ireland. This is due, in part, to a failing on the part of successive Irish governments to deal with corporate wrongdoing in a manner proportionate to its impact upon society, or indeed at all."*[7]

Until the establishment of the Office of Director of Corporate Enforcement (ODCE) (now the Corporate Enforcement Authority) in 2001, these prohibited transactions often went undetected and unpunished. However, the ODCE has been vigilant in enforcing the law regarding directors' loans[8], and today prosecutions in this regard are quite commonplace[9]. A ten-year review of the work of the former Office of the Director of Corporate Enforcement in prosecuting directors in respect of prohibited loans and seeking the repayment of these loans to the company, can be seen in the following graph:



This graph shows a sharp decline in the number of prohibited loans in recent years, which peaked in 2013 with 175 cases prosecuted, as well as a decline in these unauthorised sums being repaid to the company, which peaked at €66m in 2014 and was down to €9.7m in 2021.

[7] Ibid at section V(i).

[8] Directors' loans infringements totalling €221m were rectified on foot of action by the ODCE, between 2012 and 2016.

[9] Following its inception in 2001, between 2003 and 2004, €100 million in illegal directors' loans was repaid to companies.

Primary Prohibition:
The primary prohibition is now contained in Section 239 of the Companies Act 2014, which forbids a company from:

A. Making loans or quasi-loans[10] to its directors[11] or directors of its holding/subsidiary companies,
B. Making loans or quasi-loans to a person connected to a director,
C. Entering into a credit transaction[12] as creditor for a director or connected person, or
D. Entering into a guarantee or providing security for a loan, quasi-loan or credit transaction for a director, or a connected person.

This prohibition also extends to loans to companies controlled by its directors[13], as well as any charges granted to directors or persons connected to directors.

In this regard, a connected person[14] can be defined as a director's spouse, civil partner, parent, brother, sister or child[15], or a person acting in his capacity as the trustee of any trust, the principal beneficiaries of which are the director, their spouse (or civil partner) or any children of that director or any corporate body which that director controls. This definition also extend to any parties in partnership with that director.

Therefore, a director should generally not be borrowing from the company, purchasing goods or services on credit from the company, entering into any transaction where the company has responsibility for the repayment of a directors' debt or obtaining a loan from the company for a business controlled by them.

Exceptions:
There are prescribed exceptions to the general prohibition on directors' loan transactions. In effect, these exceptions permit a company to engage in such prohibited transactions, provided:

A. ***The value of the loan is less than 10% of the value of the company's relevant assets[16]:*** For the purpose of this exception, the value of a company's relevant assets is calculated as the value of its net assets, determined by reference to the last set of annual accounts, if any. Where no such accounts exist, the amount of the relevant assets is calculated as the amount of the company's called-up share capital[17].

   Where at the time the loan transaction was entered into the amount of the loan was less than the 10% threshold, but thereafter the director/s become aware[18] that it exceeds this value[19], then the

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[10] Section 219(2) defines a quasi-loan as a transaction under which the creditor agrees to pay, or pays, a sum for the borrower or agrees to reimburse, or reimburses, expenditure incurred by another party for the borrower on terms that the borrower will reimburse the creditor, or in circumstances giving rise to a liability on the borrower to reimburse the creditor.
[11] This definition encompasses de jure directors, as well as shadow and *de facto* directors.
[12] This includes credit transactions for goods, services and land, as well as hire purchase agreements and conditional sale agreement, or any agreements equivalent to credit or loans – see footnote 10 at subsection (3).
[13] This arises where the director has an interest in one-half or more of the equity share capital of the company, or can exercise control over one-half of the voting power at a general meeting of that company.
[14] Section 220, CA 2014.
[15] This includes the child of a director's civil partner, who is ordinarily resident with the director and the civil partner.
[16] Section 240, CA 2014.
[17] Ibid at Section 238(2).
[18] Or in the circumstances, ought reasonably to be aware.
[19] This may potentially arise where, for whatever reason, there is a decline in the value of company assets.

director/s must take steps to bring the loan below the requisite threshold[20]. This rectification should arise within a period of two months of becoming aware of the issue. Non-compliance results in the loan transaction being voidable at the instance of the company.

B. ***Where the loan relates to the advancement of monies to a director for reasonable expenses***[21]: In the context of the performance of legitimate duties, directors may incur expenditure on behalf of the company. Therefore, the advancement of monies to a director to meet this expenditure is an exception to the general prohibition in relation to directors' loan transactions. To fall under this exception the expenditure must be for the purposes of the company, to avoid the director incurring personal expenditure or to enable the director properly to perform their duties as a company officer. In addition, this expenditure must be vouched for (receipted) within six months of the date on which it was incurred. Non-compliance with this procedural requirement within the specified timeframe is classed as a Category 4 offence[22].

   According to MacCann[23]:

   > *"This exemption is really only of relevance, however, where the director is liable to repay the company in respect of credit provided to discharge business expenses. If the expenses are simply discharged by the company, with no liability to repay on the part of the director, then section [239] would not have applied in the first place since there would have been no loan, quasi-loan or credit-transaction."*[24]

C. ***Where the loan is classified as an intra-company loan***[25]: This may arise in a situation where a holding or parent company makes a loan to its subsidiary company, and a director of the holding or parent company is also a director of the subsidiary company. However, this exception does not extend to associated companies.

D. ***Where the company is a licensed financial or credit institution and lends money to the director in the normal course of business***[26]: Therefore, if the company is a financial or credit institution, authorised and licensed to lend money by the Central Bank of Ireland, then the prohibition is inapplicable. To avail of this exception, the value of the transaction must not be greater, nor the terms of the transaction more favourable, than those that the institution ordinarily offers, or would be expected to offer, to a person of the same financial standing but unconnected with the company.

In addition, Section 242 of the Companies Act 2014 does not prohibit a company from making a loan or quasi-loan, entering into a credit transaction, or entering into a guarantee or providing any security, where the summary approval procedure has been followed. This procedure[27] involves the company undertaking the following actions:

(1) A declaration of solvency must be made by the directors of the company[28],

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[20] Section 242, Companies Act 2014.
[21] Ibid at Section 244.
[22] Such an offence is prosecuted summarily, and is punishable by the imposition of a Class A fine.
[23] See footnote 1.
[24] Ibid at para. 4.
[25] Section 243, Companies Act 2014.
[26] Ibid at Section 245.
[27] Ibid at Sections 202-208.
[28] This declaration must state: (1) the circumstances in which the transaction or arrangement is to be entered into; (2) the nature of the transaction or arrangement; (3) the person or persons to or for whom the transaction or arrangement is to be made; (4) the purpose for which the company is entering into the arrangement or

(2) A special resolution of the shareholders at a general meeting must be passed within 12 months of effecting the loan transaction,
(3) A report of an independent person qualified to act as a statutory auditor must confirm that the declaration of solvency is not unreasonable, and
(4) A copy of the declarations and resolutions must be forwarded to the Registrar of Companies (CRO). The declaration must be submitted not later than 21 days after the date on which the loan transaction is commenced. Non-compliance can result in the High Court invalidating the Summary Approval Procedure[29]

Disclosure of Directors Loans:
In accordance with Section 307 all such transactions must be disclosed in the financial statements of the company. This disclosure should include:

A. The name of the person for whom the arrangements were made and where that person is or was connected with a director of the company or undertaking, the name of the director,
B. The value of the arrangements at the beginning and end of the financial year,
C. Advances made under the arrangements during the financial year,
D. Amounts repaid under the arrangements during the financial year,
E. The amounts of any allowance made during the financial year in respect of any failure or anticipated failure by the borrower to repay the whole or part of the outstanding amount,
F. The maximum amount outstanding under the arrangements during the financial year,
G. An indication of the interest rate, and
H. The arrangements' other main conditions.

Such an obligation does not apply where the value of the loan transaction is less than €7,500[30].

If the terms of a loan to a director are not in writing, then it will be presumed, until the contrary is proved, that the loan is repayable on demand and will be interest-bearing until the time that it is repaid[31]. This presumption applies to loans taken by director both pre and post the enactment of the Companies Act 2014. According to Smyth[32] the rationale for this presumption is that:

> *"Advances between directors and companies [were] often undocumented and the terms relating to such advances [were] often vague and unclear …. [posing] difficulties for liquidators when met with explanations for such advances, [and] whereby loans to directors are offset against alleged advances from the directors to the company."*

Consequences of a Breach:
Any transaction in contravention of Section 239 is voidable by the company, unless restitution is not possible, or where the breach impacts innocent third party rights. In this situation, Justice Gage in *Currencies Direct Ltd v Ellis* (2001)[33] stated that public policy does not prevent a company from recovering a loan that had been made to a director in breach of Section 330 of the English Companies

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transaction; (5) the nature of the benefit which will accrue to the company directly or indirectly from entering into the transaction or arrangement; and (6) the declarants have made a full inquiry into the affairs of the company and that, having done so, they have formed the opinion that the company, having entered into the transaction or arrangement, will be able to pay or discharge its debts and other liabilities in full as they fall due within a 12 month period from the date of entering into the transaction or arrangement.

[29] Section 203(4), Companies Act 2014.
[30] Ibid at Section 308(3).
[31] Ibid at Section 236.
[32] Smyth, Cathy, *Companies Act 2014,* The Bar Review 2015, 20(2), 22-26.
[33] [2001] T.L.R. 654.

Act 1985 (Section 239 of the Irish Act). This was notwithstanding the fact that the making of such a loan was a criminal offence. The Justice reasoned that such a loan was not void, merely voidable, and only then at the instance of the company and from this implied that public policy did not prevent a company from recovering a loan to a director that had been made in breach of the legislation[34].

A breach may also result in personal liability without limit where the transaction results in an insolvent liquidation or contributes to the company being unable to pay its debts[35]. In determining whether to impose this liability, the court takes into consideration the extent to which liabilities arising pursuant to such agreements were discharged before the commencement of the liquidation of the company, as well as the extent to which the prohibited transaction materially contributed to the company's insolvency, or substantially impeded its orderly liquidation[36].

Engaging in a prohibited loan transaction may also result in the imposition of a restriction order (where the company is subsequently declared insolvent). In *The Matter of Inch View Limited (In Liquidation) and In the Matter of the Companies Act 2014 and In the Matter of Sections 819 and 683 of the Companies Act 2014; Sean Mulhern v John Blaney and Neil Blaney* (2019)[37] the issue to be determined was whether restriction orders should be imposed upon the directors of the insolvent company. Justice Quinn noted a loan balance that first appeared in the financial statements for 2012 (in favour of a company controlled by a director) and that there was no evidence that the loan was ever repaid. Consequently, the Justice noted that this *"evidenced a want of responsibility on the part of the respondents"*[38] and justified the imposition of restriction orders.

Such a breach may also result in the imposition of a disqualification order. This disqualification order is automatic, where a successful prosecution arises on indictment, and discretionary in all other circumstances. In a UK case, James McAllister was the sole director of Greetings (International) Ltd. When the company was placed into insolvent liquidation, owing in excess of ST£1.76m to its creditors, there was an outstanding directors loan in McAllister's favour in the amount of £235,000. In imposing a six-year disqualification order on McAllister, Robert Clarke, chief investigator for the Insolvency Service, noted that:

> *"McAllister flagrantly abused his position as company director, failing to perform the due diligence expected of him in order to clear his director's loan and causing his company's creditors to suffer as a result. This behaviour is totally unacceptable … This ban should serve as a warning to other directors tempted to help themselves first: you have a duty to your creditors and if you neglect this duty you could be investigated by the Insolvency Service and removed from the business environment."*[39]

[34] See: Courtney, Thomas, *Company Law Update*, Commercial Law Practitioner 2002, 9(2), 46-49.
[35] Section 247, Companies Act 2014.
[36] Two Irish directors of Cork-based Dolphin International Group were given loans by the company of €1.8m each before it was wound up in 2019. These loans, together with lavish directors salaries and expenses are likely to have contributed to the insolvency of the company.
See: https://www.independent.ie/business/dolphin-execs-got-18m-loans-pre-liquidation-40167187.html
[37] [2022] IEHC 24.
[38] Ibid at para. 67.
[39] See: https://www.accountancydaily.co/ban-boss-who-prioritised-directors-loan-over-creditor-payments

Furthermore, the breach is also actionable as a Category 2[40] offence in criminal law, carrying the possibility of both a fine and a term of imprisonment. According to Justice McKechnie in *DPP v Duffy* (2009)[41] the imposition of both a custodial sentence, combined with a fine, is intended to provide a *"uniquely strong moral message"* that such behaviour is reprehensive and that offenders will be dealt with severely.

[40] In accordance with Section 871(2) CA 2014 such an offence may result in the imposition of the following sanctions: (a) upon summary conviction, liability to a class A fine or imprisonment for a term not exceeding 12 months, or both, or (b) upon conviction on indictment, liability to a fine not exceeding €50,000 or imprisonment for a term not exceeding 5 years, or both.
[41] [2009] IEHC 208.