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Claim No: BL-2017-000429
Claim No: BL-2018-002252

IN THE HIGH COURT OF JUSTICE
BUSINESS AND PROPERTY COURTS OF ENGLAND AND WALES
BUSINESS LIST (ChD)

Royal Courts of Justice
Rolls Building
Fetter Lane, London, EC4A 1NL

Date: 5 May 2020

Before:

MR MICHAEL GREEN QC

(sitting as a Deputy Judge of the Chancery Division)

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Between:

CHALCOT TRAINING LIMITED **Claimant**

- and -

(1) MATTHEW ANTHONY RALPH
(2) THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Defendants**

And Between:

CHALCOT TRAINING LIMITED **Claimant**

and –

(1) SUSAN ELIZABETH STONEMAN
(2) THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Defendants**

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Mr Edward Davies QC and Mr Laurent Sykes QC (instructed by **Lewis Silkin LLP**) for the **Claimant**

Mr Richard Vallat QC and Mr Jack Rivett (instructed by **Solicitor to HM Revenue and Customs**) for the **Second Defendant**

Hearing dates: 5 to 7, 11 to 13 February 2020

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Approved Judgment

I direct that pursuant to CPR PD 39A para 6.1 no official shorthand note shall be taken of this Judgment and that copies of this version as handed down may be treated as authentic.

....

MR MICHAEL GREEN QC

Covid-19 Protocol: This judgment was handed down remotely by circulation to the parties' representatives by email, release to BAILII and publication on the Courts and Tribunals website. The date and time for hand-down is deemed to be 10.30am on 5 May 2020.

MR MICHAEL GREEN QC:

A. INTRODUCTION

1. The old adage "*if it seems too good to be true, it probably is*" is particularly applicable to the tax avoidance scheme entered into by the Claimant company, Chalcot Training Limited (**the Company**) which is the subject matter of this case (called hereafter the **E Shares scheme**). Even Ms Susan Stoneman, one of the Defendants but also the sole shareholder and director of the Company, said in her witness statement that it seemed to her at the time "*a little too good to be true*". The E Shares scheme purported to avoid all corporation tax, income tax and national insurance contributions (**NIC**) on monies paid out by the Company to Ms Stoneman and her ex-husband, Mr Matthew Ralph.

2. There are a number of cases progressing through the First Tier Tax Tribunal (**FTT**) concerned with the E Shares scheme, including appeals by the Company. I have been told that they have all been stayed pending the outcome of this case. That is because this case concerns an attempt by the Company to set aside all the material transactions that were entered into as part of its E Shares scheme on the grounds that they were unlawful on various company law grounds. The Company says principally that the transactions should properly be characterised as distributions to shareholders, rather than remuneration to directors/employees (as they were described), and that they were

therefore unlawful; additionally, the Company asserts that the transactions fell foul of restrictions in the Companies Act 2006 (the **Act**) relating to the issue of shares at a discount (s.580 of the Act) and the payment of commissions (ss.552 and 553 of the Act). If the Company is right in those respects, it says that everything should be unwound, its share register rectified and it should be placed back into the position that it would have been had the E Shares scheme never been entered into.

3. This is opposed by the Commissioners for Her Majesty's Revenue and Customs (**HMRC**). HMRC says that the Company is bound by the transactions it entered into, which were reflected in its accounts and supporting documentation and that those transactions should be characterised in the way the Company itself did at the time, namely as remuneration to the Company's directors. Whatever tax consequences flow from that will ultimately be determined by the FTT and are not a matter for me. This case is purely concerned with the lawfulness and effectiveness of the transactions from a company law perspective.

4. Each side has criticised the other in relation to their respective positions adopted in this case: the Company says that HMRC's stance is "*surprising and unmeritorious*" as HMRC should be expected not to support the formal E Shares scheme documentation over the true substance of the transactions; whereas HMRC says that the Company's claims are "*brazen*" as it is the very individuals who caused the Company to use the E Shares scheme for three years running who are now seeking to set aside those transactions on the grounds that they were not the real transactions that they and the Company entered into. My main task is to decide the true nature and characterisation of the transactions that were integral to the E Shares scheme; that will be based on the evidence and submissions of Counsel, uninfluenced by the parties' descriptions of each other's position.

B. BRIEF OUTLINE OF THE FACTS AND THE E SHARES SCHEME

5. The Company was established in 2005 by Mr Ralph and Ms Stoneman. Its business was to provide learning and communications products and services to large global organisations. From its inception, the Company was owned 50/50 by Mr Ralph and Ms Stoneman and they were the only two directors. In May 2007, Mr Ralph and Ms Stoneman married.

6. After a difficult start, by 2011 the business of the Company had become well established and following a large pre-payment from a customer, Mr Ralph and Ms Stoneman decided to explore tax planning for the anticipated profits that the Company appeared likely to generate. They were referred by the Company's accountant, Mr David Leigh of Leigh Saxton Green, to specialist tax advisers, Financial and Professional Support Services (**FPSS**). The initial advice was to transfer the Company's business to a limited liability partnership that was called NKD Learning LLP (the **LLP**). The transfer happened gradually over the course of a year from October 2011. The Company, Mr Ralph and Ms Stoneman were appointed as the members of the LLP. While drawings (effectively borrowings) taken from the LLP were tax free, tax was payable on the profits of the LLP by the members (it is treated as their income) and the intention was to transfer the LLP's profits to the Company, as a member of the LLP, to take advantage of the more favourable corporation tax rate.

7. In September 2011, through FPSS, Mr Ralph and Ms Stoneman were introduced to the E Shares scheme which had been developed and sold by Blackstar (Europe) Limited (**Blackstar**). The E Shares scheme was designed to avoid corporation tax payable on the Company's profits, which were intended to be the profits allocated by the LLP. This was to be achieved by payments being made out of those profits to employees in respect of their employment which was deductible for the purposes of corporation tax. The clever twist of the E Shares scheme was that the payments to the employees would not be subject to PAYE income tax or NIC because they did not constitute taxable earnings of the employees. This was because the payments were subject to the obligation of the employees to subscribe for shares in the employer, via the E Shares scheme.

8. On 28 November 2011, the Company, Mr Ralph and Ms Stoneman entered into the first iteration of the E Shares scheme by signing various documents including agreements to subscribe for E Shares, board minutes and written resolutions of the shareholders (the **2011 scheme**). By this first iteration, total payments of £2,180,000 were made to Mr Ralph and Ms Stoneman (£1,090,000 each) in the form of £10,900 paid into their respective bank accounts and the balance of £1,079,100 credited to their director's loan accounts. The £10,900 was immediately paid back to the Company as being 1% of the nominal value of the E Shares that each had subscribed for. The remaining 99% of the nominal value of the E Shares remained uncalled.

9. Mr Ralph and Ms Stoneman had intended to draw on the monies credited to their loan accounts to purchase a holiday home they had found in Ibiza. Unfortunately, however, they separated in January 2012. The events that unfolded during 2012 were against the backdrop of their impending divorce and the removal of Mr Ralph from the business. Ms Stoneman decided to go ahead with the purchase of the house in Ibiza and for such purpose a sum of £1,000,500 was transferred to her from the Company against her loan account. In April 2012, a sum of £1,289,100 was transferred to Mr Ralph also against his loan account. In accordance with the E Shares scheme, no income tax or NIC was paid on these sums or the amounts credited to the loan accounts.

10. On 31 August 2012, as part of the separation arrangements, Ms Stoneman and Mr Ralph entered into a Restructure Agreement whereby Mr Ralph resigned as a director of the Company and transferred his ordinary shares in the Company to Ms Stoneman. In order not to trigger a call on the E Shares, Mr Ralph continued to be employed by the Company potentially for a term of 5 more years.

11. On 19 November 2012, Ms Stoneman and the Company entered into the second iteration of the E Shares scheme with the amount of £2,230,000 being put through the scheme (the **2012 scheme**). As with the first iteration, 1% of that amount, £22,300, was paid to Ms Stoneman and immediately paid back by her to the Company as payment of 1% of the nominal value of the 2,230,000 E Shares allotted to her. The balance of £2,207,700 was credited to Ms Stoneman's loan account with the Company. This sum was never paid out by the Company to Ms Stoneman.

12. On 21 December 2012, the Company's accounts for the year to 31 March 2012 were signed off by Ms Stoneman and Mr Leigh. These included the first iteration of the E Shares scheme and, in accordance with Blackstar's advice, the amount put into the scheme was entered as part of directors' remuneration. Ms Stoneman and Mr Ralph also signed director's emolument certificates in which was included the amount received through the E Shares scheme.

13. On 1 July 2013, Ms Stoneman caused the Company to use the E Shares scheme for the third and final time (the **2013 scheme**). This time the shares allotted were actually called F Shares but the terms were the same. The sum paid to Ms Stoneman was £1,725,000, with the 1% amount paid back to the Company being £17,250, and the balance of £1,707,750 credited to Ms Stoneman's loan account.

14. In March 2015, HMRC opened an enquiry into the Company's tax returns and on 17 February 2016 issued a number of determinations in respect of PAYE income tax and NIC in a total amount of approximately £3.89 million plus interest. The Company has appealed those determinations to the FTT but they are presently stayed pending the resolution of these proceedings.

15. On 21 July 2016, HMRC issued accelerated payment notices (**APNs**) for the sums specified in the determinations. The company issued Judicial Review proceedings in respect of the APNs in October 2016. These proceedings are also stayed pending my decision.

16. On 23 November 2017, the Company commenced the first of the proceedings before me initially against Mr Ralph whereby the Company was seeking the return of the monies paid to him from the 2011 scheme on the basis that they were unlawful distributions of assets to a shareholder (the **Ralph proceedings**). HMRC was not originally joined to the proceedings but it was added as Second Defendant on 30 July 2018.

17. On 17 October 2018, the second set of proceedings were begun by the Company, instigated on the authority of Ms Stoneman, against herself and HMRC (the **Stoneman proceedings**). On 20 November 2018, both proceedings were ordered to be managed and tried together. On 8 October 2019, the Company's claim against Mr Ralph was compromised.

18. Ms Stoneman has attempted to effect a reversal of the E Shares scheme at least insofar as she is concerned and in order to support the Company's position in these proceedings. She has therefore repaid the money that she actually received from the Company under the 2011 scheme and has cancelled the credits that were applied to her loan account under the 2012 and 2013 schemes. She has also invited HMRC to cancel the corporation tax deductions that the Company made as part of the E Shares scheme but HMRC maintain that such deductions were properly made because the payments should be characterised as remuneration not distributions. That is the issue that I must decide.

19. The curiosity of this case is that the persons who entered into the E Shares scheme on the basis that the transactions were directors' remuneration which would be deductible for corporation tax purposes are now saying that the real substance of the transactions was that they were distributions to the shareholders which would not be so deductible. Normally this sort of claim would be expected to be made by a liquidator or perhaps a new owner of the Company (or even HMRC), somebody who was not involved in the impugned transactions. It seems to me that these unusual circumstances make it important for the Court to be cautious about accepting the evidence of those same persons in whose interests the particular characterisation of the transactions is being advanced.

C. THE RELIEF SOUGHT AND MAIN ISSUES

20. The substantive relief sought now only against HMRC as set out in the prayers to the Ralph and Stoneman proceedings is:

(1) A declaration that the Agreements by which the 2011, 2012 and 2013 schemes were effected and the purported issue of the E Shares and F Shares are void;

(2) Rectification of the Company's register of members to remove Ms Stoneman and Mr Ralph as the holder of E Shares and to remove Ms Stoneman as the holder of F Shares.

21. The basis upon which the Company claims that the Agreements are void is not that they are unlawful but rather on the grounds of common mistake. The Company does say that they were unlawful under the Act but that the reason why they should be declared void is because the Company, Ms Stoneman and Mr Ralph proceeded on the allegedly false assumption that the payments were not unlawful distributions and would not be repayable to the Company. This element of mistake is a further matter that the Company has to prove on top of the unlawfulness of the underlying transactions.

22. Therefore the main material issues that have been tried before me are as follows:

(1) Whether the payments made under the E Shares scheme should be characterised as remuneration or distributions – the **characterisation issue**.

(2) If the payments were not unlawful distributions, did the arrangements constitute either:

(a) Unlawful discounts contrary to s. 580 of the Act; and/or

(b) Unlawful commissions contrary to ss. 552 and 553 of the Act;

(Together referred to as the **discount and commission issues**)

(3) If the payments and/or arrangements were unlawful on any or all of the grounds set out above, were the sums received by Mr Ralph and Ms Stoneman repayable to the Company – the **repayment issue**;

(4) If the sums were repayable to the Company, should the Agreements and E and F Shares issues be set aside on the grounds of common mistake – the **mistake issue**;

(5) Even if the Company succeeds in establishing that the Agreements and E and F Shares issues are void, should the Court decline in its discretion to make the declarations and rectification orders that are sought – the **discretion issue**.

23. I will deal with my legal and factual findings in relation to all of the above issues in turn but, before doing so, I will set out some preliminary general comments on the oral evidence that I heard followed by my detailed factual findings.

D. THE WITNESSES

24. The Company called two witnesses: Ms Stoneman, the First Defendant to the Stoneman proceedings; and Mr Leigh, the Company's accountant. I agree with Mr Edward Davies QC, who appeared with Mr Laurent Sykes QC on behalf of the Company, that it would have been odd for the Company not to call its owner and controller, even though she is a Defendant, albeit one that has admitted the Company's claim. It is however the Company's case that the subjective intentions of the parties to the E Shares scheme are irrelevant as the Court must decide objectively whether the payments were actually distributions. Mr Davies QC submitted in closing that:

> "…evidence of what Ms Stoneman now says about what she was thinking about her capacity and the legal character of these transactions is not very helpful…"

Nevertheless, it seems to me that much of Ms Stoneman's evidence was directed at those very issues.

25. Mr Ralph is in exactly the same position as Ms Stoneman in relation to the 2011 Scheme. Indeed, it was Ms Stoneman's evidence that the discussions with FPSS and Blackstar and the responsibility for sorting out the documentation for the 2011 scheme were all conducted by Mr Ralph on behalf of the Company as well as himself and Ms Stoneman. Accordingly, his evidence would perhaps be more relevant in relation to the parties' purposes in entering into the 2011 scheme, assuming that subjective intentions have some relevance, than that of Ms Stoneman. However, Mr Ralph was not called by either side.

26. The reason that the Company has not called Mr Ralph is that it appears that he would not support its case. His Amended Defence, supported by a Statement of Truth signed by his solicitors, pleaded that:

> "…[the impugned arrangements were entered into] to recognise and reward the contributions of [Mr Ralph] and Ms Stoneman by paying a substantial bonus to each of them." (Para. 10)

And at paragraph 23A of the Amended Defence, he said:

> "The fundamental purpose of the Agreement was to provide the intended bonus to [Mr Ralph] which could be and was achieved whether or not the offer to subscribe for E shares was or could be validly accepted."

Mr Ralph was thereby agreeing with HMRC's position that the payments were directors' remuneration rather than distributions.

27. It is understandable that the Company would not want to call Mr Ralph. There is the additional complication of the acrimonious divorce and the settlement of the proceedings against him. But if the Company's intention and purpose is of any relevance to the issues that I have to decide, and it is at least in terms of the assumptions allegedly made by the Company for the purposes of establishing common mistake, then it is problematic for the Company that Mr Ralph has not been called.

28. Mr Davies QC submitted that, in the circumstances, HMRC should have called Mr Ralph as he appears to support HMRC's case and they are both Defendants. I think that is somewhat unrealistic. He also submitted that Mr Ralph's evidence is as immaterial as Ms Stoneman's evidence on the legal characterisation of the transactions and no question of corporate attribution arises. Accordingly, no adverse inference should be drawn against the Company for not calling Mr Ralph.

29. For the reasons set out below, I need to exercise caution in relation to the witness evidence that I have read and heard. The contemporaneous documentation is far more reliable evidence than the recollection of witnesses that has been based on legal advice and drafting, and adduced so as to support their interests in the litigation. In HMRC's closing submissions reference was made to the well-known observations of Leggatt J (as he then was) in *Gestmin SGPS S.A. v Credit Suisse (UK) Limited and another* [2013] EWHC 3560 on the fallibility of witnesses' memory. At paragraph 22, the learned Judge said:

> "In the light of these considerations, the best approach for a judge to adopt in the trial of a commercial case is, in my view, to place little if any reliance at all on witnesses' recollections of what was said in meetings and conversations, and to base factual findings on inferences drawn from the documentary evidence and known or probable facts."

I propose to adopt that approach.

Ms Stoneman's evidence

30. In causing the Company to pursue these proceedings, Ms Stoneman was clearly motivated by the prospect of avoiding the Company's potential tax liability of £3.89 million that is the subject matter of the FTT proceedings. If she is successful in these proceedings it would also avoid her personal liabilities towards the Company on a call on the 99% outstanding nominal value of the E and F shares, but these have effectively been settled by the repayments made and cancellation of the loan account. She said in her witness statement that since May 2014 when she found out that HMRC might be challenging the E Shares scheme, she has spent over £1 million so far on tax and legal advice in order to avoid the tax that HMRC are claiming.

31. Her success depends on the Company establishing that the payments should be characterised in a certain way and peppered throughout her written evidence, and repeated orally, was her insistence that she viewed the payments as her and her ex-husband's extraction of the profits of the business as shareholders. She was adamant that this was not considered by them at the time to be remuneration or a bonus to them as directors and/or employees. In her oral evidence, however, she maintained that at the material time she did not distinguish between her various roles as director, employee and shareholder, which is understandable. When I asked her why she was so clear that the payments were made to her as a shareholder, her answer was quite revealing: "*because I have been asked a heck of a lot of questions between then and now as to what capacity we entered into it*". The context of her evidence is therefore her knowledge of the way the Company's case on the company law challenges to the E Shares scheme was being put.

32. I accept HMRC's submission as to the reliability of Ms Stoneman's evidence as it does seem to me that her current view of the events of 2011 to 2013 is distorted by the prism of the legal case that she has been advised to bring on behalf of the Company. Her dismissal of the various documents, including the Company's accounts that she signed on the basis that they were merely documents prepared by Blackstar and which were necessary to be worded in that way in order to achieve the promised tax saving, mirrors the Company's legal case that these documents applied false labels that disguised the true purpose of distributing the Company's assets to its shareholders. This was not attractive evidence, particularly as Ms Stoneman admitted that all she was concerned about in signing the documentation was to achieve the tax benefit that she had been promised.

33. It should also not be forgotten that her separation and divorce from Mr Ralph was going on from January 2012 onwards and this was a very emotional time for her. She emphasised throughout her written and oral evidence that the circumstances surrounding their separation were painful for her at the time and that was apparent even in their recollection while she was giving evidence.

34. In giving her evidence, I found Ms Stoneman to be highly intelligent and driven. She was not evasive at all in the way she answered questions; on the contrary she was forthcoming and gave full answers, even if not always to the question that had been asked. She was clearly most perturbed by the notion that she could be taxed for monies that she never even received, namely the 2012 and 2013 scheme payments that were only credited to her loan account. She bridled at any suggestion that she knew that the payments had to be remuneration in order for them to work for the tax saving, but I do not think that she could have been in any doubt about that. Furthermore she knew what a dividend was and she knew that the payments were not meant to be dividends because, if they were, they would not be deductible for corporation tax purposes.

35. In the circumstances, and in particular because of her heavily lawyered witness statement and the context of her evidence, I do not rely on Ms Stoneman's evidence save where it is uncontroversial or supported by contemporaneous documentation reasonably interpreted in the light of other proven facts. In any event, the issues for determination are largely legal and, as Mr Davies QC conceded, Ms Stoneman's evidence is not particularly material. Likewise, I discount Mr Ralph's "*evidence*", or his pleaded statements, for the same reasons.

Mr Leigh's evidence

36. I have to say that I found Mr Leigh's evidence to be unsatisfactory. He was involved in many of the discussions with Blackstar and FPSS concerning the entry into the E Shares scheme. He was also party to the discussions concerning Ms Stoneman's and Mr Ralph's separation and the impact on the business and the E Shares scheme. And he was the person responsible for the Company's accounts and ensuring that the transactions that were part of the E Shares scheme were properly authorised and accurately reflected in the Company's accounts, even if they were not formally audited.

37. Mr Leigh's stock response to questions about the accounts and supporting documentation was that this had all been provided by Blackstar and the wording in the

accounts was what he assumed was necessary for the particular tax treatment they were after. He obviously knew the difference between an employment expense and a dividend and he included the payments in the Company's profit and loss account as part of directors' remuneration. Eventually, however, Mr Leigh admitted that what went into the accounts was reflective of what he thought had actually taken place, namely the payment of remuneration. If this had not been so, Mr Leigh would have been a party to accounts that he knew did not show a true and fair view of the Company's affairs and furthermore his corporation tax computations would have been false.

38. Apart from his belated acceptance of the accuracy of the Company's accounts, I do not derive any real assistance from the rest of Mr Leigh's evidence, which because of his desire to support the Company's case, should I think be treated with caution.

E. THE DETAILED FACTS

39. With those general comments on the witness evidence, I now turn to a chronological exposition of the facts.

The establishment of the Company

40. Ms Stoneman and Mr Ralph met when they were both working for Barclays Bank plc. Ms Stoneman was a Director of Transformational Change and Mr Ralph was responsible for assessing and granting loans to SME companies. Ms Stoneman left Barclays in 2001 and joined Terra Firma Capital Partners as their Business Transformation Director. I understand her role and expertise to be in designing and implementing large scale company culture transformations, particularly after a takeover or merger.

41. In 2005, Ms Stoneman and Mr Ralph decided to get together and start their own business providing learning and communications products and services to large global organisations. They planned on building the business over a period of eight to ten years by which stage they hoped it would have been successful and could be sold for a substantial sum. They then intended to retire together and travel.

42. For such purpose they incorporated the Company on 11 February 2005 under the name Promise Communications Limited. The name was changed to NKD Group Limited on 7 September 2005 and to its current name on 31 July 2015.

43. From incorporation, Mr Ralph and Ms Stoneman each held 50 ordinary shares of £1 each in the Company. On 31 March 2008, the authorised share capital increased from £100 to £10,000 which was divided into 1,000,000 ordinary shares of 1p each. There was a period of approximately a year from April 2008 when Mr Andrew Macmillan held shares in the Company but following his departure, the Company was again owned 50/50 by Ms Stoneman and Mr Ralph in the form of 5000 ordinary shares of 1p each. This remained so until Mr Ralph's agreed departure on 31 August 2012, as described below.

44. Mr Ralph and Ms Stoneman were the only directors of the Company, until Mr Ralph resigned on 31 August 2012. From then on, Ms Stoneman has been the Company's sole director. Ms Stoneman was the Managing Director, her prime responsibility being to bring in all of the clients and to develop high quality products to meet their clients' needs. Mr Ralph was named the Creative Director but his main responsibility was on the financial and administrative sides of the Company's business.

45. On 1 April 2005 and 1 June 2005 respectively, the Company entered into Service Agreements with Mr Ralph and Ms Stoneman on the same terms. By these Service Agreements they were each entitled to an annual salary of £125,000, subject to review each year. There was no separate provision in the Service Agreements for the payment of a bonus.

46. In May 2007, Mr Ralph and Ms Stoneman were married.

47. The early years of the business were a struggle, not helped by the 2008 global financial crisis and recession.

48. The salaries that the Company paid to Mr Ralph and Ms Stoneman were based on what they believed that it could afford at that time. Those salaries were:

Year ending	**Ms Stoneman**	**Mr Ralph**	**Total**
31 March 2006	£108,333	£75,833	£184,166
31 March 2007	£130,000	£105,000	£235,000
31 March 2008	£130,819	£125,819	£256,638
31 March 2009	£67,500	£65,000	£132,500
31 March 2010	£135,000	£130,000	£265,000
31 March 2011	£146,000	£135,500	£271,500

49. Ms Stoneman was consistently paid a slightly higher amount than Mr Ralph which she said was to reflect her greater experience and seniority. From 2005 to 2010, no dividends were declared. In the year to 31 March 2011, the Company's increased turnover and profit led to Ms Stoneman and Mr Ralph declaring a dividend to themselves of £29,250 each.

The first stage of tax planning – the LLP

50. The business picked up considerably in 2010/11 because of one particular customer, DHL Express, which made a substantial pre-payment in respect of the services to be provided by the Company. It was this pre-payment that prompted Mr Ralph and Ms Stoneman to explore how the business could more efficiently structure itself to save tax.

51. In or around April 2011, Mr Leigh introduced the Company to FPSS and on 8 April 2011, Mr Ralph and Ms Stoneman met with Mr Simon Howitt of FPSS. Mr Howitt proposed a framework structure for the business comprising a combination of the existing Company and the LLP. FPSS's analysis was set out in a discussion document in which the benefits of introducing the LLP into the structure was summarised as follows:

(1) The members of the LLP could take drawings from the LLP tax free; drawings are effectively borrowings by the member which are repayable, normally by the LLP declaring profits to the member to set off against their drawings;

(2) As members were treated as self-employed, there were NIC savings;

(3) Income tax was payable by the members, not the LLP, on the profits of the LLP; by making the Company a member of the LLP, all the profits of the LLP could be allocated to the Company, not to Mr Ralph and Ms Stoneman, and, as profits of the Company, would then be taxed at the corporation tax rate which was more favourable than the tax regime for individuals.

Mr Howitt estimated approximately £95,000 worth of direct tax savings by using the LLP structure.

52. Mr Ralph and Ms Stoneman approved the LLP restructuring and the LLP was renamed as NKD Learning LLP on 24 June 2011 given the impending transfer of the business from the Company to it. As stated above, the Company, Mr Ralph and Ms Stoneman were the initial members of the LLP. Even though it was hoped that the transfer of the business to the LLP would be completed by 1 September 2011, this did not happen and the transition took place more gradually over a period of more than a year. The LLP started trading on 10 October 2011 but the transfer was not completed until a formal LLP Agreement was entered into on 12 October 2012 (the **LLP Agreement**).

53. It seems to have been part of the restructuring that, even though the business was to be conducted through the LLP, the directors and employees would continue to be employed by the Company. Nevertheless, it is true to say that once the LLP was up and running, Mr Ralph and Ms Stoneman took regular drawings from the LLP. The Company submitted, at least from the time of its skeleton argument, that these drawings should be considered as their remuneration, whereas the payments via the E Shares scheme should be considered to be the manner by which the profits of the business were extracted by its owners. I will have to decide in due course the significance of the LLP drawings.

<u>Introduction to the E Shares scheme</u>

54. The LLP restructuring sought to take advantage of the lower corporation tax rate if the profits were transferred to the Company than if they were allocated to Mr Ralph and Ms Stoneman as members of the LLP. However, FPSS had heard of the Blackstar E Shares scheme that could potentially avoid not only the corporation tax on those profits but also any income tax and NIC on payments to employees that were included in the scheme.

55. In an email of 16 September 2011, Mr Howitt summarised the E Shares scheme as follows (underlining added):

> "E-Securities is a Strategy that enables Limited Companies to reward key employees tax-efficiently. This strategy has been disclosed to HMRC and is aimed at owner-managed businesses…
>
> In essence, E-Securities enable the Employer to make a deductible reward to an employee. Both the payment (in respect of the company) and the reward (in the hands of the employee) do not attract any tax or NIC…
>
> …The strategy has been verified by Andrew Thornhill QC, a leading tax barrister. Also by Grant Thornton Accountants, one of the UK's biggest Accountancy firms."

This summary clearly assumes that the payments would have to be rewards to employees as such. In fairness, it does also refer to the scheme being aimed at owner-managed businesses but the rewards do not appear to be limited to those owner-managers.

56. Mr Howitt attached to his email a confidentiality (NDA) agreement which identified Blackstar as the developer of the E Shares scheme; he also attached a "*Due Diligence Response*" which contained an overview of Blackstar's policies and procedures.

57. By coincidence at this time Mr Ralph and Ms Stoneman were in Ibiza and they emailed Mr Leigh on 17 September 2011 to tell him that they had found a property that they wanted to buy. They were seeking advice from him as to the possible risks of buying a property abroad but they were also interested in finding a way of using the Company's money to finance the purchase. Mr Ralph asked about the "*dividend/drawings options*".

58. As Mr Leigh had just heard from Mr Howitt about the E Shares scheme, he told Mr Ralph that Mr Howitt had told him about a new scheme which could work well as an accompaniment to the LLP restructuring. He suggested that they have a meeting with Mr Howitt on their return from Ibiza.

59. That meeting took place on 27 September 2011 attended by Mr Ralph, Mr Leigh, Mr Howitt and Ms Francesca Bottomley (later to become Francesca Herratt), who had recently been appointed as the Company's so-called Finance Director (she was not an actual director of the Company – her role was as financial controller, responsible for the bookkeeping and preparing management accounts and projections). Mr Leigh made detailed manuscript notes at the meeting (as he did for all meetings he attended) and they contained the following regarding the proposed Blackstar E Shares scheme:

> "5. Blackstar
>
> Ex KPMG tax team plus tax barrister plus HMRC inspector have designed a corporation tax solution
>
> 31.1.11: registration of NKD Learning LLP
>
> Could take 2/12 of profits from NKD Group Ltd or look at non-time apportionment, based on actual performance.

retained profit - £375k @ 31.3.2011

+80% of current profits can be utilised (80% of £2 million = £1.6 million).

The scheme is a tax avoidance scheme; has a DOTAS number (not yet issued by HMRC).

Total available funds:

£2 million @ 80%	£1.6m
Reserves b/fwd	£375k
Say	£2.0 million

6. E shares issued with no dividends & no voting rights

Payment made as a reward to directors

Profit £2 million ← Ltd Co 30% tax

↓

Directors

Reward £2.0m

Contract issued for payment to be made that can be called upon by the company to subscribe for shares.

1% paid on the day the contract is signed as a purchase for shares.

Monies loaned to Company as director loan accounts.

Director's loan accounts can then be drawn down at any time.

Ie to purchase property in Spain.

The property is then assigned to Asset LLP

If the contract needs to be transferred, it can be novated to another company (set up as dormant no-value companies).

All challenges would be dealt with by Blackstar.

Costs

12½% of savings; or 15% with a return fee if the scheme is challenged by HMRC and fails (to be paid by Company and tax deductible).

92 companies have so far completed the process in the first 6 weeks."

60. Mr Howitt's understanding of the E Shares scheme, as explained at the meeting, was that it enabled a payment to be made "*as a reward to directors*". This could be used by Mr Ralph and Ms Stoneman to purchase the property in Ibiza and they would not have to pay income tax or NIC on the payments. Immediately following the meeting, Ms Bottomley emailed to FPSS a revised financial forecast for the Company for the year to 31 March 2012. This showed anticipated profits of £1,985,143 and she confirmed that actual results to 31 August 2011 had been in line with the forecast.

61. Ms Stoneman had decided to leave the discussions regarding the E Shares scheme to Mr Ralph and Ms Bottomley, partly because they were better able to understand the accounting and financial complexities of it and also because she was often abroad on business. Her impression was that they were keen to pursue it and were encouraged by the approval of a leading tax QC and Grant Thornton.

62. Prior to a first meeting with Blackstar representatives scheduled for 18 October 2011, there were some further email exchanges between Mr Howitt and Mr Leigh. On 12 October 2011, Mr Howitt asked Mr Leigh for certain information:

> "We need to be clear on the maximum sum to be sheltered this year made up of
>
> 1. Retained profit
> 2. 4/12ths of last years profit and
> 3. 80% of this years profit
> 4. Inc cross charged other company profits
> 5. I think this should be around £2.368M
>
> I think it would be helpful if you were to draw up a brief outline of what the tax liability would be on the extraction of £sum to be sheltered from the business into the hands of Sue and Matt, what do you think?"

63. On 14 October 2011, Mr Leigh asked some questions of Mr Howitt to which he responded on 15 October 2011. One question was why they were limited to taking 80% of the profit; Mr Howitt said that *"The "E shares" scheme only allows 80% of current years profit that don't want to enrage HRMC [sic]…"*

64. Another question concerned whether charges to Andrew Barton Consultants Limited should be from the LLP or the Company; Mr Howitt said: "*We will charge it from the Ltd company so we get the uplift in profit there where the E shares solution resides*" – in other words they wanted to maximise the amount of profit to be placed in the E Shares scheme. Andrew Barton was a well-known hairdresser and good friend of Mr Ralph and Ms Stoneman. Over the years they had helped him in his business by providing accounting and administrative support and they were shareholders and directors of his two companies, Andrew Barton Consultants Limited and Andrew Barton Salons Limited. The services were provided by Company staff as well as Mr Ralph and Ms Stoneman and charged by the Company. So the question was whether the Company should continue to charge for these services or whether it should switch to the LLP as the business was being transferred to it.

65. On 17 October 2011, Mr Howitt emailed Mr Leigh with an explanation as to how the amount to be paid to Mr Ralph and Ms Stoneman as part of the E Shares scheme should be calculated:

> "Ok all profits are allocated to the Ltd Company from the LLP and in this case invoiced (£260K) by NKD limited company…and allocated to NKD limited company
>
> If this comes to say a £2.3 million (I am guesstimating this) then we can shelter this amount in the E shares transaction in the NKD limited company the corporation tax gets dealt with and it will leave a directors loan account in the limited company for Matt and Sue of £1.15M each saving them their personal tax and NI.
>
> So in the limited company for NKD we are looking at making up the amount to be sheltered as a mix of the following…
>
> 1. 80% of current trading year profits to March 2012 est = £1.6m
>
> 2. A % of March 2011 trading profit = £ David to advise 2/12ths??
>
> 3. £260,000 cross charge for Sue and Matt on Andrew Bolton ltd? not sure of correct co name sorry David
>
> 4. Retained Profit in NKD limited = £36k I think from memory
>
> Whatever that totals up to is the amount that can be sheltered and we would understand the tax charge on that if we do nothing with it but client extracts the cash…?"

66. Thus the amount to be paid to Mr Ralph and Ms Stoneman would be calculated partly by reference to the profits earned by the Company and the LLP to date but principally by reference to the profits that they were forecasting they would make in the current tax year. The payments would therefore not be calculated by reference to the Company's actual distributable profits.

67. Mr Leigh prepared the requested figures as to how much could go into the E Shares scheme together with a comparison of the tax implications of alternative methods of making payments to Mr Ralph and Ms Stoneman. On 18 October 2011 Mr Leigh emailed to Mr Howitt ahead of their meeting with Blackstar later that day in the following terms (underlining added):

> "Following our recent exchange of emails, I have now prepared some draft computations of the likely tax liabilities that would arise <u>if the surplus funds were distributed in more conventional fashion</u>.
>
> I am attaching my calculations and as you will see, I have considered two alternatives: one if the funds were withdrawn <u>in the form of a conventional bonus</u>, assuming that for this purpose, Sue and Matt are additional rate tax payers. The second alternative is on the basis that the funds are distributed in the form of dividends and again taking into account that Sue and Matt are additional rate tax payers."

It is fairly clear that Mr Leigh saw the proposed payments as being a form of unconventional bonus, even though he insisted in his evidence that he saw them as "*unconventional payments*".

68. The attached table with the calculations showed that the following amount could be sheltered from tax:

NKD Group Limited: retained profit as at 1 April, 2010	3,166
"Relevant proportion" of the pre-tax profit for the year ended 31 March, 2011	321,000
	324,166
80% of the profit forecast for the year ending 31st March 2012 (£2.0 million)	1,600,000
	1,924,166
Management Charge raised upon Andrew Barton Consultants Limited for the year ended 31st March 2011	260,000
Total available profits	**£2,184,166**

Mr Leigh said that he obtained the figures for the profit forecast for the year ended 31 March 2012 from those prepared by Ms Bottomley and discussed at the meeting on 27 September 2011.

69. Mr Leigh also calculated that if the same amount of £2,184,166 were paid by way of "*Directors' Bonus*" (what he referred to as the "*conventional bonus*"), there would be PAYE and NIC payable of £998,037. Alternatively, if that amount was paid by way of "*Dividends*" there would be corporation tax of £578,680 (because it would not be deductible for corporation tax purposes) and tax on dividends of £579,740. The obvious conclusion from this is that dividend payments would attract the most tax, while the conventional bonus would also attract nearly £1 million of tax. Mr Ralph and Ms Stoneman would therefore save a huge amount of tax by using the E Shares scheme. Everyone knew that the Company would not be paying a dividend.

70. The meeting on 18 October 2011 at Blackstar's offices was attended by Mr Leigh, Mr Howitt and Ms Bottomley and by Mr Ed Lorman and Mr Peter Snowden of Blackstar. From Mr Leigh's notes, it appears that Blackstar explained how the E Shares scheme worked, that they would defend the scheme to the Upper Tier Tribunal and Blackstar's

fees (12.5% plus VAT of the amount put into the scheme). Mr Leigh's notes specifically recorded that Blackstar explained the following:

> "The payment to the director is recorded as an 'employment expense'.
>
> There is no PAYE & NIC due because there may be an obligation on the individual to purchase the E Shares ie a payment with an obligation.
>
> Need to consider the provisions for the 'E' shares in the event of a sale.
>
> - need to assign the shares at some point to an "asset protection vehicle" which would acquire the shares and then when the Company made a call on the shares, the APV could not pay and the shares would be forfeited"

The latter point, even though raised in the context of a potential sale of the Company, was the first mention of a form of exit strategy from the E Shares scheme, whereby Mr Ralph and Ms Stoneman might ultimately be able to avoid their obligations on an automatic triggering of a call on the unpaid 99% of the E Shares. This was the "*twist*" to the scheme that Mr Leigh referred to in an email to Ms Bottomley that same day. This exit strategy was something that was raised periodically but Ms Stoneman said that throughout she "*remained sceptical about this 'exit route' possibility*." She and Mr Ralph considered that the call on the shares would likely remain within their control and that if necessary assets could be liquidated, such as the Ibiza property, or the Company sold, in order to meet the call.

71. Sometime during the next month, Mr Leigh and Ms Bottomley went to Blackstar's offices to review the paperwork in connection with the E Shares scheme. They were allowed to look at the documentation which was presented as a sort of "*manual*" for the operation of the scheme but were not allowed to take copies or notes. They did not speak to anyone from Blackstar during the course of their review. Mr Leigh's recollection was that he saw templates for new memorandum and articles of association, minutes of meetings and the requisite recording of the transactions in the company's books and in the notes to the accounts. On 10 November 2011, Mr Leigh emailed Mr Howitt to say that he was "*very happy with everything that we have learned so far*". He said in his witness statement that he meant that he was comfortable as the Company's accountant that he "*could complete the accounts in accordance with Blackstar's guidance.*"

72. On 14 November 2011, Mr Howitt sent to Ms Bottomley a "*Due Diligence Response*" from Blackstar and also a further document prepared by Blackstar called "*Employment Reward Frequently Asked Questions*". The FAQs confirmed that the E Shares scheme could be used to benefit non-shareholders: "*A reward can be made to employees of the Company*". And in answer to the question as to the commercial rationale of the E Shares scheme, it said:

> "Each company will have its own commercial rationale as to how it wishes to reward staff and some will see E securities as a tax efficient way of doing this while giving the business a future call on the money if it needs further capital in future. It can also be seen as a way of retaining staff as one of the trigger events for the share capital to be called is if the employee leaves the employment. A shareholder director can be rewarded in a number of different

> ways and tax will be a legitimate commercial consideration. In considering their options they will take into account the NIC cost to the company, the tax and NIC cost to the director and the effect of the Company's corporation tax therefore tax can be the commercial consideration that drives the decision. Deciding to use E Securities to recognise performance has the same commercial consideration that is present in recurring discussions about how best to reward a shareholder director."

In answer to the question as to the downside risk if the tax treatment was not accepted by HMRC, it said:

> "Corporation Tax could be payable by the Company and payment could be reclassified as remuneration."

Finally, when asked why 100% shareholders of a close company would use this scheme, the FAQs answered:

> "The Company provides the payment to the employee as a reward for services. A Shareholder employee of a close company can decide to award himself an amount via this scheme in the same way that a close company may awards [sic] its shareholders bonuses rather than dividends. They can provide awards in this innovative way which benefits both parties."

73. By 14 November 2011, Mr Ralph and Ms Stoneman had decided that they did want to go ahead with the E Shares scheme. They put a non-refundable deposit of EUR150,000 on the Ibiza property. Following a further meeting with Blackstar, Mr Ralph signed the Blackstar engagement letter on behalf of the Company and this was sent to Blackstar on 17 November 2011 together with the Company's management accounts for the seven-month period ending 31 October 2011 and a Personal Details Form for each of Mr Ralph and Ms Stoneman. The management accounts showed that in that period the Company had made a profit of £1,812,083 and had net assets on its balance sheet of £2,303,757. The Personal Details Forms made clear that they intended to put a total of £2,180,000 into the E Shares scheme (£1,090,000 each).

<u>Entry into the 2011 E Shares Scheme</u>

74. On 25 November 2011, Blackstar provided various documents for execution by Mr Ralph and Ms Stoneman in order to effect the 2011 E Shares scheme. On 28 November 2011, those documents were executed. They were as follows:

(1) Minutes of a Board Meeting approving the creation of E Shares and the entry into the contracts to subscribe for the E shares;

(2) Written resolution of the Company's shareholders adopting new articles of association and authorising the Company to enter into contracts "*facilitating the subscription*" for the E Shares by Mr Ralph and Ms Stoneman; there was also a Consent Form signed by Mr Ralph and Ms Stoneman to the variation of their rights as holders of the ordinary shares in the Company to the creation of the new class of E shares;

(3) Agreements between the Company and each of Mr Ralph and Ms Stoneman "*to subscribe for Class E shares*", to which was attached a "*Form of Application for Class E Shares*".

75. In more detail:

(1) The minutes of the board meeting were signed by both Mr Ralph (as Chairman) and Ms Stoneman. They record the following (underlining added):

> "**IT WAS NOTED** that the Company's results for the period ended 31 March 2012 were positive and that it was appropriate <u>to consider recognising the contribution of the following individuals</u>:
>
> Matthew Ralph
>
> Susan Ralph
>
> **IN RECOGNITION** of the foregoing, draft resolutions concerned with the creation of class E shares were produced and are attached to these minutes for reference purposes. In addition there were produced to the meeting draft contracts facilitating the subscription for class E shares (copies are attached to these minutes for reference purposes). The contracts provided for the following acquisitions by the following individuals:
>
> | | |
> |---|---|
> | Matthew Ralph | 1,090,000 class E shares |
> | Susan Ralph | 1,090,000 class E shares |
>
> It was noted that the approval of the shareholders would be required to permit the Company to enter into <u>contracts with directors</u> in connection with the class E shares and that a suitable proposed resolution had been included in the resolutions produced to the meeting for consideration.
>
> **IT WAS RESOLVED** subject to obtaining shareholder approval of the necessary amendments to the Company's articles of association and agreement to the Company entering into the contracts mentioned above with those individuals who are directors that:
>
> 1. class E shares be created;
>
> 2. related special resolutions and form SH01 be filed at Companies House;
>
> 3. amended articles of association be filed at Companies House;
>
> 4. contracts to facilitate the acquisition of class E shares be entered into by the Company and related offers to subscribe be accepted when made; and
>
> 5. class E shares be issued pursuant to the offers by the individuals and acceptance by the Company with entries being made in the Company's share register and share certificates being issued to the allottees."

(2) The Written Resolution of the shareholders was signed by Mr Ralph and Ms Stoneman providing for the adoption of the new articles of association. Resolution 4, mirroring the board minutes, was in the following terms:

"4. That the Company be authorised to enter into contracts facilitating the subscription for class E shares by the following individuals who are directors of the Company involving the payments described below

Name	**Number of E Shares**	**Payment**
Matthew Anthony Ralph	1,090,000	£1,090,000
Susan Elizabeth Ralph	1,090,000	£1,090,000"

(3) The new articles of association contained the following regulations concerning the E Shares:

"3.6 E Shares shall not carry any right to vote

3.7 E Shares shall not carry any right to receive notice of or to attend any meeting of the shareholders of the Company

3.8 On a winding up of the Company and only to the extent that there are assets available to be to be [sic] distributed to the shareholders of the Company each E share shall only be entitled to receive a payment of 1p but such payment shall rank in priority to the payment in respect of other classes of share

3.9 The directors may pay a dividend on the E Shares but where a dividend is paid on any other class of share there shall not in consequence be an entitlement for the holders of the E Shares to require any dividend to be paid in respect of the E Shares

3.10 Upon confirmation by an accountant ("the Independent Accountant") acting as an expert and not as an arbitrator who is acting upon the joint instructions of the Company and all holders of E Shares … that both the turnover of the company and profits before taxation during the twelve month period ending 28/11/2014 are in excess of 500% in each case of the turnover and profit before taxation during the twelve months to 27/11/2011 subject to such adjustments as the Independent Accountant considers necessary to ensure that the figures for the two periods concerned are produced on a comparable basis and unaffected by any actions that may have been entered into for the purpose of manipulating the results of the company for the purposes of this provision then upon a subsequent disposal of the entire share capital of the Company on arm's length terms to an unconnected purchaser 10% of the consideration payable by the purchaser shall be allocated to the holders of E Shares and divided between them in proportion to the number of E Shares held by each

3.11 Where an E shareholder does not hold shares of the Company of any other class his or her consent is not required to permit a variation of rights attached to non-E shares notwithstanding any incidental impact on E shareholder rights

3.12 E Shares may only be transferred with the unanimous consent of the directors of the Company

3.13 E Shares shall be allotted 1p paid, 99p uncalled

3.14 The Company may by giving notice to the holder of an E Share make a call for the full amount previously uncalled or for any part of the amount previously uncalled. The amount called shall be due for payment on the ninetieth day following the date of the notice …

3.15 Any amount uncalled in respect of an E Share shall be treated as called in full and payable immediately upon the appointment of a liquidator of the Company

3.16 In the event that calls are not paid when due to be paid the holder of the share may be required to forfeit his E Share but for the avoidance of doubt the Company reserves its right fully to pursue by all lawful means the payment of any called but unpaid amounts."

(4) The "*Agreement to subscribe for Class E shares*" was between Mr Ralph and Ms Stoneman, described in each as "*the Employee*", and the Company, described as "*the Employer*". It contained the following material recitals and terms (underlining added):

"**B WHEREAS:**

(a) <u>The Employee is employed by the Employer</u>;

(b) <u>As part of the employment arrangements between the Employer and the Employee and in particular in recognition of the services of the Employee during the period ended 31 March 2012</u> the Employer is willing <u>to assist</u> the Employee to subscribe for Class E shares of the Employer on the terms more particularly set out below; and

(c) Class E shares are to be £1 shares with an initial called up amount of 1p with 99p uncalled.

C NOW IT IS HEREBY AGREED:

C.1 <u>In consideration of the Employee offering to subscribe for Class E shares</u> substantially in the form of the offer to subscribe set out in the schedule to this agreement ("the Offer") and subject to the Employee complying with the further terms set out below ("the Terms") the Employer shall pay to the Employee a sum of £10,900 followed by a sum of £1,079,100 ("the Payments") which sums shall when paid be <u>non-refundable.</u>

C.2 The sum of £10,900 shall be applied by the Employee in making the Allotment Payment as described in the Offer.

…

C.4 The payment of the sum of £1,079,100 shall take place immediately following the payment of the sum of £10,900 described in clause C.1 and shall be made by the payment sum being applied as a credit to the Employee's loan account with the Employer …

D THE TERMS

D.1 The Employee shall not withdraw the Offer prior to acceptance by the Employer.

…

E IMPACT ON EMPLOYMENT CONTRACT AND EFFECTIVE LAW

E.1 The rights granted to the Employee under this Agreement shall not afford the Employee any rights or additional rights to compensation or damages in consequence of the loss or termination of the Employee's office or employment with the Company for any reason whatsoever and whether any such termination is subsequently held to be wrongful or unfair…"

(5) The "*Form of Application for Class E Shares*" in the Schedule to the Agreement (referred to in clause C.1) contained the offer to subscribe for the E shares and was signed by each of Mr Ralph and Ms Stoneman separately. In respect of calls, the Application added "*cessation of employment*" to the two situations when calls could be made as specified in the articles, that is on notice or automatically on the appointment of a liquidator. It stated:

"**Calls**

1. On Notice

…

2. On the appointment of a liquidator of the Company

…

3. On Cessation of employment with the Company

At any time whilst I am the holder of a Class E share any amount uncalled in respect of the share shall be treated as called in full and payable immediately should I, at any point during the period, be neither an employee nor an officer of the Company"

76. The terms of these documents, particularly the Agreement to subscribe for the E Shares, form an important part of the case, with the Company saying that the labels "*Employer*" and "*Employee*" and the references to "*Employment*" can be ignored because they are just the prescribed wording provided by Blackstar. There is no doubt, however, that all these documents were drafted by Blackstar on the basis that the payments should be

characterised as employment related. They clearly contemplate that the recipient might not be an existing shareholder (see, for example, regulations 3.7, 3.9, 3.10 and 3.11 of the new articles which would be unnecessary if the holder of E shares was an existing shareholder). The wording in the board minutes and the Agreement to subscribe which referred to "*recognising the contribution*" and "*in recognition of the services of the Employee*" are there for a specific purpose, as those entering the scheme knew, so as to be able to claim the enormous tax saving promised by the E Shares scheme. I found Ms Stoneman's evidence that she claimed to have understood the reference to "*contribution*" to be her contribution as a shareholder to be particularly unconvincing and disingenuous, considering that she did not, at the time, distinguish her roles in the Company.

77. The Company paid the large sum of £327,000 (incl. VAT) to Blackstar for the privilege of using the E Shares scheme. The fee of £272,500 was calculated as 12.5% of the amount put into the scheme which was £2,180,000 for 2011. The invoice from Blackstar described its services as "*In respect of the provision of tax advice in relation to the grant of employment rewards*". Mr Ralph and Ms Stoneman were prepared to spend this sum on behalf of the Company for the promised tax savings. In the circumstances I find it difficult to accept that Ms Stoneman could have been in any doubt that it was necessary for the transactions to be related to their employment to be effective.

78. On the same day as the above documents were signed, 28 November 2011, the sum of £21,800, being 2 x £10,900, was paid to Mr Ralph's and Ms Stoneman's joint bank account, but it was immediately paid back to the Company's account. This therefore complied with clause C.1 and C.2 of the Agreement to subscribe for E Shares. Then, in accordance with clause C.4, the sum of £1,079,100 was credited to each of Mr Ralph's and Ms Stoneman's loan accounts with the Company. Although this was initially recorded in the Company's books under "*sundry expenses*", after they had checked with Blackstar as to the appropriate journal entries and wording for the accounts, this was changed to "*employment expense*". As will be seen, it was described in the Company's final accounts for the year ended 31 March 2012 as "*Directors' employment expense*".

79. Also on 28 November 2011, the 2,180,000 E shares were issued to Mr Ralph and Ms Stoneman. It took a little while for all the paperwork in such respect to be completed and filed at Companies House but it was eventually done, with the assistance of Blackstar, by the end of March 2012.

80. The accounts for the year ended 31 March 2011 were signed off on behalf of the board of directors by Ms Stoneman on 22 December 2011. These showed a profit for the year of £612,154 and net assets on the balance sheet of £556,920.

<u>Separation and divorce of Mr Ralph and Ms Stoneman</u>

81. Unexpectedly and unfortunately, at the beginning of January 2012, Mr Ralph told Ms Stoneman that he wanted to separate. Ms Stoneman was distraught about this, particularly as she discovered that Mr Ralph had been having an affair with a junior member of staff. As she says in her witness statement: "*This was a very traumatic and immensely stressful time for me. Our business was and remains, a very small business.*

Our separation was played out amongst a small close-knit team." Although they initially agreed to continue to run the business together, that proved to be unsustainable in the months that followed.

82. A very immediate decision however concerned the E Shares scheme and whether Mr Ralph and Ms Stoneman did want to continue with it in the light of their changed circumstances. Ms Stoneman consulted the Company's lawyer, Ms Suzanne Eva, a partner then at the firm, Cumberland Ellis LLP (which later that year merged with Wedlake Bell LLP). Ms Eva had not been consulted prior to the entry into the E Shares scheme (something which Ms Stoneman said she regretted) but in January 2012 she was asked to look into it. Ms Eva read the documents signed on 28 November 2011 and then spoke to a Ms Bodfish at Blackstar to try to understand how the E Shares scheme was meant to work. In an email of 9 January 2012 to Ms Stoneman she set out her understanding of the documents that had been signed, emphasising that a call on the unpaid amounts of the E Shares would automatically happen if Mr Ralph ceased to be employed by the Company. Ms Eva suggested that, while she could not advise on the tax aspects of the E Shares scheme, Ms Stoneman and Mr Ralph might want to reconsider whether they wished to go ahead with the E Shares scheme, particularly bearing in mind the problems that would arise if Mr Ralph left.

83. On 10 January 2012, Ms Eva sent a further email having reviewed the Company's new articles of association. Again she queried whether they should proceed with the E Shares scheme and urged them to consult with their tax advisors as to whether it was really worth it. She said:

> "If you decide, having spoken to you [sic] tax consultants, that you do not wish to proceed, then although in theory the new E shares have already been approved and should have been issued, it should be a simple enough thing to simply tear up the paperwork (provided you and Matt are in agreement) and not file anything at Companies House or write up the statutory books".

84. Ms Eva was clearly sceptical of the E Shares scheme and was concerned to check that Ms Stoneman and Mr Ralph knew what they were getting into and the potential risks of, in particular, a future call being made. Ms Stoneman and Mr Ralph cannot have been in any doubt about the broad terms of the E Shares scheme and the risk of a call having to be made. Despite Ms Eva's caution, they decided that they would go ahead, principally because they both wanted the money. Ms Stoneman wanted the £1 million now credited to her loan account so that she would be able to complete the purchase of the Ibiza property. Mr Ralph just wanted the cash.

85. Ms Eva was a specialist corporate lawyer. Despite knowing the details of the E Shares scheme, there is no indication in the evidence that she considered at the time or suggested to Ms Stoneman or anyone else, that the payments might be characterised as disguised distributions of capital to the Company's shareholders.

86. On 25 January 2012, Ms Stoneman emailed Mr Leigh to tell him that she and Mr Ralph had decided that they did wish to proceed with both the transfer of the business to the LLP and the E Shares scheme. She asked to have a meeting with FPSS and Blackstar to discuss the implications that their separation might have on the business and the E Shares scheme. That meeting took place on 22 February 2012 and included a wide-ranging discussion on what was going to happen to the Company, the LLP and the

income from Andrew Barton Consultants. Again the risks of either of Mr Ralph or Ms Stoneman ceasing to be a director and employee of the Company in relation to the E Shares scheme were spelled out.

87. On 29 March 2012, Ms Stoneman was paid a sum of £1,000,500 in order to enable her to purchase the Ibiza property. The money was actually paid from LLP's bank account with reference "*Sue House*". This was later recharged by the LLP to the Company and applied against Ms Stoneman's loan account.

88. On 24 April 2012, Mr Ralph was paid the sum of £1,289,100 from the LLP's bank account which was also recharged to the Company and applied against his loan account. As a result, Ms Stoneman and Mr Ralph each effectively received in cash the amounts prescribed in the Agreements to subscribe for E Shares. In respect of the 2012 and 2013 iterations of the E Shares scheme, Ms Stoneman did not receive any of the payments by way of cash (except for the 1% that had to be paid back immediately).

89. By May 2012, the discussions about the way forward for the business had not gone well and it was clear that Ms Stoneman and Mr Ralph could not both remain in the business. On 17 April 2012, Ms Stoneman emailed Mr Leigh with the various options and she said that the only way they could proceed would be by Mr Ralph leaving the business:

> "Matt will leave the business and has understood this though no one else knows yet and we haven't decided when…he understands he cannot stay as a shareholder…I am concerned about valuing the business and acquiring his shares…he will get far too much money which I don't have."

90. On 15 May 2012, Ms Stoneman emailed Ms Bottomley, copied to Mr Leigh and Mr Ralph asking the following:

> "Of the money Matt and I have extracted from the business in 2011/12…precisely what amounts relate to work undertaken in 2010/11 and 2011/12 … and what precise amounts relate to work that will be undertaken in 2012/13? I want to understand what profit/monies we have pulled forward for work paid for but not yet executed."

In her witness statement, Ms Stoneman explained that this request was about the money that they had taken as part of the E Shares scheme. She said:

> "As part of the divorce settlement calculation I wanted to understand precisely what amounts related to work Matt had contributed to whilst employed and what amounts related to work yet to be completed that he would not contribute to. I wanted to be sure we were being fair in our divorce settlement."

It was put to Ms Stoneman in cross examination that this showed that she was concerned that Mr Ralph should only be entitled to be rewarded through the E Shares scheme for work that he had contributed to. Ms Stoneman tried to suggest that she was really referring to his position as a shareholder and that it was the Company's work, not Mr Ralph's, that she was concerned about:

> "Q. …You do not want him to receive any money or you want him to pay back money which does not relate to work he has contributed while employed?

A. Again as a shareholder, the business is doing the work. He was not doing any of that particular work. I wanted to make sure that the funds he was going to receive were fair.

THE JUDGE: Ms Stoneman, he is focusing on your actual words, which says, "related to work Matt had contributed whilst employed".

A. Again, it is the same thing of employed, shareholder, I am not – I am just saying while he was part of the company. I have used the word "employed", yes. But I meant while he was involved in us carrying out work. Whether that was as an employee, or a shareholder, or a director, I am not distinguishing. It is just while he was working alongside me."

91. At the beginning of June 2012, the parties were focussed on the terms upon which Mr Ralph could leave the business without triggering an automatic call on his E Shares. He went on gardening leave and he and Ms Stoneman sought to engage with Mr Leigh, Ms Eva, FPSS and Blackstar as to how their business relationship could be brought to a satisfactory end.

92. Ms Eva took steps to try to understand in more detail the true essence of the E Shares scheme. On 21 June 2012, she asked Ms Stoneman and Mr Leigh whether the payments of £1,079,100 had been paid to them and if so what the nature of such payments was. Ms Bottomley responded the same day by email and she explained that the payments had indeed been made via the LLP bank account. She further explained as follows:

"The Blackstar money was agreed to be taken as their share of profits from NKD Group and NKD Learning LLP combined, by way of Drawings. The Blackstar money has been matched to profits for 2011.12 for the two companies and for future forecasted profits for the period 2012.13. The issue has arisen where they have both taken all their money already but we have only earned 3/12 of the forecasted profits for 2012.13. At the time there was sufficient cash to pay these profits but as a result of trading activities NKD will run out of cash in November. If the profits were paid out when earned, this would have stopped in November as there will be no cash available.

All the drawings are drawings, Matt and sue took monthly drawings which we called their "salary" just so they were receiving monthly income. This is to be allocated as their profit share."

93. Mr Leigh sent to Ms Eva Blackstar's guidance particularly in respect of the payments to Ms Stoneman and Mr Ralph being entered as "*employment expenses*" in the accounts. Having seen this, Ms Eva emailed Mr Leigh on 25 June 2012 with her concerns:

"I have had a quick look at the Black Star advice as regards accounting entries for the E share scheme and I confess that I am still at a loss. On the one hand the notes suggest that the payment to the director may be remuneration (in which case, surely, it is taxable) and on the other it is referred to as a credit to the director's loan account (in which case, presumably, only the benefit of the interest free loan is taxable). It is remarkably unclear to me and whilst I appreciate that I am not an accountant and cannot understand the intricacies of a scheme like this, it might be helpful if you could line up Peter Snowden to speak to us on Wednesday if at all possible. We need to make sure that NKD does nothing which might jeopardise the possible tax savings that this scheme might generate and it is essential that any correspondence with Matt's lawyers does not prejudice the position either. Frankie seems to think that the £2m odd is actually drawings, but that really cannot be right. Oh well, maybe we will be able to sort it out on Wednesday."

94. It appears that Ms Eva spoke to Mr Peter Allen of Blackstar shortly thereafter and was satisfied with his clarification. In the notes of her meeting with Ms Stoneman, Mr Leigh and Ms Bottomley on 27 June 2012, she recorded the following (underlining added):

> "1. [Ms Eva] opened the meeting stating that she had spoken to Peter Allen of Black Star the previous day about the E shares in Group and that she now understood the structure of the shareholdings and the rationale behind them much better.
>
> 2. [Ms Eva] explained that Peter Allen had emphasised that the £1,079,100 which had been "given" to each of Matt Ralph ("MR") and SR by Group <u>was neither remuneration nor a loan (in respect of which tax would be payable in either case), but consideration for MR and SR agreeing to assume the onerous obligation to subscribe for the E shares in Group.</u> Peter Allen confirmed that Black star had received opinions by two tax counsel which confirmed that tax should not be payable on the £1,079,100 "given" to each of SR and MR because it was <u>not remuneration/loans</u>. The obligation to subscribe for shares at £1 each, even though at this stage only £0.01p in the pound had so far been paid was onerous because a[t] any time Group could call on the rest of the subscription price to be paid."

As to the possibility of an exit strategy from the E Shares scheme, Ms Eva noted as one of the options to consider:

> "d) MR/SR, as applicable, remain as an employee of Group, on minimum salary, doing no work, and retaining the E shares for a minimum of 4 years, but also remaining at risk of being called upon by Group to pay the balance of the subscription price for the E shares should Group or LLP need those funds. After this time it may be possible to transfer the E shares into an SPV and, effectively "dump" them, but [Ms Eva] could not advise on whether or not this would be effective, although Black Star could probably give a view"

95. On 2 July 2012, there was a meeting attended by Mr Ralph, Ms Stoneman, Mr Leigh, Ms Bottomley, from Blackstar Messrs Allen, Snowden and Lorman and from FPSS, Mr Howitt and Ms Noble. Ms Eva also participated in the meeting by telephone. There was a discussion about the four options suggested by Ms Eva and there was agreement that her option "d" (as set out in the paragraph above) was the best way forward. That meant Mr Ralph resigning as a director but continuing to be employed by the Company for 5 more years on a fixed term contract, renewable at Mr Ralph's option. In addition, Ms Stoneman would give Mr Ralph an indemnity to cover the cost (or part of the cost) in the event of a call on the E Shares. There was some discussion on a possible exit strategy, either the use of an SPV or the Company buying back the E Shares, but Mr Snowden of Blackstar said that an early use of either option may not be viewed favourably by HMRC. Mr Ralph raised the possibility of "*repaying his employment expense of £1million*" but he went off the idea when advised of the tax implications.

96. Both Ms Stoneman and Mr Ralph had divorce lawyers involved (as well as Ms Eva for the Company) and throughout July and August 2012, they continued to negotiate the terms of the divorce. For the purpose of agreeing the figures in the divorce settlement, it was necessary to value the Company and Mr Leigh was asked to do this. On 3 July 2012, Mr Leigh sent an email to Ms Stoneman and Mr Ralph with a summary of the trading performance of and financial position in respect of both the LLP and the Company. Their combined trading performance for the year ended 31 March 2012 showed a loss of £314,000. Mr Leigh went on to explain this (underlining added):

> "1.2 However, included within the costs for NKD Group Limited is a deduction for "Employment expense" in the sum of £2.18million which relates to the E Securities arrangement.
>
> 1.3 <u>This payment is really a distribution of profits, rather than an expense of the business</u>.
>
> 1.4 Consequently, in order to gauge the actual performance, I would suggest that the employment expense of £2.18million be added back."

In his witness statement, Mr Leigh explained his reference to the payments being "*really a distribution of profits*" because "*they were calculated by reference to levels of profit and paid by reference to shareholdings; they were not expenses incurred in the pursuit of generating profits*". This is rather hard to reconcile with the fact that Mr Leigh was content to sign off the Company's accounts six months later as being directors' remuneration and a deductible employment expense. When cross examined about this he confirmed that what he was doing was trying to value the business and for that purpose the payments were one-off payments and so should not be used for valuation of the ongoing business.

> "A. I was trying to genuinely value the business for how much the business was worth, and I wanted to exclude that amount as an expense because I did not think that would then fairly reflect the trading performance of the business. It was such a large payment.
>
> Q. It was a one-off?
>
> A. Exactly. It was large, it was unusual, non-recurring.
>
> Q. It is not because it was a distribution or an employment expense: it was because it was a one-off?
>
> A. Yes. I took it out of the expenses because it was a one-off and then I took it out of the value because it had been distributed, so it was almost like some of the value in the business had already been passed."

97. Ms Stoneman seems to have been keen to establish whether too much had been paid out pursuant to the E Shares scheme so as to attempt to claw back amounts from Mr Ralph within the divorce settlement. Having obtained some figures from Mr Leigh, she emailed Mr Ralph copied to the divorce lawyers on 12 July 2012 saying as follows:

"At our last meeting at David's office we estimated the 'over drawings' we had both received against 2012/13 work/profits was circa 150K. David and Frankie have now completed a further analysis of this and the 'overpayment' we have both received against 2012/13 work/profits is 217,500 each.

I though [sic] you should see how the figure was reached. You may wish to share this with Philip as Judith[1] will use this in our final settlement arrangements. I will continue working in the company to 'earn' this overpayment…your overpayment needs to be deducted from any settlement amount as you will not be contributing to generating this profit for the business and these funds have already been released to you."

It seems as though Ms Stoneman was regarding the payments as having to be "*earned*" by her and Mr Ralph by reference to their respective contributions to the success of the business.

98. Eventually, Ms Stoneman and Mr Ralph agreed the terms of their divorce and part of this was contained in a "*Restructure Agreement*" dated 31 August 2012 dealing with their business relationship in the Company, the LLP and in relation to Andrew Barton Consultants and certain other companies. Mr Ralph agreed to sell his ordinary shares in the Company to Ms Stoneman for £250,000 and to resign as a director. He retained his E Shares. Clause 2.4 of the Restructure Agreement provided as follows:

"[Mr Ralph] will resign as a director of [the Company] with effect from 1 August 2012, but will remain as an employee of [the Company] on the terms of a new contract of employment. [Ms Stoneman] shall procure that [the Company] issues to [Mr Ralph] a new fixed term contract of employment, effective until 31 July 2017 (unless otherwise agreed between the parties), under which [Mr Ralph] will be an employee of [the Company] for special projects, earning a salary of £3,000 per annum with no benefits with effect from 1 August 2012…

Clause 2.8 provided for an indemnity from Ms Stoneman to Mr Ralph:

"[Ms Stoneman] hereby indemnifies and agrees to keep indemnified [Mr Ralph] against thirty per cent. (30%) of the sum that [Mr Ralph] is required to pay to [the Company] in the event that [the Company] makes a call against [Mr Ralph] in connection with [Mr Ralph's] E Shares under the terms of paragraph 1 (*Calls*) of the Form of Application for Class E Shares signed by [Mr Ralph] on 28 November 2011. [Ms Stoneman] hereby undertakes to use all reasonable endeavours, so far as she is legally able to do so, to procure that [the Company] does not make any Call against [Mr Ralph's] E Shares. [Ms Stoneman] and [Mr Ralph] may agree otherwise if it is to their mutual benefit. In the event that any such Call is made, [Ms Stoneman] will procure that such Call is made against both [Mr Ralph's] and [Ms Stoneman's] E Shares equally…

And clause 2.10 stated:

"[Mr Ralph] and [Ms Stoneman] hereby undertake with each other to use all reasonable endeavours to find a solution to the E Shares issue within 5 years of the

[1] These were the divorce lawyers acting for Mr Ralph and Ms Stoneman.

Effective Date and to that end each of [Ms Stoneman] and [Mr Ralph] shall commence actively exploring the possible solutions with [the Company's] tax advisers within three (3) years after the Effective Date."

99. The Restructure Agreement and particularly the above terms, show the sharp focus by all on the risks involved with the E Shares scheme. These were carefully scrutinised throughout the divorce negotiations and all concerned could have been in no doubt as to the way the E Shares scheme worked, that there was no defined "*exit strategy*" that might avoid any call on the E Shares and how it was to be characterised for the purposes of the Company's accounts and tax return. Ms Eva, who was probably the most cautious about the E Shares scheme, knew that it could not have involved a distribution to shareholders to be effective and she appears never to have considered that the payments were really disguised returns of capital to the Company's shareholders. I do not criticise her for that; it is not unreasonable that it did not occur to her that the E Shares scheme should be characterised as something different to what the documentation suggested.

Entry into the 2012 E Shares scheme

100. Despite awareness of the problems and risks with the E Shares scheme, Ms Stoneman decided to enter into it for a second time, shortly after signing the Restructure Agreement. During September 2012, FPSS and Blackstar were re-engaged to advise on tax planning options but there does not seem to have been any real doubt that the Company would use the E Shares scheme again. Mr Leigh took steps to obtain the relevant figures for the purpose of calculating the amount that could be "*sheltered*" using the E Shares scheme. Those would be based principally on a forecast of the anticipated profits for the current year to 31 March 2013.

101. On 18 October 2012, following a meeting the day before between Ms Stoneman, Mr Howitt and Mr Leigh, Mr Howitt emailed Ms Bottomley with "*the final number for sheltering*" being as follows:

"80% of profit (2012-13 £2,516,335)	£2,013,068
Cross charge from [Andrew Barton Consultants Ltd]	£219,540.02
TOTAL SHELTER	**£2,232,608**
E SHARES FEE	£279,076"

The sum was rounded down to £2,230,000.

102. It appears that the sum was agreed by Ms Stoneman on that day because Blackstar sent an invoice on 19 October 2012 for its fees of £334,500 (incl. VAT), being 12.5% of £2,230,000. The description of its services in the invoice was the same as for the year before: "*In respect of the provision of taxation advice in relation to the grant of employment rewards*".

103. On 13 November 2012, Blackstar received an updated forecast and the Company's management accounts to 30 September 2012. On the same date, Blackstar sent a letter to the Company confirming the advice that it had given and setting out the main terms

of the E Shares scheme. In the "*Objectives*" section of the letter, Blackstar stated: "*The Company has generated profits during the year and wishes to provide directors/employees with tax efficient, flexible benefits from the Company in a manner which is attractive to both the Company and the employee/s*". Blackstar said that the documentation for the 2012 E Shares scheme would be provided shortly.

104. On 19 November 2012, Ms Stoneman signed all the various documents to implement the second iteration of the E Shares scheme. These were in identical form to the 2011 Scheme save that she was the only party entering into the Agreement with the Company and the relevant figures were £22,300 for the 1p paid up amount on the E Shares and £2,207,700 was the balance that was to be credited to her loan account. The Board meeting minutes, the written resolution of the Company's ordinary shareholder and the Agreement to subscribe for the E Shares were in all material respects the same wording as used in the 2011 E Shares scheme.

105. On 20 November 2012, the Company paid Ms Stoneman £22,300 which was immediately repaid back to the Company. By letter dated 29 November 2012, the Company confirmed to Ms Stoneman that the sum of £2,207,700 had been credited to her loan account. The Company also confirmed that 2,230,000 E Shares had been allotted to Ms Stoneman on 19 November 2012.

The treatment of the E Shares Scheme in the 2012 Accounts

106. During the course of the divorce negotiations and the preparation for the second iteration of the E Shares scheme, the Company's accounts for the year to 31 March 2012 were being drawn up. As explained in paragraphs [92] to [94] above, Ms Eva had queried with Mr Leigh and Blackstar as to the guidance in relation to the appropriate description of the payments to go into the accounts. She appears to have been satisfied with the response received from Blackstar, as recorded in her notes of the meeting on 27 June 2012.

107. Mr Leigh had seen the accounting guidance issued by Blackstar both before entry into the 2011 E Shares scheme and also again in May 2012 when they were beginning to think about the Company's accounts. In his witness statement Mr Leigh said that he "*was completely reliant upon Blackstar's guidance as to how to account for the E-Shares transactions*". However, he was the person who was responsible for preparing the accounts and therefore had to be satisfied that they correctly reflected the transactions that had taken place. Eventually, after some vacillation in cross examination, Mr Leigh accepted that the entries in the accounts reflected what he himself thought had actually taken place.

108. In December 2012, Mr Laurence Bishop joined the LLP as its Chief Financial Officer. On 4 December 2012, there was a meeting attended by Ms Stoneman, Ms Bottomley, Mr Bishop and Mr Leigh in order to discuss the accounts for the Company, the LLP and Andrew Barton Consultants. The question was asked, apparently by Mr Bishop, as to: "*Should the 'E' Shares payment be recorded separately from Directors Remuneration, as an "employment expense*". According to Ms Stoneman, Mr Leigh explained that this accounting approach was based on Blackstar's guidelines. Ms

Stoneman was therefore a party to specific discussion as to how the E Shares scheme payments should be recorded in the accounts.

109. On 21 December 2012, Mr Robert Keen of Leigh Saxton Green sent various documents to the Company in relation to the accounts, all of which required signature by Ms Stoneman. The documents were:

(1) The abbreviated accounts of the Company for the year ended 31 March 2012 for filing at Companies House;

(2) A Letter of Representation;

(3) Minutes of meeting of the directors approving the accounts;

(4) Minutes of the Company's Annual General Meeting;

(5) A Director's emolument certificate;

(6) HMRC corporation tax return form CT600.

110. The Company's accounts for the year ended 31 March 2012 were unaudited. The accounts state that the Company made a loss for the year of £118,293 (this was after deduction of the E Shares scheme payments) and had net assets of £460,427. Ms Stoneman signed the following statements in the accounts:

> "The director is responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable her to ensure that the financial statements comply with the Companies Act 2006."
>
> "The director acknowledges her responsibilities for ensuring that the company keeps accounting records which comply with section 386 of the Act and for preparing financial statements which give a true and fair view of the state of affairs of the company as at the end of the financial year and of its profit or loss for the financial year in accordance with the requirements of sections 394 and 395 and which otherwise comply with the requirements of the Companies Act 2006 relating to accounts, so far as applicable to the company."

111. Apart from the figure for turnover, the E Shares scheme payments were the largest single item in the accounts. They were referred to in the accounts in the following places (underlining added):

(1) Note 2:

"2	**Operating (loss)/profit**	**2012**	**2011**
		£	£
	Operating (loss)/profit is stated after charging:		
	Depreciation of tangible assets	31,716	12,004

Director's remuneration	2,208,391	321,500

Included in the total directors' remuneration figure is an amount of £2,180,000 paid to directors in consideration for each director agreeing to subscribe for 1,080,000[2] Class E shares."

(2) The Schedule of Administrative Expenses:

	2012	**2011**
	£	£
Administrative Expenses		
Wages and salaries	545,676	269,131
Directors' remuneration	28,391	281,500
Directors' employment expense	2,180,000	-

…"

(3) Note 11:

"**11 Share capital**	**2012**	**2011**
	£	**£**
Allotted, called up and fully paid		
10,000 Ordinary shares of 1p each	100	100
2,180,000 Class E shares called up of 1p each	21,800	-
	21,900	100

On 28 November 2011 the Company entered into an agreement with two directors' [sic] in connection with the issue of 2,180,000 £1 Class E shares by the Company. The directors' [sic] agreed immediately to subscribe for the shares with initial called up amount of 1p per share in consideration for a payment to each director of £1,080,000 of which £1,080,000 was fully paid and £1,079,100 credited to a director's loan account with the Company. The shares were issued on 28 November 2011."

(4) Note 13 under the heading "**Related party relationships and transactions**":

"The company entered into an agreement with S E Stoneman, in connection with the issue during the year of 1,080,000 £1 Class E shares by the Company. S E Stoneman agreed immediately to subscribe for the shares with

[2] This figure, which is repeated throughout the accounts, is wrong – it should be 1,090,000.

initial called up amount of 1p per share in consideration for a payment of £1,080,000, of which £1,079,100 was settled by credit to her loan account with the company.

The company entered into an agreement with M A Ralph, in connection with the issue during the year of 1,080,000 £1 Class E shares by the Company. M Ralph agreed immediately to subscribe for the shares with initial called up amount of 1p per share in consideration for a payment of £1,080,000."

112. The Director's Emolument certificate that was signed by both Ms Stoneman and Mr Ralph stated materially the following (from Ms Stoneman's certificate):

"In accordance with the Companies Act 2006, I confirm for the year ended 31 March 2012 that:

1. The emoluments received by me in respect of my services to the company were £1,193,071, excluding pension contributions.
2. The balance on my current account as at 31 March 2012 was £1,079,100.
3. There were no loans, quasi-loans, credit transactions, arrangements in respect of them or related guarantees or securities made by the company on my behalf or on behalf of my connected persons.
4. There were no transactions or arrangements in which I, or a connected person, had a material interest."

113. As well as approving and adopting the Company's accounts for the year ended 31 March 2012, the minutes of the Company's AGM, signed by Ms Stoneman as Chairman record the following:

"Director's remuneration

IT WAS RESOLVED that director's remuneration, as shown in the accounts, be and is hereby approved.

…

Dividend

IT WAS RESOLVED that a dividend of £nil per share be recommended on the ordinary shares for the year under review."

114. The Company says that the accounting treatment is of only "*limited assistance*" in understanding the true substance and purpose of the E Shares scheme. It says that the accounts were not signed off contemporaneously with the entry into the E Shares scheme and the first relevant accounts were actually completed after the second iteration of the E Shares scheme. It also says that the Notes distinguish the payments from "*Directors' remuneration*" and give a nuanced explanation, particularly in the related party transactions note, as to the basis of the payments. Furthermore, this was all provided by Blackstar and reflected its thinking and purpose for the scheme.

115. It seems to me that no one could read those accounts, let alone sign them, without appreciating that the payments were being treated as at least related to directors' remuneration. That is what I take Mr Leigh to have eventually confirmed when he said that the accounts reflected what he understood the payments to be. Ms Stoneman also said in cross examination that she "*believed that I was signing the accounts to reflect what had happened.*" Neither Mr Leigh nor Ms Stoneman could have thought that these were payments to shareholders qua shareholders; these were payments to directors/employees in their capacity as such. If they had been considered to be payments to shareholders, that could only have been in the form of a dividend and they deliberately decided not to do this as it would not have been deductible for corporation tax purposes and would not have had the desired tax effect.

The 2013 F Shares scheme

116. In March 2013, Ms Stoneman was already thinking about using the E Shares scheme again for the 2013/14 year. In January 2013 she had appointed Cavendish Corporate Finance LLP (**Cavendish**) to act as her sales agent for the purposes of preparing the business for a sale. They were concerned about the impact on a sale of the existence of the E Shares. Before the budget on 20 March 2013, Ms Bottomley made contact with Mr Lorman of Blackstar to see what they expected in relation to the E Shares scheme in the budget. Mr Lorman replied on 5 March 2013, saying that they were not expecting the budget to close E Shares schemes but he went on to say:

> "We expect the likelihood is that mid-July is the more likely death knell for this particular piece of award planning…
>
> So if the budget is favourable, NKD have a small window from April 1st to mid-July to maximise the benefit by sheltering within the 2013-14 year."

Ms Stoneman took this as meaning that she had an opportunity to do a third iteration of the E Shares scheme for the 2013/14 year.

117. On 5 June 2013, Mr Howitt emailed Ms Stoneman, copied to Ms Bottomley, Mr Bishop and Mr Lorman, asking whether she had decided whether the Company "*will take up its option to do one more profit shelter before the budget finance Bill that includes the new GAR rules will come into force*". This was becoming urgent as it would have to be completed by mid-July as foreshadowed in Mr Lorman's 5 March 2013 email. Mr Howitt also set out in this email a proposal that Blackstar had for the removal of the potential liability to a call on the unpaid 99p on the E Shares. He expressed this as follows:

> "Blackstar have a very simple solution I am very pleased to confirm for closing down each contract that has been put in place for E-[S]hares for [the Company]. The company has the remaining 99% of shares in each contract that have not yet been subscribed too [sic], independently valued. The remaining E-shares are valued for a pittance and then bought by [the Company] thus ending the contractual obligations on you and the company. Ed Lorman has offered to bring in Blackstar who are happy to meet with you, your team and explain fully this contract closing solution. Would you like your sales agents to understand it as well I have spoken

to them at some length on the structure and the contract being outside of the sale of the LLP?"

Ms Stoneman queried why she would say "*no*" to doing a further iteration of the E Shares scheme, to which Ms Bottomley responded that it might be "*because you may be tied in with them for 5 years…*" She said that Mr Lorman would be coming in to talk about the "*exit strategy*".

118. On 14 June 2013, Ms Bottomley sent to Mr Lorman and Mr Howitt, copied to Mr Bishop, the Company's forecast for the year ended 31 March 2014. This showed a forecast profit for that year of £1,947,567. Taking 80% of that forecast profit (in accordance with the guidance for the two previous iterations) and adding in an amount of £144,000 in respect of the "*cross-charge*" from Andrew Barton Consultants, the figure to go into the new scheme was £1,725,000.

119. That figure had been agreed by 18 June 2013, because on that date Blackstar had sent its invoice for 12.5% of £1,725,000 plus VAT totalling £258,750, which was paid immediately.

120. The only difference with this third iteration was the use of F Shares, rather than E Shares. It is unclear why this was done, as the F Shares appear to have exactly the same rights and conditions attached to them as the E Shares. Using F Shares however necessitated further amendments to the articles of association and these were adopted by written resolution of the Company. Other than that, all the other documentation, being the board resolution, shareholder consent and the Agreement to subscribe for Class F shares had identical wording to the earlier iterations. The relevant figures were 1,725,000 Class F £1 shares, with immediate payment of 1p on each share, being £17,250, and the balance of £1,707,750 being credited to Ms Stoneman's loan account.

121. The documentation was entered into by Ms Stoneman on 1 July 2013 and the payments of £17,250 back and forth were completed on 2 July 2013. The F Shares were issued to Ms Stoneman on 1 July 2013. Despite knowing that no "*exit strategy*" had been established, Ms Stoneman was happy to proceed with the scheme for a third time, accepting the risk that there may have to be a call on the considerable unpaid amounts on the E and F Shares.

The 2013 and 2014 Accounts

122. The Company's accounts for the year ended 31 March 2013 were signed off on 23 December 2013. The accounts showed a loss for the year of £2,977,413 and net liabilities of £2,494,686. The second iteration of the E Shares scheme in the sum of £2,230,000 was included within the accounts as "*Director's employment expense*" which was itself included within the total figure for "*Director's remuneration*". Exactly the same wording as was used in the 2012 accounts in respect of the E Shares scheme was adopted in these accounts. The Company again passed a resolution at its AGM approving the "*director's remuneration*."

123. The same happened the following year. The Company's accounts for the year ended 31 March 2014 were signed off on 19 December 2014. These accounts showed a profit for

the year of £248,076 and net liabilities of £2,229,360. The F Shares in the amount of £1,725,000 were treated in the same way as the previous two E Share iterations and the same resolutions were passed.

F. CHARACTERISATION

(a) Introduction

124. It is common ground that the issue of characterisation is determined by looking at the substance of the transaction rather than its form. That does not mean that the "*label*", as Mr Davies QC put it, or the way the transaction was described in the documentation is irrelevant. The extent to which the parties' subjective intentions can be taken into account is the main area of disagreement on the law between the Company and HMRC.

125. Whether one is looking at the common law or the statutory position, the classic statement as to what constitutes an unlawful distribution is Pennycuick J's observation in *Ridge Securities Ltd v Inland Revenue Commissioners* [1964] 1 WLR 479, 495:

> "A company can only lawfully deal with its assets in furtherance of its objects. The corporators may take assets out of the company by way of dividend, or with the leave of the court, by way of a reduction of capital, or in a winding up. They may, of course, acquire them for full consideration. They cannot take assets out of the company by way of voluntary distribution, however described, and if they attempt to do so, the distribution is ultra vires the company."

126. That statement, which has been endorsed at the highest level (see paragraph 1 of Lord Walker's judgment in *Progress Property Company Limited v Moorgath Group Limited* [2010] UKSC 55, (***Progress Property***) discussed further below), does not directly deal with remuneration paid to directors or employees, who are also shareholders. Furthermore, it was stated as an issue of "*ultra vires*" and the older authorities on the common law rule are based on *ultra vires* in the narrow sense of being outside the objects of the company's memorandum. The relevance of this is analysed below. I turn to the parties' contentions on the law.

(b) The Company's submissions

127. The Company appears to rely solely on the statutory rule against unlawful distributions as contained in Part 23 of the Act. It says that the payments to Mr Ralph and Ms Stoneman were distributions within the meaning of s.829 of the Act which defines distributions as being "*every description of distribution of a company's assets to its members, whether in cash or otherwise*". This broad definition has certain specific exceptions, reduction of capital or distribution on a winding up, that do not apply in this case. Furthermore, Mr Davies QC submitted that there must be implicit in the word "*distribution*" the notion of a transfer of value to the shareholder. Proper remuneration is not a transfer of value because the payment is offset by the value of the services

provided. Conversely, a normal dividend is not offset by any transfer of value from the shareholder to the company.

128. The cases that the Company relied upon were not however concerned with the statutory definition. Rather they were cases on the common law rule. These were principally: *Ridge Securities* (supra); *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016 (***Re Halt Garage***); *Aveling Barford Ltd v Period Ltd* [1989] BCLC 626 (***Aveling Barford***); *Progress Property* (supra); and much reliance was placed on the recent decision of Chief ICC Judge Briggs in *Toone v Ross* [2019] EWHC 2855 (Ch) (which was based on the statutory definition).

129. The Company's main argument, as adapted in its closing submissions, is that the Court should apply a purely objective test as to whether value has been transferred from the Company to its shareholders. The subjective beliefs of the parties involved as to the legal nature of the transactions are immaterial. Mr Davies QC, who led on this issue for the Company, submitted that the payments under the E Shares scheme were gratuitous dispositions in favour of its shareholders in proportion to their shareholdings, calculated by reference to the Company's profits and motivated by a desire on the part of the shareholders to extract funds from the Company.

130. Mr Davies QC argued, and I believe that this is accepted, that distributions can be "*disguised*" as such and the "*labels*" applied to transactions are not determinative as to their true characterisation. The Court must look at "*the true purpose and substance of the impugned transaction*" (per Lord Walker in *Progress Property* at para. 27). Because of the circumstances surrounding the payments, Mr Davies QC said that it is not possible to characterise them as remuneration or performance-based bonuses, as HMRC seeks to do.

131. Mr Davies QC said that it follows that if these were disguised distributions to shareholders then, as the Company admittedly did not follow the required steps in Part 23 of the Act for declaring a dividend, the payments were unlawful. The consequence of their unlawfulness is that the recipients of the distributions may be required to repay them under s.847 of the Act, if he or she "*knew or had reasonable grounds*" for believing that the distribution was in contravention of the rules set out in Part 23 of the Act. (The Company does not rely on the common law rule, which may render the distributions *void ab initio*.)

<u>(c) HMRC's submissions</u>

132. Mr Jack Rivett on behalf of HMRC made submissions on the company law aspects (and conducted the cross examination) and he did so impressively. He preferred to look at the characterisation issue as one concerned with whether the decision by Ms Stoneman and Mr Ralph to award themselves this level of remuneration was a genuine exercise of the power to award themselves remuneration. It was a commercial decision for the directors and one which, particularly in the context of a solvent company, the Court will not generally interfere. Mr Rivett maintained that the Court allows a "*margin of appreciation*" to the directors in this sort of decision-making. That margin of appreciation is exemplified by Oliver J (as he then was) in *Re Halt Garage* (supra)

allowing the wife who was incurably ill and living several hundred miles from the business to be awarded some remuneration for her "*services*" as a director.

133. So HMRC frame the issue as to whether the payments were rewards for services or something else and that the purpose and substance of the payments are key. While there may come a point, even in a solvent company, where the remuneration that the directors award themselves is so outlandish that it should more properly be described as a disguised return of capital, that did not happen in this case. This was a genuine exercise of the power and it had to be done in that way to get the intended tax benefit, in particular the corporation tax deduction.

134. The cases that are relied upon, in particular *Re Halt Garage* and *Toone v Ross*, normally arise in the context of an insolvency situation and are brought by a liquidator to recover payments made in breach of fiduciary duty. If payments are made in an insolvent, or near insolvent company, the directors could well be in breach of their duties to consider the interests of creditors and the characterisation issue does not really arise.

(d) Discussion and analysis

135. The common law rule as to distributions has its origin in the capital maintenance doctrine, a fundamental pillar of company law. In *Trevor v Whitworth and anor* (1887) 12 App. Cas. 409, HL, Lord Watson explained that the law prohibits:

> "…every transaction between a company and a shareholder, by means of which the money already paid to the company in respect of his shares is returned to him, unless the Court has sanctioned the transaction. Paid-up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business."

136. A clear distinction is made between the company's capital and its profits. Dividends or distributions have always been allowed to be paid out of profits. Eligible profits are now defined in Part 23 of the Act and were only first restricted by statute in Part III of the Companies Act 1980. Before the statutory restrictions were imposed, the requirement to pay dividends out of profits was normally prescribed by a company's Articles of Association. It is important to bear this in mind, in my view, when considering the older authorities on alleged disguised distributions of capital.

137. The leading authority in this area now must be the Supreme Court decision in the *Progress Property* case in which Lord Walker dealt with the largely first instance decisions in which the common law rule against distributions out of capital had been developed. *Progress Property* concerned the sale of an asset to a shareholder at an alleged undervalue and whether that was a disguised distribution of capital to the shareholder. The Supreme Court had to decide whether in that situation it is a purely objective test, namely: whether it was a sale at an undervalue; or whether the states of

mind of those participating in the transaction are relevant to whether this was a genuine sale of an asset at what they believed to be the market price or whether it was a disguised return of capital. The Supreme Court decided that, in this situation, the participants' subjective intentions are "*highly relevant*".

138. However, this is not a case of a sale at an undervalue. It is a case of remuneration paid to a director/employee who is a shareholder. Lord Walker dealt with *Re Halt Garage* in some detail in his analysis of the authorities, and said that the case shows:

> "that if the label of remuneration does not square with the facts, the facts will prevail and the result may be an unlawful distribution, even if the directors in question intended no impropriety." (para. 19)

139. In relation to *Re Halt Garage,* Lord Walker went on to consider the relevance of the participants' states of mind and in paragraph 28, said this:

> "Sometimes their states of mind are totally irrelevant…Where there is a challenge to the propriety of a director's remuneration the test is objective (*In Re Halt Garage* [1982] 3 All ER 1016), but probably subject in practice to what has been called, in a recent Scottish case, a "margin of appreciation": *Clydebank Football Club Ltd v Steedman* 2002 SLT 109 (discussed further below)."

I sense however that Lord Mance was not of the same view in interpreting the effect of *Re Halt Garage*. In paragraph 42 of his judgment in *Progress Property,* Lord Mance said the issue of characterisation:

> "…is not necessarily answered by the way in which the parties have expressed themselves. Like Lord Walker, I would not go so far as Mr McGhee QC for Moorgath in his submission that the ultimate test is always one of the directors' (subjective) motives in effecting the transaction. The courts will not second-guess companies with regard to the appropriateness or wisdom of the terms of any transaction: see eg *In Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016."

140. As a result, I consider it is necessary to go back to the earlier authorities, in particular *Re Halt Garage*, to establish the appropriate test to apply for re-characterising remuneration as a distribution.

141. The older authorities, with respect, became somewhat confused by their reliance on the three tests propounded by Eve J in *In Re Lee, Behrens and Co. Ltd.* [1932] 2 Ch 46 (***Re Lee, Behrens***). That problematical case was concerned with whether an agreement by the company to pay an annuity to the widow of a former managing director of the company was *ultra vires*. The three tests were contained in this passage from Eve J's judgment:

> "But whether they be made under an express or implied power, all such grants involve an expenditure of the company's money, and that money can only be spent for the purposes reasonably incidental to the carrying on of the company's business, and the validity of such grants is to be tested, as is shown in all the authorities, by the answers to three pertinent questions: (i) Is the transaction reasonably incidental to the carrying on of the company's business? (ii) Is it a bona fide transaction? and (iii) Is it done for the benefit and to promote the prosperity of the company?"

142. The three tests were aimed at the *ultra vires* doctrine and made the subjective states of mind clearly relevant. On the face of it, they were nothing to do with the capital maintenance doctrine or the common law rule against disguised distributions of capital. That is not surprising because the widow was not a shareholder of the company. It is surprising however that *Re Lee, Behrens* was relied on in the cases that were concerned with the common law rule. It shows that the question was then being analysed in terms of the *ultra vires* doctrine. Even in relation to the *ultra vires* doctrine, the three tests have since been strongly disapproved of in Slade LJ's judgment in *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] Ch 246, 288 where he said that the three tests:

> "…should in my opinion, now be recognised as being of no assistance, and indeed positively misleading, when the relevant question is whether a particular gratuitous transaction is within the company's corporate capacity."

143. It is also important to bear in mind that the *ultra vires* doctrine has now been virtually abolished – see s.39(1) of the Act. If the common law rule is founded on the *ultra vires* doctrine, the consequences of the latter's abolishment may have to be explored in another case. But, as I have said above, the Company bases its case on the statutory prohibition, not the common law rule.

144. *Ridge Securities* (supra) was principally nothing to do with disguised distributions. The relevant part of the case concerned debentures issued by subsidiaries to their parent which provided for the payment of an extortionate rate of interest. Within a few days of the debentures being issued, the subsidiaries had to pay a sum by way of "*interest*" that was far greater than the amount of the advance. The purpose of this was to enable the parent company to apply for a repayment of tax, as the receipt of taxed interest could be credited against its income tax liability.

145. Pennycuick J upheld the special commissioners' finding that the payments were not "*interest*" within the meaning of s.169 of the Income Tax Act 1952. That was because "*each debenture provided for payment of interest grotesquely out of proportion to the principal amounts secured*" (p.493). The learned Judge also said that the "*description "interest" is, I think, merely a label which inaccurately describes the transaction as it appears upon the terms of the instrument read in the light of surrounding circumstances*." (p.494). However (as pointed out by Lord Walker in paragraph 17 of his judgment in *Progress Property*) this conclusion was on the correct meaning of "*interest*" in the particular taxing statute.

146. Having disposed of that point, Pennycuick J then dealt with a further contention on the part of the taxpayer that had not been run before the special commissioners. This was that the payments were within the same section of the taxing statute because they were within the expression "*other annual payment*". The Judge allowed the taxpayer to run this argument so long as the Inland Revenue was able to argue that "*the payments were a nullity as being ultra vires the companies which made them*".

147. Pennycuick J made the general observation about distributions that I have set out in paragraph [125] above. But he characterised the payments by reference to their failure of all three tests of Eve J in *Re Lee, Behrens,* including that they were not *bona fide*

transactions and were not done for the benefit of and to promote the prosperity of the company. This seems to have been based on the findings of the special commissioners that none of the subsidiaries had any reason to issue the debentures unless the parent company had caused them to do so presumably for its own tax purposes. Pennycuick J concluded that:

> "the terms of each debenture indicate on the face of it that the so-called "interest" represented in fact a gratuitous disposition of an enormous sum by the company concerned in favour of Ridge."

148. In a later case of his, *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62, Pennycuick J not only distinguished *Re Lee, Behrens* but also explained how he viewed the basis for his decision in *Ridge Securities* as being *ultra vires* in the narrow sense of being outside the company's capacity:

> "The relevant transaction in that case was a dressed-up gift of a large sum by certain companies to another company which had acquired their shares. In the absence of a power in the memorandum of those companies, the transaction was clearly ultra vires, and, at p.495, I so held."

149. *Re Halt Garage* was a completely different sort of case. For a start it was brought by the liquidator under s.333 of the Companies Act 1948 (now s.212 of the Insolvency Act 1986) against Mr and Mrs Charlesworth for a declaration that they had acted in breach of their fiduciary duties in paying remuneration to Mrs Charlesworth after she was incurably ill and unable to work and to Mr Charlesworth while the company was insolvent or near insolvent. Consideration of this issue was therefore bound up by the insolvency of the company and it could be questioned whether it has application to the decision of a solvent company to pay remuneration to its directors. There was no doubt that the sums being claimed by the liquidator had been paid out of capital rather than profits.

150. As a claim for breach of fiduciary duty, it was not necessary to establish that it was *ultra vires* or an unlawful return of capital and I daresay that if it had been litigated in these days the liquidator would have been able simply to rely on the directors' breach of the duty to have regard to the interests of creditors – see *BTI 2014 LLC v. Sequana SA* [2019] Bus L.R. 2178 (presently on appeal to the Supreme Court). But Oliver J's judgment was the first case to deal with the circumstances when remuneration could be considered to be a disguised return of capital and it has been influential.

151. The focus of Oliver J's judgment was the shareholders' power to award directors remuneration in the company's articles of association and whether there had been a proper use of that power in particular where it involved a payment out of the company's capital. He was more concerned with whether this was within the objects of the company and therefore whether the payment was *ultra vires*. He carefully analysed a number of the authorities including *Re Lee, Behrens* and *Ridge Securities,* but the most pertinent part of the judgment is at p.1039f-g, where he said (underlining added):

> "<u>The real test must, I think, be whether the transaction in question was a genuine exercise of the power [to award remuneration]. The motive is more important than the label.</u> Those who deal with a limited company do so on the basis that its affairs will be conducted in accordance with its constitution, one of the express incidents

of which is that directors may be paid remuneration. Subject to that, they are entitled to have the capital kept intact. They have to accept the shareholders' assessment of the scale of that remuneration, but they are entitled to assume that, whether liberal or illiberal, what is paid is genuinely remuneration and that the power is not used as a cloak for making payments out of capital to the shareholders as such."

152. It seems to me that there is a strong element of subjective intention that has to be taken account of in judging whether a payment is a "*genuine exercise of the power*". It is not simply a matter of scale or some objective level above which remuneration ceases to be remuneration and becomes a disguised distribution of capital. The transaction must be looked at as a whole and in context. The purpose of the payments must be a key factor in determining their character. Oliver J did not rule out all of Mrs Charlesworth's remuneration – he allowed her £10 rather than £30 per week in recognition of her role as a director. But as she did not and could not work in the business, she could not be entitled to remuneration as an employee. It is fairly obvious that in an insolvent situation a director cannot be paid ahead of the company's creditors for services or work that was simply not provided. The Judge was not prepared to rule out any of Mr Charlesworth's remuneration even though for many periods he himself was not working in the business because of various accidents that befell him.

153. Both the Company and HMRC rely on *Re Halt Garage* for different purposes: the Company says that it shows that even if a payment has the "*label*" remuneration, the Court does not have to accept that and furthermore that the Court applies a reasonableness test (ie objective test) as to whether it was truly remuneration; HMRC by contrast says that it shows the extent of the "*margin of appreciation*" that the Court will allow companies in the setting of remuneration payable to directors/shareholders. Furthermore, it is only the part that does not genuinely represent a reward for services that falls foul of the rule, not the entirety of the remuneration.

154. It is difficult to discern the true import of the decision in *Re Halt Garage* on this area, particularly given that it was a claim by a liquidator for breach of fiduciary duty but I think at least this much can be said: that the test adopted by Oliver J was whether the power to award remuneration to directors and employees was genuinely exercised by those that had the power to do so. In an insolvent situation, the exercise of the power could prejudice creditors and to that extent it could constitute a wrongful return of capital to shareholders. I consider that Oliver J did take into account the subjective intentions of the parties involved by his repeated use of the word "*dressed up*" which carries with it the conscious appreciation of the parties that they were trying to circumvent the law in some way.

155. However, what if excessive remuneration is awarded to a director who is not a shareholder? That cannot be characterised as an unlawful distribution to a shareholder. The only way that sort of remuneration could be attacked would be by way of a breach of fiduciary duty claim against those that exercised the power to award such remuneration. Where does the court draw the line in respect of excessive remuneration?

156. Mr Davies QC submitted that, even in a solvent company where creditors are completely unaffected, there is a line above which the directors cannot go in terms of awarding directors/employees remuneration, and if they do, then the amount above that level, insofar as it is paid to shareholders, will be considered to be a distribution. I have

difficulty in seeing firstly how the Court can decide what is excessive remuneration and secondly how there can be a distinction in such respect between payments to shareholders and payments to non-shareholder directors/employees. It seems to me that excessive remuneration is still remuneration – Oliver J said that: "*Remuneration does not cease to be remuneration because it is generous or even, perhaps, unwisely generous*" - and the question remains whether the exercise of the power to award remuneration was done genuinely and in good faith.

157. These issues were not resolved in *Re Halt Garage* where Oliver J decided that, because the wife did no work at all for the company, the sums paid purportedly by way of remuneration, rather than for holding the office of director, were not a genuine exercise of the power to award remuneration. It is perhaps more in the way *Re Halt Garage* has been interpreted in later cases that is relevant.

158. The next case in the series is *Aveling Barford* (supra), the decision of Hoffmann J (as he then was) concerning a sale at an undervalue to a shareholder (or more accurately, a company controlled by the shareholder of the selling company[3]). This was not the trial of the action but a motion to set aside judgment that had been entered in default of defence. Furthermore, the claim was brought by the liquidator of the selling company against the purchasing company that the latter was accountable as a constructive trustee of the proceeds of sale of the property sold at an undervalue. It was not the original parties to the transaction seeking to undo it.

159. After referring to *Ridge Securities* and *Re Halt Garage*, Hoffmann J, like Oliver J, focused on the exercise of the power of sale and its connection to *ultra vires* (underlining added):

> "So it seems to me in this case that looking at the matter objectively; the sale to Perion <u>was not a genuine exercise of the company's power under its memorandum to sell its assets</u>. It was a sale at a gross undervalue for the purpose of enabling a profit to be realised by an entity controlled and put forward by its sole beneficial shareholder. This was as much a dressed up distribution as the payment of excessive interest in *Ridge Securities* or excessive remuneration in *Re Halt Garage.* The company at the time had no distributable reserves and the sale was therefore ultra vires and incapable of validation by the approval or ratification of the shareholder."

And towards the end of his judgment, Hoffmann J made it clear that he thought that the subjective states of mind of the individuals involved are relevant as to whether it was a disguised return of capital:

> "As for the transaction being a sham, I accept that it was in law a sale. The false dressing it wore was that of a sale at arms' length or at market value. It was the fact that it was known and intended to be a sale at an undervalue which made it an unlawful distribution."

160. *Progress Property* was similar to *Aveling Barford* in that they both concerned a sale of an asset at an undervalue to or for the benefit of the seller's shareholder. The Supreme

[3] Hoffmann J thought this fact was immaterial as it was effectively a distribution to the ultimate beneficial owner.

Court emphasised, and it is common ground, that the characterisation issue is a matter of substance not form. As Lord Walker said:

> "16. Whether a transaction infringes the common law rule is a matter of substance, not form. The label attached to the transaction by the parties is not decisive."

> "27. …in cases of this sort the court's real task is to inquire into the true purpose and substance of the impugned transaction. That calls for an investigation of all the relevant facts, which sometimes includes the state of mind of the human beings who are orchestrating the corporate activity."

161. One would have thought that a sale at an undervalue would be the paradigm case for adopting the objective approach. But Lord Walker, following in particular *Aveling Barford,* was of the view that it was actually a case where the subjective intentions of the parties were "*highly relevant*". That is the ratio of the decision because the fact that the person who conducted the transaction on behalf of the selling company, Mr Cornus Moore, genuinely believed that it was a sale of the shares at market value, even though he mistakenly took into account an indemnity (see Lord Mance's judgment on this aspect), was the crucial factor in the decision that it was not a disguised return of capital:

> "If the conclusion is that it was a <u>genuine arm's length transaction</u> then it will stand, even if it may, with hindsight, appear to have been a bad bargain. If it was an improper attempt to extract value by the pretence of an arm's length sale, it will be held unlawful. But either conclusion will depend on a realistic assessment of all the relevant facts, not simply a retrospective valuation exercise in isolation from all other inquiries." (para. 29) (underlining added)

162. I find it difficult to see why the "*relevant facts*" should be different when judging whether a payment is genuine remuneration or a disguised return of capital. Disguising something as something else is a conscious process that cannot be divorced from the context, purpose and subjective states of mind of those involved.

163. Mr Davies QC submitted that *Toone v Ross* (supra) is indistinguishable from this case. While it appears to be concerned with a tax avoidance scheme using Employment Benefit Trusts (**EBT**) as a way of remunerating its directors/shareholders, I have found it a difficult case to follow and understand. It is unclear from the judgment as to the actual nature of the payment that was made into the EBT, although it appears to have been regarded, by HMRC at least, combined with the payment out from the EBT, as a payment of remuneration for tax purposes. Before the decision in the *Rangers*[4] case, where the use of EBTs was found by the Supreme Court not to affect the fact that employees were receiving remuneration subject to income tax and NIC, I imagine it was hoped that the use of such tax avoidance would mean that payments to or for the benefit of employees via EBTs would not be considered to be taxable remuneration. In other words, the company was not alleging that these were remuneration payments rather than distributions; but it is not at all clear what the company was asserting the payments to the EBT were.

[4] *RFC 2012 plc (in liquidation) (formerly Rangers Football Club plc) v Advocate General for Scotland* [2017] 1 WLR 2767

164. Chief ICC Judge Briggs went through all the above authorities, including *Progress Property*, but also seemed ultimately to place much reliance on the three tests of Eve J in *Re Lee, Behrens* (see para. 79). The Judge was influenced by the fact that it was only the three shareholders who benefitted from the EBT scheme and they each received money in direct proportion to their respective shareholding. Mr Davies QC particularly relied on paragraph 76 of the judgment where the Judge says:

> "76. The EBTs were intended to and did act as a conduit through which the shareholders, who were also directors and/or employees of the Company, were given a tax free sum taken from the Company's capital".

Mr Davies QC submitted that this shows the Court's willingness to look at what is really going on – the transfer of value from company to shareholder - and not being distracted by legal form.

165. I do not find *Toone v Ross* to be helpful in determining whether in this case the payments were genuinely in respect of remuneration or whether they were disguised distributions. There does not seem to have been any consideration as to whether there was a genuine exercise of the power to award remuneration. Furthermore, the interposition of the EBTs between the company and the shareholders and the divergence between how the transactions were being viewed for tax purposes and how the Judge viewed them from a company law perspective are complicating factors that are difficult to reconcile with this case. It is also relevant to point out that the proceedings in *Toone v Ross* were brought by the liquidator in the context of insolvency against the shareholders who received the money; those shareholders, who were the persons who made the relevant decisions in relation to the tax avoidance scheme, were trying to maintain that the transactions should not be re-characterized, which is the opposite to the position in this case.

166. My conclusions then on the legal test for re-characterising remuneration as a distribution to shareholders are as follows:

(1) The test is not a purely objective one;

(2) The subjective states of mind of those deciding upon the transactions in question, in this case the payment of remuneration, can be relevant facts for the purposes of determining "*the true purpose and substance of the impugned transaction*";

(3) The way those parties have chosen to describe the transaction both in the documents governing the transaction and also in other documents such as the Company's accounts (which were signed off on the basis that they showed a true and fair view) can also be relevant facts to be taken into account because they may indicate not only the true nature of the transaction but also what those deciding on the transaction considered it to be;

(4) Ultimately, the Court will have to decide whether there was a genuine exercise of the power to award remuneration or whether that power was being used (or abused) to disguise the true nature of the payments which were really distributions to shareholders;

(5) In deciding whether there was a genuine exercise of the power to award remuneration, particularly in a solvent company, the directors will be judged in the way that other commercial decisions are adjudicated upon; the Courts will generally not interfere in commercial decisions taken by directors and a wide "*margin of appreciation*" is allowed (see eg. Para.120 of *Re AMT Coffee Ltd* [2019] EWHC 46 (Ch), an unfair prejudice petition under s.994 of the Act, in which excessive remuneration was one of the allegations).

(e) Application of the legal test to the facts

167. HMRC submitted that there is a straight choice in this case: either the payments and credits were remuneration to Ms Stoneman and Mr Ralph as directors/employees; or they were distributions to them as shareholders. There is no middle ground or hybrid categorisation of the payments. They are one or the other and HMRC of course say that they are clearly remuneration and all the documentation concerning the payments and the Company's accounts and records, including minutes of meetings, support their case.

168. Eventually, the Company agreed that there is that decision to be made but Mr Davies QC preferred to frame the question purely as to whether the payments and credits should properly be considered to be distributions. He dismissed the documentation relied upon by HMRC as "*labelling of the most insidious kind*" provided by Blackstar so as to achieve the promised tax avoidance. The Company's case evolved considerably, even during the course of the trial, so that by Mr Davies QC's reply closing submissions, the main point was that the payments were "*gratuitous*" or "*ex gratia*", that the Company got nothing in return, no "*quid pro quo*" whether by way of services provided or from the Agreement to subscribe for the E Shares, and that there was therefore no relevant "*exchange for value*"[5] which would be necessary to avoid the payments being characterised as distributions.

169. I propose to deal with these and the other factual matters in the following order:

(1) The purpose of the E Shares scheme;

(2) The documentation effecting the E Shares schemes;

(3) The Company's accounts and other documentation referring to the E Shares schemes;

(4) The nature of the payments;

(5) Drawings from the LLP;

(6) The perception of relevant individuals at the time.

[5] This phrase was taken from Lord Hamilton's judgment in *Clydebank Football Club Ltd v Stedman* [2002] SLT 109, cited with approval by Lord Walker in paras. 31 and 32 of *Progress Property* (supra).

(1) The purpose of the E Shares scheme

170. The purpose of the E Shares scheme was twofold: (a) to avoid corporation tax on the profits being made by the business; and (b) to enable tax-free payments to be made to Ms Stoneman and Mr Ralph. They were the only shareholders and directors of the Company. After Mr Ralph's resignation as a director on 31 August 2012, Ms Stoneman was the Company's sole director.

171. In order to achieve the corporation tax deduction, the payments and credits had to be allowable expenses. While they did not necessarily have to be remuneration as such, it was common ground that the arrangements as a whole had to be "*employment-related*". If the payments and credits were actually distributions to shareholders, they would not be deductible for corporation tax purposes. Lawful dividends are paid out of a company's post-tax profits. It was therefore imperative for the corporation tax purpose that the payments and credits were not distributions and were made to Ms Stoneman and Mr Ralph in their capacity as directors and/or employees and in reward for their services to the Company.

172. In order that the payments would not attract income tax or NIC, the recipients had to be subject to a concomitant obligation which was that they had to subscribe for the E Shares with a contingent liability to pay up the full nominal value of the E Shares. Whether the E Shares scheme was effective for such purpose is a matter for the FTT proceedings, not me. What is relevant for me is that the payments and credits themselves had to be a form of remuneration that would otherwise be taxable as the recipient's earnings.

173. It was necessary therefore for both purposes of the E Shares scheme for Ms Stoneman and Mr Ralph to be receiving the payments in their capacity as directors or employees; it was not necessary for them to be shareholders in the Company.

174. Blackstar's literature made very clear that the purpose of the E Shares scheme was to reward key employees in a way which avoided both corporation tax and income tax and NIC. Ms Stoneman's and Mr Ralph's objective was to get substantial sums of money out of the Company without paying any tax and the E Shares scheme seemed to enable this. If ordinary dividends had been paid, they would not have been deductible for corporation tax purposes and they would be taxable in their hands (at a lower rate and not subject to NIC). If ordinary remuneration had been paid, it would have been subject to both income tax and NIC, payable by the Company through PAYE and including employer's NIC. By the E Shares scheme, all this was apparently avoided so long as the payments were a form of remuneration to Ms Stoneman and Mr Ralph in their capacity as directors and/or employees.

175. Because the prize was so big, Ms Stoneman was content to allow the Company to spend a huge sum on Blackstar's fees over the three iterations of the E Shares scheme. This totalled £920,250 (including VAT) but this is without the other professional fees incurred, such as to FPSS and Mr Leigh. She was undoubtedly willing to do whatever Blackstar told her to do in order to achieve the tax savings that would allow her (and Mr Ralph for the 2011 Scheme) to take money out of the business tax free. She received a total of £4,994,550 credited to her loan account with £1,079,000 actually paid out to her. Mr Ralph received the first £1,079,000 in cash. That is over £6 million put through the E Shares scheme.

(2) The Documentation effecting the E Shares schemes

176. The relevant documentation was the same for all material purposes in respect of all three iterations of the E Shares scheme. Mr Davies QC submitted that HMRC's reliance on the wording in the documentation "*is surprising and anomalous*" as it puts form over substance. It seems to me that the wording in the documentation by which the E Shares scheme was brought into effect must necessarily be the starting point for considering the correct characterisation of the payments made pursuant to that scheme. HMRC, in any event, countered the Company's criticism of their approach by saying that they are very much looking at the substance of the transaction and are not fixated by the form or wording in particular documents but putting those in the context of the purpose of the E Shares scheme as a whole and other contemporaneous documents such as the accounts which were prepared by an experienced accountant and signed off by Ms Stoneman.

177. The reason the Company dismisses the wording in the documentation as merely labelling without legal effect is because that documentation clearly assumes that the payments and credits are to be characterised as remuneration or employment-related. This is not just the references to Ms Stoneman and Mr Ralph as "*Employee*" and the Company as "*Employer*" but it is the substantive wording as well. As noted above:

(1) The board meeting minutes dated 28 November 2011 (also 19 November 2012 and 1 July 2013) recorded that the E Shares scheme was being entered into because "*it was appropriate to consider recognising the contribution of*" Mr Ralph and Ms Stoneman. I do not accept Ms Stoneman's re-interpretation of this as referring to their contributions as shareholders. Within the overall purpose of the arrangements, it was clearly referring to their contributions as directors and employees.

(2) The Agreement to subscribe for Class E Shares was described as being part of Mr Ralph's and Ms Stoneman's employment arrangements with the Company. It referred to the fact that they (the "*Employee[s]*") are employed by the Company (the "*Employer*") and that the agreement was being entered into "*[as] part of the employment arrangements between the Employer and the Employee and in particular in recognition of the services of the Employee during the period ended 31 March 2012*".

(3) The payment of the net sum was, under the terms of the Agreement, to be applied as a credit to the Employee's loan account, meaning their director's loan account;

(4) The Form of Application for the Class E Shares in the schedule to the Agreement specified that a call on the unpaid amount of the E Shares would automatically be made when either of Mr Ralph or Ms Stoneman ceased to be either an employee or officer of the Company; therefore there was a real incentive to remain working for the Company and to make it a success, as liquidation was the other automatic trigger for a call.

178. The Company pointed to the fact that the payments and credits themselves are not referred to as remuneration, whether as salary or performance-based bonus or otherwise. Instead they are expressed to be "*in consideration of the Employee offering to subscribe for Class E shares in the form of the offer to subscribe set out in the schedule to this agreement*".

179. On the face of it, if the Agreement is considered to be in substance a subscription agreement and nothing to do with remuneration, it was very uncommercial for both parties:

(a) So far as the Company was concerned, it was paying out the full nominal value of the E Shares being subscribed for in return for just 1% of that nominal value. It has the prospect of receiving at some indeterminate point in the future the full nominal value but that is very uncertain and may not ever happen if an exit strategy avoids there being a call. As was seen in relation to Mr Ralph, it was totally within Ms Stoneman's control as to whether there would ever be a call.

(b) From Ms Stoneman's and Mr Ralph's point of view, they were subscribing for worthless shares. The E Shares had virtually no rights whether to vote or attend meetings, to dividends or to share in the Company's assets on a sale or winding up (subject to achieving 500% of the 2011 turnover by 2014). They were potentially exposing themselves to a call for the unpaid nominal value of the E Shares.

180. If that was all that the Agreements were about, they would not sensibly have been entered into. The reason that they were entered into by the Company and Ms Stoneman and Mr Ralph is because they enabled substantial sums to be paid to them out of the Company tax free, which they could use as they wished. The Agreements were the vehicle by which Ms Stoneman and Mr Ralph could be paid for their services to the Company while achieving the tax purpose of the scheme. While there was a theoretical liability on the call, which they anticipated being avoided (despite Ms Stoneman's alleged lack of belief in there being an effective exit strategy), the reality was that they had the money from the Company and could use it as they pleased, like any other form of remuneration. The fact that Ms Stoneman was prepared to enter into the second and third iterations of the E Shares scheme while knowing of all the potential dangers of a call and no exit strategy shows her apparent lack of concern as to those risks, and she viewed the saving of tax as much more important.

181. Therefore, the substance of the Agreements and looking at them as a whole and in context confirms that they were part of the "*employment arrangements*" and were a means of rewarding Ms Stoneman and Mr Ralph for their services to the Company. The coupling of those rewards with an obligation to subscribe for the E Shares was the mechanism for achieving the tax purpose of the scheme but, in my view, that obligation does not detract from the true nature of the payments.

(3) <u>The Company's accounts and other documentation referring to the E Shares schemes</u>

182. The Company's accounts for the relevant periods ended 31 March 2012, 2013 and 2014 each recorded the payments and credits from the E and F Shares schemes as part of directors' remuneration and more specifically as an "*employment expense*". These were one of the largest items in the accounts and could not have escaped the attention of anyone reading, let alone signing, the accounts.

183. The Company has submitted that the Notes, particularly Note 13 headed "*Related Party relationships and transactions*", in which the E Shares scheme is described, make clear that this was not normal directors' remuneration. This reflected, the Company said, Mr Leigh's total reliance on Blackstar for the requisite wording to go into the accounts. Be that as it may, Mr Leigh could not have been in any doubt that this was being regarded as a form of remuneration being paid to the directors/employees in their capacity as such. He could not have considered that the payments were any sort of distribution as he knew that that would have to be accounted for differently, particularly post-tax in the profit and loss account. Furthermore, the Notes to the accounts do not affect the fact that the payments were recorded as being part of directors' remuneration.

184. To support those entries in the accounts, Ms Stoneman and Mr Ralph signed Director's Emolument Certificates which confirmed in relation to the E Shares scheme payments that (in the year ended 31 March 2012): *"[t]he emoluments received by me in respect of my services to the company were £1,193,071, excluding pension contributions.*" The AGM minutes for each year included a resolution approving the "*director's remuneration, as shown in the accounts*."

185. It was of course critical for the whole success of the E Shares scheme that the accounts recorded the payments as remuneration, that such remuneration was subject to an obligation to subscribe for the E Shares and that the remuneration would be deductible for corporation tax. That would be the basis for the Company's tax return. There was no point doing the E Shares scheme unless the payments were so regarded. There is no doubt that the accounts recorded the payments as remuneration.

186. As noted in paragraphs [114] to [115] above, the Company submitted that the accounting treatment is of limited assistance in understanding the true substance and purpose of the E Shares scheme. This was said to be largely because the accounts were not contemporaneous with the entry into the 2011 Scheme (indeed the 2012 accounts recording the 2011 Scheme were signed off after the 2012 Scheme had been entered into) and that they can be discounted as merely what was required to be done by Blackstar. For the reasons set out in those paragraphs above, I do not accept that the accounting treatment is of limited assistance. It was integral to the success of the E Shares scheme not only that the payments were said to be remuneration but that they actually were. The accounts reflected not only how Blackstar wanted to portray the payments but also how the Company, Ms Stoneman, Mr Ralph and Mr Leigh viewed them. There can be no other basis for their signatures on the accounts.

(4) <u>The nature of the payments</u>

187. As stated above, Mr Davies QC's main point by the end of his submissions was that the payments were effectively gratuitous and there was no "*exchange of value*". He said that they were not remuneration or a performance-based bonus because there was no

contractual entitlement to such remuneration or bonus and by a proper interpretation of the Agreements to subscribe for the E Shares, they were not in consideration of services provided to the Company.

188. In relation to the Agreements to subscribe for the E and F Shares, Mr Davies QC submitted that this was not an "*exchange of value*" because the value of the payments would not be diminished by the obligation of the Company to issue shares in itself. This somewhat technical argument rests on the basis that any value received by the Company in respect of the E Shares would be credited to share capital, which is effectively a liability of the Company, and not to replenishing its distributable reserves. Therefore, the Company has made the payments without receiving anything of value in return. Accordingly, so Mr Davies QC submitted, the payments were effectively gratuitous and should therefore be seen for their true substance which was a distribution to shareholders.

189. The Company may be correct in their technical argument but it only works if the payments were not made to Ms Stoneman and Mr Ralph as a reward for their services and as part of their "*employment arrangements*". Just because remuneration is coupled with an obligation to subscribe for E Shares does not mean that it ceases to be remuneration. For instance, remuneration could be paid to an employee subject to an obligation on the part of the employee to pay a certain amount of it into a pension. The remuneration is still a profit from the employment.

190. The Company also relied on the following as demonstrating that the payments were really distributions to shareholders:

(i) that the payments were calculated by reference to the profits of the business;

(ii) that the 2011 Scheme split the payments 50/50 between Ms Stoneman and Mr Ralph;

(iii) that there was no contractual or other entitlement to remuneration or bonuses on this scale.

<u>(i) Calculation by reference to profits of the business</u>

191. The Company said that the whole purpose of the E Shares scheme was so that the owners of the Company could extract the profits from the business in a tax efficient way. This was confirmed to be the objective at an early stage when FPSS were first consulted on tax planning, before the E Shares scheme had been mentioned. The focus on profit extraction is a clear indication, the Company said, that the underlying rationale was to return value to the Company's shareholders. They were motivated to enter the 2011 Scheme in order to fund the purchase of the property in Ibiza and they therefore saw the profits of the business as theirs to spend on what they wanted. Furthermore, the calculation of the payments was purely based on the profits, including forecast profits of the Company.

192. In my view, there is nothing in this point. As HMRC have submitted, owner-directors of a company have a choice whether to pay themselves by way of remuneration or

dividends, sometimes by a combination of the two. The profits of the company are a reflection of their performance in driving the company forward and managing its business. In a solvent company, I see nothing wrong in the directors deciding to award themselves remuneration by reference to the profits of the company, rather than by reference to any other metric. If it has beneficial tax consequences, then that too would be in the interests of the company.

(ii) 50/50 split between Mr Ralph and Ms Stoneman

193. The Company submitted that the 50/50 split reflected their shareholdings in the Company, not their respective contributions to the success of the Company. Ms Stoneman had always received more salary than Mr Ralph and the Company says that this reflected her greater experience and contribution to the Company.

194. HMRC submitted that in fact it was Ms Stoneman's view that the income from the business should be split 50/50. The reason that she was paid more salary before the E Shares scheme was because she was older than Mr Ralph, as Ms Stoneman admitted in re-examination. Furthermore, pre-separation she regarded the income as effectively joint: "*ultimately we were living together and it was a joint income.*"

195. In the course of the divorce negotiations, Ms Stoneman sought to find a way to claw back some of the monies received by Mr Ralph on the grounds that, as she said in her witness statement, it did not relate to "*work Matt had contributed to whilst employed*" (see paragraph [97] above). She calculated the "*overpayment*" as being £217,500 and this was ultimately used to discharge the greater part of the consideration payable to Mr Ralph by Ms Stoneman for his ordinary shares in the Company under the Restructure Agreement.

196. In itself, the fact that the payments were split 50/50 is not a particularly material factor in terms of characterisation. As Chadwick LJ observed in *Macpherson and anor. v European Strategic Bureau Ltd* [2000] 2 BCLC 683, CA (at para.31):

> "There is no reason, in principle, why a company should not agree that the amounts of the payments to be made to persons who have provided, or who are to provide, services for its benefit are to be apportioned amongst those persons in the proportions in which they hold shares in the company; provided, of course, that the agreement to pay for those services, and in those amounts, is otherwise a proper one for the company to make."

(iii) No contractual or other entitlement to remuneration or bonuses on this scale

197. Ms Stoneman's and Mr Ralph's service contracts were in identical terms and provided a "basic salary" of £125,000. This was reviewable each year and as can be seen from paragraph [48] above, it went both below and above the £125,000 specified. There were no provisions in the service contracts in relation to the payment of a bonus.

198. The articles of association for the Company adopted on 28 November 2011, incorporated Regulation 19 of Schedule 1 to the Companies (Model Articles) Regulations 2008. This provides as follows:

> "19(2) Directors are entitled to such remuneration as the directors determine-
>
> (a) For their services to the company as directors, and
>
> (b) For any other service which they undertake for the company
>
> (3) Subject to the articles, a director's remuneration may –
>
> (a) take any form…"

199. The Company submitted that insofar as the payments are to be considered to be "*performance-based bonuses*" (which is how HMRC had characterised them) it was incoherent to base their size on profit forecasts and there is no evidence that the decision to pay such bonuses was based on any real assessment of Ms Stoneman's and Mr Ralph's performance. The board minutes referring to their "*contribution*" were merely part of the documentation provided by Blackstar and there is no evidence of any real deliberation by the directors in relation to awarding such large sums by way of director's remuneration. Finally, the Company submitted that the prospect of having to pay the full nominal value of the E Shares is inconsistent with the notion of the payments being a bonus.

200. I do not consider that any of these points detract from the payments being a form of remuneration. The directors, who owned the Company, were able to decide that the Company should reward them by the payment of a substantial form of remuneration. It does not matter if it is called a bonus, a benefit in kind, salary or any other type of remuneration. For the purposes of the E Shares scheme and in order to achieve its purpose, they decided to pay themselves by way of remuneration rather than dividend and this was in recognition of their services to the Company. As can be seen from the previous section, Ms Stoneman was concerned that they should only be rewarded for their actual contributions to the success of the Company. As she said herself, her contribution to the Company was: "*time, energy, patience, direction of the business, a heck of a lot*", all of which are consistent with her contribution being as a director.

201. The prospect of triggering a call on the E Shares by leaving the Company was clearly a disincentive to their doing so. That is why Mr Ralph had to remain employed by the Company for at least 5 years after the Restructure Agreement. Ms Stoneman's evidence to the effect that she never considered there to be a credible exit strategy was unconvincing as she seemed to accept the professional advice she received on all other aspects of the E Shares scheme. Furthermore, she decided to go ahead with the 2012 and 2013 Schemes despite apparently being dubious about the exit strategy and thereby potentially exposing herself to a liability to pay up an additional £3,760,200, on top of the original £1,079,100 from the 2011 Scheme.

(5) Drawings from the LLP

202. Prior to the trial, whether in the pleadings or the witness statements, the Company had not referred to the drawings that Ms Stoneman and Mr Ralph took from the LLP. The Company's skeleton argument made three passing references to their regular income from the business being drawings from the LLP but it was only in Mr Davies QC's oral opening submissions that the point was developed and appeared to be quite a major part of the way Mr Davies QC was putting the Company's case.

203. The Company submitted that HMRC's case that the payments were remuneration was "*completely undermined by the fact that Ms Stoneman and Mr Ralph took their regular income in the form of drawings from the LLP*". It was apparently envisaged, as part of the setting up of the LLP structure, that while the business's profits would be transferred to the Company, which was a member of the LLP, that Ms Stoneman and Mr Ralph would receive a regular income from the LLP by way of drawings. Such drawings are basically borrowings from the LLP which have to be repaid at some point. At the time, drawings from an LLP did not attract tax, and so this was also a tax efficient way of taking money out of the business.

204. It appears from the documents that some time shortly after the LLP started trading in October 2011, there was an agreement that both Mr Ralph and Ms Stoneman would draw £14,000 per month from the LLP. It is interesting that they agreed to draw the same amount. The LLP's management accounts show that quite substantial sums were drawn by Ms Stoneman and Mr Ralph. For instance, the LLP's balance sheet as at 31 March 2013 showed accumulated drawings of £594,453 for Mr Ralph and £1,893,606 for Ms Stoneman, which indicates somewhat more than the £14,000 per month was being drawn. While that may be an indication that the business was doing very well, it is probably more to do with the fact that the LLP had all the cash which it was able to pay out in the form of drawings.

205. Ms Stoneman, Mr Ralph and Ms Bottomley referred to these drawings at the time as their "*salary*" and when questioned about the drawings in cross examination, Ms Stoneman replied:

> "A. Yes. I had to live, yes."
>
> "A. …I was drawing down funds from the LLP and that is how I was living."
>
> "A. …I was taking drawings so they compensate. I was not being paid in any other way other than taking monthly drawings, compensated for the services I was providing."

206. While drawings might have seemed like salary in terms of their regularity, it remained the case that Ms Stoneman and Mr Ralph (and all of the employees in the business) were actually employed by the Company even though they were effectively working for the LLP. The trouble with drawing those amounts of money from the LLP was that they had to be repaid at some point. There were a number of ways that that could be done, the most obvious of which were the allocation of LLP's profits to them to set off against the drawings or for there to be a sale of the business. In the event both routes were utilised.

207. In 2014, because of a change in the law, profit allocations from the LLP to the Company were no longer effective for tax planning purposes. Accordingly, for the year to 31 March 2015 there was no profit allocated to the Company. That was the first year that the E Shares scheme was not used by Ms Stoneman. Instead a profit allocation was made by the LLP to Ms Stoneman in the amount of £974,030. In the following year ending 31 March 2016, a huge taxable profit allocation of £2,375,935 was made to Ms Stoneman. If anything, this amount indicates the extent to which Ms Stoneman valued her services to the business and shows that the amounts of the payments and credits under the E Shares scheme were not out of line with that.

208. On 1 July 2016, the LLP's trade and assets were sold to a new company set up by Ms Stoneman called NKD Learning (UK) Limited for £6 million and the entire capital gain realised on the sale, a sum of £5,293,131.93, was allocated to Ms Stoneman. These allocations of profit to Ms Stoneman were set off against her drawings from the LLP and left a net credit in Ms Stoneman's favour of £3,649,257.06 as at 28 February 2017. Ms Stoneman has used some of this to settle her personal CGT liability resulting from the sale of the business and her personal income tax liabilities on her profit allocations.

209. HMRC submitted that a way of dealing with the repayment of the LLP drawings could have been to use their Company loan accounts to satisfy their debts to the LLP. In fact this was to an extent done when Ms Stoneman and Mr Ralph received their payments in respect of the 2011 Scheme. As explained in paragraphs [87] to [88] above, the cash was paid from the LLP bank account. As a result, it was treated as drawings by each of them. Shortly after, the drawings were effectively repaid by a credit that was matched by an equivalent debit to their loan accounts with the Company. In short, the payments under the 2011 Scheme to Ms Stoneman and Mr Ralph were in fact made by way of credits against their drawings from the LLP. HMRC submitted that this method could have been used, by applying the later credits to their loan accounts to repay the LLP on their drawings.

210. The Company dismissed this suggestion as highly speculative and having no basis in fact. Furthermore the Company submitted that Ms Stoneman remained concerned throughout about her potential liability to a call on the E and F Shares and so she would not have spent her loan account with the Company on discharging her debt to the LLP.

211. I do not need to resolve these hypothetical issues. I do not consider that the fact that regular sums were being paid to Ms Stoneman and Mr Ralph while the E Shares scheme was being operated answers the question as to the proper characterisation of the payments made under the E Shares scheme. It perhaps explains where their cash was coming from and why Ms Stoneman did not need to draw down any of the monies credited to her director's loan account with the Company under the 2012 and 2013 Schemes. But it does not affect, in my view, the analysis as to the nature of the payments being a reward for services and authorised and accounted for as such.

(6) <u>The perception of relevant individuals at the time</u>

212. The Company submitted that the way relevant individuals perceived the arrangements at the time is immaterial because the test on characterisation is purely an objective one. I have disagreed with that proposition as a matter of law. In the end, I do not think that

my conclusions in relation to what Ms Stoneman or Mr Leigh or any other of the professional advisors perceived have affected the analysis of the E Shares scheme and particularly whether the payments were a form of remuneration or really disguised distributions. Having said that, it has certainly reinforced my view.

213. I have given my general comments about the evidence of Ms Stoneman and Mr Leigh in paragraphs [30] to [38] above. I also said that I would similarly discount Mr Ralph's evidence as appears from his Amended Defence.

214. It is unsurprising that in 2011, Ms Stoneman and Mr Ralph were looking to reward themselves and to do so in the most tax efficient manner. Having steered the Company through a very difficult first 5 years, they won the contract with DHL Express in 2010 and that dramatically changed the trajectory of the business. Ms Stoneman said that she and Mr Ralph were "*going to recognise ourselves, and get some degree of payment back for sticking with the business through a double dip recession*", albeit that she did qualify that by saying that this would be in their capacity as shareholders. I do not think she distinguished at the time whether she was rewarding themselves as shareholders or directors. The simple fact was that the Company was in a very healthy financial position (it had over £2.3 million in its profit and loss account as at the date of the 2011 Scheme) and they were looking to reward themselves handsomely as a result.

215. There is no escaping the fact that Ms Stoneman signed off three sets of accounts that all recorded the E Shares scheme payments as the major part of director's remuneration and as an "*employment expense*". Just 2½ weeks before signing the accounts for the year ended 31 March 2012, Ms Stoneman attended a meeting with Mr Leigh, Ms Bottomley and Mr Bishop during the course of which there was specific discussion about whether the payments should be recorded as an "*employment expense*" separate from director's remuneration. In signing the accounts she accepted responsibility that they gave a true and fair view of the Company's state of affairs. Ultimately she agreed that she "*believed she was signing the accounts to reflect what had happened*". She also signed the Director's Emolument Certificates which confirmed the payments as part of her director's remuneration.

216. In my view there can be little doubt that Ms Stoneman regarded the payments made to her under the E Shares scheme as being rewards for her services to the business. She knew that they were not dividends as this would not have worked for the tax purpose of the E Shares scheme. Whether or not the documentation was provided to her by Blackstar because it was necessary to be in that form in order to achieve the promised tax avoidance, Ms Stoneman must have genuinely believed at the time that she could award herself and Mr Ralph these large sums by way of remuneration.

217. Mr Leigh was involved in the E Shares scheme discussion from the outset and at every step of the way. While he maintained that he had very little experience of tax avoidance schemes, he had over 30 years of practice as an accountant and he knew very well the difference between remuneration and dividends and that the accounts had to show a true and fair view of the Company's financial position. He could have been in no doubt that the payments were not dividends and that they were a form of remuneration being paid to Ms Stoneman and Mr Ralph in their capacities as directors or employees, not shareholders. He eventually agreed in his oral evidence that the description of the payments as director's remuneration and an "*employment expense*" reflected what he thought had actually taken place. Even if Mr Leigh may have occasionally used the

word "*distribution*" by reference to the payments he was clearly not doing so in the technical sense of a distribution to shareholders within the meaning of s.829(1) of the Act. I find that Mr Leigh at the time considered the payments to be remuneration paid to Ms Stoneman and Mr Ralph as directors in reward for their services as such to the Company.

218. It is also of some significance that Ms Eva, an experienced corporate lawyer, did not consider that the payments were disguised distributions to shareholders. She looked at the E Shares scheme documentation twice during 2012 in the context of the divorce negotiations and she discussed it with Blackstar and FPSS. She specifically queried the accounting treatment in her email to Mr Leigh of 25 June 2012 (see paragraph [93] above) but was satisfied, having spoken to Mr Allen at Blackstar. The only conclusion that can be drawn as to Ms Eva's perception of the arrangements is that she considered the payments to be remuneration being paid in recognition of Ms Stoneman's and Mr Ralph's services to the Company as directors and employees and that they could not have been distributions to them as shareholders.

219. Therefore, all the individuals outside of Blackstar and FPSS who were involved in looking at the E Shares scheme concluded that the payments were remuneration for services to the Company, not distributions to shareholders.

(f) Conclusion on Characterisation

220. In my judgment, by applying the legal tests that I set out in paragraph [166] above to the facts as analysed above, the payments made under the E Shares scheme to Ms Stoneman and Mr Ralph are to be characterised in the way they were described in all the relevant documentation as a form of remuneration in recognition of their services to the Company as directors and employees. They were not disguised distributions to them as shareholders.

221. I consider that the directors' power to award themselves remuneration was properly and genuinely exercised for the purpose of effecting the E Shares scheme. It was done with the benefit of professional advice. The Company was solvent and able to pay such remuneration without affecting creditors or any other third parties. The Company does not argue that this was excessive remuneration in the sense that a smaller figure would have been acceptable (as in *Re Halt Garage* (supra)). The Company says simply that the payments were not a reward for any services provided and were purely paid as consideration for the subscription of the E Shares. I disagree with that analysis of the Agreement and the nature of the payments. It was within the power of the directors and shareholders of the Company to authorise the payment of remuneration in that form. As it was a genuine exercise of that power, the payments were not disguised distributions to shareholders.

222. In his closing submissions, Mr Davies QC invited me to consider how these arrangements would be considered if these proceedings had been brought by a liquidator seeking to recover the payments on behalf of creditors (as in *Re Halt Garage* and *Toone v Ross* (supra)). In doing so, Mr Davies QC understandably wanted me to put out of my mind the fact that it was Ms Stoneman, the person who decided to enter into the E Shares scheme three times, who was seeking to unwind them to avoid a large

tax liability that may arise as a result. Mr Davies QC submitted that a liquidator would have no trouble dismissing the paperwork, including the board minutes and accounts, as merely cover for a disguised distribution.

223. Mr Davies QC is right to say that the legal test for re-characterising remuneration as a disguised distribution must be the same whoever is the claimant asserting that re-characterisation. But context is important. If the Company was in liquidation and the claim was being pursued by a liquidator, there would be issues around insolvency and whether the payments were paid at a time when it was likely that the Company would become insolvent and the directors may have breached their fiduciary duties. As I have said above, where the Company was solvent, it was open to the directors and shareholders to reward themselves by way of remuneration rather than dividends and that is what they decided to do because of the huge tax savings they thought they would achieve by doing so.

224. Accordingly I hold that the correct characterisation of the payments and credits to the directors' loan accounts as part of the three E and F Shares schemes is that they were remuneration by way of rewards for services and were not disguised distributions.

G. DISCOUNT AND COMMISSION

225. By way of alternative (or in addition), the Company claims that the payments and credits that it made under the E Shares schemes constituted either or both unlawful commissions under ss.552 and 553 of the Act and/or unlawful discounts on the E Shares contrary to s.580 of the Act. This is a complicated area on which there is no modern authority.

226. HMRC's simple response to this is that it is decided by the characterisation issue because if, as I have found, the payments and credits were remuneration, they cannot be a discount against the nominal value of the E Shares; nor can they be a commission for the Agreement to subscribe for the E Shares. They were remuneration paid as rewards for services even if they were coupled with an obligation to purchase the E Shares.

(a) Analysis of the law on discounts and commissions

227. Mr Sykes QC led for the Company on these issues. The Company's original case on these issues, as set out in its skeleton argument and opening submissions, was that the arrangements fell foul of s.553 of the Act and that this was a freestanding prohibition on commissions not dependent on, or a carve out from, s.552 of the Act. However, half way through Mr Sykes QC's submissions in closing, he withdrew that argument on behalf of the Company.

228. As I understand the Company's position, that means that it only relies on ss.552 and 580 of the Act and is saying that those sections work together in some way that results

in the payments and credits under the E Shares scheme being unlawful discounts on the E Shares and/or commissions for the subscription for the E Shares. I have to say at the outset that I do have difficulty seeing that those sections have any application to the facts of this case, particularly in the light of my findings on the characterisation issue.

229. I start with s.580 of the Act. This is within Chapter 5 of Part 17 of the Act and is headed "*Payment for Shares*". It provides as follows:

> "**580 Shares not to be allotted at a discount**
>
> (1) A company's shares must not be allotted at a discount.
>
> (2) If shares are allotted in contravention of this section, the allottee is liable to pay the company an amount equal to the amount of the discount, with interest at the appropriate."

By s.590 of the Act, the contravention of s.580 is a criminal offence by the company and "*every officer of the company who is in default*".

230. It is fairly obvious what this section is aimed at, that is: preventing an allottee from subscribing for shares at less than their nominal value. It is nothing to do with whether shares are paid or unpaid. So long as the allottee is liable for the full nominal value of the shares, they have not been issued at a discount. Section 580 was only first enacted in close to its current form by s.21 of the Companies Act 1980. I have seen no authorities that deal with s.580 or its predecessors[6]. The only authorities Mr Sykes QC has shown me concern the common law prohibition on issuing shares at a discount. Some caution will therefore have to be exercised in applying them to the statutory prohibition.

231. My Sykes QC submitted that the predecessors of ss.552 and 553 of the Act (more particularly s.8 of the Companies Act 1900) were brought in to enable certain commissions to be paid for the subscription for shares because such commissions otherwise amounted to unlawful discounts. I am not sure that that is correct and will deal with that submission below. The sections appear in Chapter 2 of Part 17 of the Act which is headed "*Allotment of Shares: general provisions*". The sections themselves have the heading "*Prohibition of commissions, discounts and allowances*" and provide as follows:

> "**552 General Prohibition of commissions, discounts and allowances**
>
> (1) Except as permitted by section 553 (permitted commission), a company must not apply any of its shares or capital money, either directly or indirectly, in payment of any commission, discount or allowance to any person in consideration of his-
>
> (a) Subscribing or agreeing to subscribe (whether absolutely or conditionally) for shares in the company, or

[6] Section 37 of the Companies Act 1928 seems to be the first statutory reference to issuing shares at a discount, but this was permissive, allowing a company to do so if it satisfied various conditions. I assume that if those conditions were not satisfied, the company would be in breach of the common law prohibition.

(b) procuring or agreeing to procure subscriptions (whether absolute or conditional) for shares in the company.

(2) It is immaterial how the shares or money are so applied, whether by being added to the purchase money of property acquired by the company or to the contract price of work to be executed for the company, or being paid out of the nominal purchase money or contract price, or otherwise.

(3) Nothing in this section affects the payment of such brokerage as has previously been lawful.

553 Permitted commission

(1) A company may, if the following conditions are satisfied, pay a commission to a person in consideration of his subscribing or agreeing to subscribe (whether absolutely or conditionally) for shares in the company, or procuring or agreeing to procure subscriptions (whether absolute or conditional) for shares in the company.

(2) The conditions are that –

(a) the payment of the commission is authorised by the company's articles; and

(b) the commission paid or agreed to be paid does not exceed –

(i) 10% of the price at which the shares are issued, or

(ii) the amount or rate authorised by the articles,

whichever is the less.

(3) A vendor to, or promoter of, or other person who receives payment in money or shares from, a company may apply any part of the money or shares so received in payment of any commission the payment of which directly by the company would be permitted by this section."

232. Two points to note at this stage in relation to ss.552 and 553 of the Act:

(i) the prohibition in s.552 of the Act is against applying "*its shares or capital money*" to pay commission; that is a slightly odd restriction – it does not say "*capital*" as opposed to "*profits*" and it appears, if anything, to be more limited than that;

(ii) s.552 refers to a "*commission, discount or allowance*" but the reference to "*discount*" does not appear to be a reference to s.580 of the Act and in my view is a broader concept.

I should also say that it is reasonably clear that s.553 is a carve-out from the prohibition in s.552 – see the opening words of s.552 – and does not contain its own freestanding prohibition. Accordingly, payments out of profits or anything that is not "*its shares or capital money*", are not prohibited by ss.552 and 553, even if they do not satisfy the conditions in s.553(2). The Company was right, therefore, to abandon its original argument that s.553 was a freestanding prohibition.

233. Mr Sykes QC advanced five propositions which he submitted demonstrated that the Company had acted in breach of these statutory prohibitions:

(1) The relevant provisions, that is ss.580, 552 and 553 of the Act, are concerned with "*consideration as a legal concept*";

(2) A payment received from the Company to subscribe for shares is *prima facie* a breach of s.580 of the Act;

(3) There was no consideration given to the Company for the payments/credits under the E Shares scheme beyond an offer to subscribe for the E Shares;

(4) Sections 552 and 553 of the Act do not "*save the arrangements from involving a breach of s.580*";

(5) Consequently, the payments are repayable.

I will take each of these in turn.

(1) <u>The provisions are concerned with "*consideration as a legal concept*"</u>

234. I think what Mr Sykes QC meant by this is that the consideration for the shares has to be contractual consideration. However, even if that is right, it does not seem to me that it helps in understanding how the provisions affect the facts of this case.

235. In relation to s.580 of the Act, Mr Sykes QC correctly pointed out that it is in the Chapter of the Act that is concerned with "*payment for shares*". However, s.580 itself does not refer to "*consideration*" at all. Other sections in Chapters 5 and 6 refer to "*cash consideration*" (s.583) and "*non-cash consideration*" (s.593) but I do not think that "*consideration*" is there being used in its strict contractual sense; rather it is concerned with the form of payment for the shares and ensuring that full value is received by the company for its shares. It is difficult to conceive of a situation where a person could subscribe for shares without entering into some form of contract with the company. The payment for the shares is therefore the contractual consideration provided to the company.

236. My Sykes QC referred to *Ooregum Gold Mining Company of India, Ltd v Roper* [1892] AC 125 (***Ooregum***) but this case was not concerned with s.580 of the Act nor any of its predecessors. It concerned the common law rule against issuing shares at a discount. In any event, I do not think that the House of Lords were saying anything other than the full nominal value of shares had to be paid.

237. In *Ooregum* the company issued preference shares with a nominal value of £1 but they were credited as paid up as to 15s leaving the allottees only liable for 5s on each preference share. The House of Lords held that this was beyond the powers of the

company and *ultra vires* (this echoes the origins of the common law rule against disguised distributions of capital to shareholders). The allottees of the preference shares were liable to pay the full nominal value of the shares. Prior to this decision, there seems to have been some doubt as to whether companies were prohibited from issuing shares at a discount. *Ooregum* confirmed that, because a company's memorandum disclosed the full nominal value of the shares and creditors were entitled to rely on the fact that the company would receive that full value in respect of its issued share capital, an issue of shares at a discount would be *ultra vires.* As Lord Halsbury LC said (p.134):

> "…I recognise the wisdom of enforcing on a company the disclosure of what its real capital is, and not permitting a statement of its affairs to be such as may mislead and deceive those who are either about to become its shareholders or about to give it credit.
>
> I think, with Fry L.J. in the *Almada* and *Tirito Company's Case* (1), that the question which your Lordships have to solve is one which may be answered by reference to an inquiry: What is the nature of an agreement to take a share in a limited company? and that that question may be answered by saying, that it is an agreement to become liable to pay to the company the amount for which the share has been created. That Agreement is one which the company itself has no authority to alter or qualify, and I am therefore of opinion that, treating the question as unaffected by the Act of 1867, the company were prohibited by law, upon the principle laid down in *Ashbury Company v Riche* (2)[7], from doing that which is compendiously described as issuing shares at a discount."

238. *Ooregum* was nothing to do with the payment of commission. Furthermore, I do not consider that it necessarily assists in interpreting the meaning of s.580 of the Act. In my view, because it potentially may amount to the commission of a criminal offence, s.580 should be strictly construed. Nevertheless, there is no real difficulty in understanding what it means. A company cannot agree to accept less than the nominal value of shares that it issues. It does not matter that shares remain unpaid in respect of some of their nominal value so long as the shareholder remains liable to a call for the unpaid amount.

239. Accordingly, on the facts of this case, the unpaid 99p on the E Shares cannot constitute a discount within the meaning of s.580 of the Act. I do not think that s.580 is intended to cover payments made by the company <u>to</u> the proposed allottee. It is simply concerned with the obligation of the allottee to pay, whether in cash or otherwise, the full nominal value of the shares and it does not matter which money is used for that purpose.

240. If money is provided by a company so as to enable a shareholder to subscribe for shares in the company, that may have been a breach of the financial assistance provisions if they were still in force in relation to private companies (the Act only now prohibits financial assistance being given by a public company – see s.678 of the Act). Because it cannot rely on financial assistance, the Company seeks to squeeze the facts of this case into s.580 of the Act. I do not believe that the payments or credits made under the E Shares scheme can sensibly be said to be a "*discount*" within the meaning of s.580.

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[7] (1874-75) LR 7 HL 653. This is the House of Lords case that is the origin of the *ultra vires* principle of a Company acting outside the objects stated in its Memorandum of Association.

241. Section 552 does refer to "*consideration*" and that could refer to contractual consideration. But it only prohibits a company's "*shares or capital money*" being applied "*either directly or indirectly*", which may mean that "*consideration*" was not being used in its strict legal sense.

(2) Payment from a company to subscribe for shares is *prima facie* a breach of s.580

242. Mr Sykes QC's argument on this rested wholly on the Privy Council decision in *Australian Investment Trust Ltd. v Strand and Pitt Street Properties Ltd* [1932] AC 735. However, this was an appeal from the Supreme Court of New South Wales, in Equity and it was based purely on the common law prohibition on discounts, as set out in *Ooregum,* and there was no statutory equivalent of either s.580 of the Act or ss.552 and 553 of the Act enacted in New South Wales at the time. Mr Sykes QC sought to transpose the finding in *Australian Investment Trust* into s.580 of the Act and submitted that this is what "*discount*" must mean in s.580.

243. In the *Australian Investment Trust* case, the appellant company agreed to underwrite an issue of shares by the respondent company in return for a commission. The underwriting agreement stated that the appellant company would subscribe for the shares that were not taken up by the public. Lord Tomlin delivered the Privy Council's judgment which held that such an underwriting agreement was *ultra vires* because it amounted to the issue of shares at a discount. Lord Tomlin made clear that as there was no equivalent to s.8 of the English Companies Act 1900 (the predecessor of s.552 of the Act) the matter had to be decided upon a "*consideration of the English law as it stood before s.8 of the Companies Act 1900 came into operation*." After referring to Lord Watson's judgment in *Ooregum,* his Lordship said:

> "The point as to the validity of commission paid by a company to a person for subscribing for or underwriting its share capital was however never clearly decided in England before the Companies Act 1900…"

His Lordship then quoted from Lord Lindley's work on Companies (6^{th} Ed) in which it was said (underlining added):

> "After some doubt it was decided before the Companies Act, 1900, was passed that a limited company might pay a reasonable sum to brokers by way of brokerage for placing its shares, but the better opinion seems to have been that such a company could not make <u>any payment out of capital</u> to a person for subscribing for or underwriting its shares."

244. Mr Sykes QC placed most reliance on the following passage, which appears to have been common ground between the parties (which is slightly strange considering the uncertain state of pre-1900 English law on this):

> "Now it is not disputed that an agreement by a company to pay a commission to a person in consideration of his subscribing in praesenti for a definite number of shares in the company's capital would be ultra vires the company. It would in effect be an arrangement whereby he was allowed a rebate or discount on the amount payable by him for the shares for which he agreed to subscribe."

There is no limitation in this to payments of commission out of capital or the "*shares or capital money*" as described in s.552. And it is not based seemingly on any English authority. Lord Tomlin went on to consider whether there was any difference between an underwriting agreement to subscribe for a certain number of shares and one which only required subscription if the public did not take up the shares. He concluded as follows:

> "In both cases the commission is agreed to be paid to induce the same thing – namely the undertaking of the obligation to subscribe. No other service than undertaking this obligation is in either case rendered by the receiver of the commission. In both cases he in effect receives from the company a discount or rebate upon the amount payable upon the shares which he has to take up. It cannot make any difference that under the underwriting agreement he may not in the event have to take up any share and may yet get his commission all the same."

245. Mr Sykes QC then submitted that s.8 of the Companies Act 1900 was brought in to "*remedy this restriction on underwriting*" as explained in the House of Lords decision in *Hilder v Dexter* [1902] AC 474. Therefore, so he submitted, as the payments under the E Shares scheme were akin to the commission payments in the *Australian Investment Trust* case, they were in breach of s.580 of the Act and the question then arises as to whether they "*are saved*" by s.552 or s.553 of the Act. There are a number of big leaps in this theory so I will take it in stages.

246. As is clear from the above, prior to the Companies Act 1900, there was uncertainty as to whether commissions paid to a person for them to subscribe for shares were *ultra vires*. There was no statutory prohibition on either the issue of shares at a discount or on the payment of commissions. Like ss.552 and 553 of the Act, s.8 of the Companies Act 1900 allowed the payment of commissions subject to certain conditions as to amount and disclosure (ie s.553) but otherwise prohibited the direct or indirect payment of "*any commission, discount or allowance*" out of "*its shares or capital money*" (ie. s.552). What Parliament therefore sought to do was to define what commissions were allowable and what were not. It was not removing a blanket restriction on commissions for underwriting for the simple reason that there was no such blanket restriction. For instance, it was only "*payments out of capital*" that may have been restricted – see the *Australian Investment Trust* case itself.

247. It is clear from the judgments in *Hilder v Dexter* (supra) that one of their Lordships, the Earl of Halsbury L.C., was involved in the drafting of s.8 of the Companies Act 1900. The Lord Chancellor therefore declined to give his own judgment on its meaning but he fully endorsed the meaning as explained in the other judgments. The case concerned an offer of shares at par (or nominal) value to the appellant and others together with an option to subscribe for further shares at par within a certain amount of time. After the market price of the shares rose so that they were trading at a premium, the appellant exercised his option and subscribed for further shares at par. The House of Lords reversed the Court of Appeal and held that the exercise of the option was not in breach of s.8 of the Companies Act 1900.

248. Lord Davey began his judgment by considering the state of the law before the statutory provision was enacted. After referring to *Ooregum*, Lord Davey said as follows (underlining added):

> "On the other hand, there was authority for saying that the payment of a commission to brokers or others who undertook to procure subscriptions, or in default to subscribe for a certain number of shares, was legitimate. That doctrine, however, did not meet with universal acceptance, although it had the support of Buckley J. in his valuable work on the Companies Acts. (2) It was thought by some that such a payment when made out of capital was a <u>misapplication of the company's capital, and was therefore ultra vires.</u> There were, therefore, two points for consideration: first, that shares could not be issued at a discount, i.e. subject to an agreement that the shareholder should pay less to the company than the nominal value of the share: and, secondly, the question whether the payment, <u>out of capital moneys or by means of shares credited as fully or partly paid</u> of what is called an underwriting commission was <u>within the powers of a company</u>.
>
> From a perusal of the 8th section of the Act of 1900 your Lordships will infer that the Legislature was desirous of enabling remuneration to be paid for services rendered in placing or procuring subscription of the company's capital, and it appears to have hit upon what may be termed a <u>compromise</u>…"

Lord Brampton also added:

> "It is not contended that the contract would have been illegal before the Act of 1900, and I do not think it is, so far as regards the question before us, affected by the Act."

249. It is slightly surprising that *Hilder v Dexter* is not referred to in the judgment of Lord Tomlin in the *Australian Investment Trust* case (it was cited in argument – see p.737). Lord Davey's judgment indicates that the origin of any restriction on the payments of commission was because it could be an aspect of misapplication of the company's capital. As such it probably derived from the maintenance of capital doctrine as explained in *Trevor v Whitworth* (supra). Lord Davey also made a clear distinction between the issue of shares at a discount and the payment of an underwriting commission out of capital.

250. Mr Sykes QC's argument depends on a conflation of those two different situations. In my view, there was uncertainty pre-1900 as to whether payments of commission out of capital were *ultra vires*. This was cleared up by the "*compromise*" in s.8 of the Companies Act 1900 but limiting the restriction to payments out of the company's "*shares or capital money*" (which was explained by Lord Davey – see below). There was no uncertainty that shares could not be issued at a discount because that was established in *Ooregum*. That straightforward principle was eventually codified into what became s.580 of the Act. In my view, s.580 of the Act is limited to that situation and has no relevance to commissions being paid for subscribing for shares. That is subject to a separate regime in ss.552 and 553, which cannot be regarded as "*saving*" arrangements that might otherwise contravene s.580 of the Act. If it did, that would have the absurd outcome that s.580 is wider than ss.552 and 553 and would, for instance, catch commissions paid out of profits (which have never been considered objectionable) and which could not come within, and so be "*saved*" by, ss.552 and 553.

251. Mr Sykes QC's reliance on the *Australian Invesmtent Trust* case is therefore misplaced. I do not believe that Parliament, when enacting the predecessor of s.580 of the Act, intended to restrict commissions being paid as they were already subject to the separate

restrictions in ss.552 and 553. In my judgment, commissions and any payments by the company related to subscription for shares are wholly regulated by ss.552 and 553 of the Act (and used to be subject to the financial assistance restrictions) and are not within s.580 of the Act which is limited to the requirement for an allottee to pay, whether in cash or otherwise, the full nominal value of the shares.

(3) Consideration provided by Ms Stoneman and Mr Ralph

252. In the light of my findings on the law (as set out above), and my findings on the characterisation issue that the payments and credits to Ms Stoneman and Mr Ralph under the E Shares scheme were remuneration paid as a genuine reward for services, it is difficult to see where this argument on "*consideration*" gets the Company. Mr Sykes QC submitted that under the Agreements to subscribe for the E Shares, the only contractual consideration provided by Ms Stoneman and Mr Ralph was the offer to subscribe for the E Shares. He said that this has to be distinguished from the "*motivation*" behind the arrangements being to recognise their contributions to the Company and to provide them with access to tax-free funds until they are required to repay those funds on a call.

253. The short answer to this point is HMRC's response to the issue of discounts and commissions: the payments made to Ms Stoneman and Mr Ralph were remuneration that was the result of a genuine exercise of the directors' power to award remuneration. The fact that that remuneration was coupled with an obligation to subscribe for the E Shares does not detract from it being remuneration. 1% of the amounts received were used to pay for 1% of the nominal value of the E Shares with the rest remaining subject to a call from the Company. That 1% payment came out of Ms Stoneman's and Mr Ralph's properly authorised remuneration. They remained liable to a call for the full nominal value of the E Shares. There can be no question of the E Shares having been issued at a discount within s.580 of the Act.

254. Mr Sykes QC's dichotomy between "*consideration*" and "*motivation*" confuses a number of issues, in particular the relevance of the value of the services provided for the remuneration received. If shares were being issued to a person in consideration for services provided by that person to a company, then clearly those services should represent at least the full nominal value of the issued shares. If they do not represent such full nominal value, the shares may have been issued at a discount. A company is given a fair degree of latitude, a "*margin of appreciation*", in valuing such services – see Lord Watson's judgment at pp.136-137 of *Ooregum* (supra) and also *Re Wragg Ltd* [1897] 1 Ch 796. However, in this case the services were being provided in return for remuneration and there is no requirement to conduct a similar valuation. The "*consideration*" for the E Shares is payment in cash of the full nominal value if called upon to do so. There is therefore no breach of s.580 of the Act.

(4) Sections 552 and 553 of the Act do not "*save*" the arrangements

255. I have dealt above with the argument both as to whether the payments and credits were a breach of s.580 of the Act and whether ss.552 and 553 of the Act can operate to "*save*"

such payments from being a breach. The Company's arguments in such respect failed on a number of grounds.

256. It is important for me to address a further reason why the Company cannot succeed on its claim under ss.552 and 553 of the Act. As I have emphasised above, the restrictions on commissions were always in relation to payments out of capital and s.552 has retained the slightly odd wording from s.8 of the Companies Act 1900 of "*shares or capital money*". Lord Davey, in *Hilder v Dexter* (supra) at p. 480 explained what these words meant:

> "The first words to be construed are, "apply any of its shares or capital money." I think that those words naturally mean apply its capital, either in the form of shares before issue, when they may be described as potential capital, or in the form of money derived from the issue of its shares. "In payment of any commission, discount, or allowance": I think this means payment by the company. The words "discount or allowance" seem to mean the same thing, namely, a rebate on what would justly be due from the subscriber on his shares."

257. It is also relevant to refer to s.552(2) of the Act which makes clear that "*shares or capital*" money is referring to the actual share issue in respect of which the commission is being paid. Therefore, it is only if the commission is being paid from the proceeds of that share issue or by the issue of shares credited as fully paid up that it comes within the restriction of s.552. If the commission is being paid out of the share issue, then it is only allowed if it is within the conditions set out in s.553 of the Act. The references to "*discount, or allowance*" seem to me to be forms of commission that can similarly be allowed if they satisfy the conditions in s.553 of the Act. As Lord Davey said, they operate as a form of rebate on the price of the shares, and that is not limited to their nominal value, for instance if shares were being issued at a premium. I do not think that the reference to "*discount*" has any bearing on s.580 because if a discount is properly being applied to the price of the shares, that is, it satisfies the conditions in s.553, the company is receiving value in the form of the services for which a commission or discount is being paid. ("*Commission*" is defined by the Oxford English Dictionary as "*remuneration for services or work done as agent, in the form of a percentage on the amount involved in the transactions*".)

258. The Company's case appears to be that the whole of the payments and credits to Ms Stoneman and Mr Ralph under the E Shares schemes was a "*commission*" paid out in consideration of Ms Stoneman and Mr Ralph agreeing to subscribe for the E Shares. Quite apart from the fact that it was actually remuneration rather than "*commission*", the Company cannot establish that the payments and credits were an application of the Company's "*shares or capital money*" as defined by Lord Davey. More fundamentally, the payments and credits were not required to be "*repaid*" to the Company - Mr Sykes QC submitted that they were akin to an interest-free loan – and the money could be used by Ms Stoneman and Mr Ralph as they wished, for instance in buying the Ibiza property. The payments and credits were necessarily paid out of the Company's profits (that is why it got the corporation tax deduction) and I do not see how the Company can prove that they came from the "*shares or capital money*" arising out of the E Shares scheme. The Company will receive the "*capital money*" only after a call has been made.

(5) Implications

259. As the Company has not proved that the E Shares scheme contravened either s.580 or s.552 of the Act, the implications of such a contravention do not arise. There was, in any event, no dispute between the parties, that a breach of either section would mean that the payments were unlawful and liable to be repaid (see also s.580(2)).

(b) Conclusions on the discount and commission issues

260. The Company's case on ss. 580 and 552 and 553 of the Act in respect of the E Shares scheme is fundamentally misconceived. If the Company was correct on the characterisation issue and the payments and credits were disguised distributions to shareholders and so unlawful, then it did not need these claims under ss.580 and 552. If however the Company failed on the characterisation issue, as it has, then that would necessarily deal a fatal blow to any argument around ss.580 and 552, because the payments and credits were genuine remuneration and cannot amount to a discount on the E Shares or a commission for the agreement to subscribe for the E Shares. In any event, their claim in such respect was wrong in law and on the facts for the reasons set out above.

261. As the Company has failed to prove its case on both the characterisation and discount and commission issues, its claims will have to be dismissed in their entirety. In case this matter goes further, I will consider the other consequential issues that were argued before me, though more shortly than I would otherwise have done in an effort not unduly to lengthen this already rather long judgment.

H. REPAYMENT

262. If the Company had succeeded on the characterisation and/or the discount and commission issues, I understand that HMRC did not dispute that the payments and credits to Ms Stoneman and Mr Ralph were unlawful and would have to be repaid. This is the first step for the Company in establishing its case on the mistake issue. Even though this is common ground, the mistake issue is disputed, and it is therefore important to clarify the basis upon which the payments and credits are said to be repayable.

263. In relation to the characterisation issue and if I had found the payments and credits to be disguised distributions to the shareholders, the Company relied solely on the statutory provisions in Part 23 of the Act. Distributions (ie dividends) can only lawfully be paid after compliance with the statutory rules around calculating the "*profits available for the purpose*" (s.830) by reference to the "*relevant accounts*" (s.836). None of this was of course done by Ms Stoneman and Mr Ralph in authorising the payments and HMRC does not dispute that, because the rules were not complied with, the payments and credits, if they were distributions, were unlawful and in contravention of

the Part 23 rules. The consequence of such contravention is set out in s.847 of the Act, as follows:

> "**847 Consequences of unlawful distribution**
>
> (1) This section applies where a distribution, or part of one, made by a company to one of its members is made in contravention of this Part.
>
> (2) If at the time of the distribution the member knows or has reasonable grounds for believing that it is so made, he is liable –
>
> (a) to repay it (or part of it, as the case may be) to the company, or
>
> (b) in the case of a distribution made otherwise than in cash, to pay the company a sum equal to the value of the distribution (or part) at that time.
>
> This is without prejudice to any obligation imposed apart from this section on a member of a company to repay a distribution unlawfully made to him."

264. The Company submitted that it is sufficient for the purposes of s.847(2), that the member knew the material facts that rendered the distributions in breach of Part 23. Ignorance of the specific requirements of Part 23 and the law will not assist the member in seeking to avoid liability if he or she knew or had reason to believe the relevant facts that constituted the breach of Part 23. Reliance was placed on the Court of Appeal decision in *It's a Wrap (UK) Ltd (in liquidation) v Gula* [2006] 2 BCLC 634, [2006] EWCA Civ 544 which was concerned with the predecessor to s.847. Arden LJ (as she then was) said in para. 23:

> "It follows from this that all the company must prove is that the shareholders knew the facts constituting the factual position that the distributions were contrary to the Act. This is fact-based knowledge."

Reference was also made to *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1986] Ch 447 in which the Court of Appeal held that an unlawful dividend was held on constructive trust for the company if the shareholder "*had notice of the facts*".

265. The Company alleged that Ms Stoneman and Mr Ralph knew or had reasonable grounds to appreciate that the amount of the payments and credits that they were to receive under the E Shares scheme exceeded the available distributable profits of the Company. As this is accepted by HMRC, I will not delve into the evidence in relation to this, but will assume it to be correct.

266. The Company also submitted that, as directors of the Company, Ms Stoneman and Mr Ralph acted in breach of their fiduciary duties in misapplying the Company's assets in paying the unlawful distributions. As such they are liable for the full amount of the unlawful distribution (which might not be the whole amount if there were some distributable profits available – see *Re Marini Ltd, Liquidator of Marini Ltd v Dickenson* [2004] BCC 172) and, although there is a debate as to whether such liability is strict or fault based, they were at fault for the same reasons as they are liable as shareholders – see *Bairstow v Queen's Moat Houses Plc* [2001] 2 BCLC 531; *Re*

Paycheck Services Ltd [2010] 1 WLR 2793 and *Burnden Holdings UK Ltd v Fielding* [2019] EWHC 1566 (Ch).

267. Part 23 of the Act does not render the unlawful distribution void. It is only recoverable under s.847 and depends on the knowledge of the shareholder. Under the common law rule, which is not relied upon by the Company, the unlawfulness of the distribution could render it void. But the reason that the Company has to go on to claim on the basis of mistake is because it wishes to set aside all the transactions around the E Shares scheme including in particular the issue of the E and F Shares and it wants them removed from the share register. Ms Stoneman wants to be relieved of any possibility of there being a call on the E and F Shares, even though she has apparently repaid the entirety of the amounts received under the 2011 Scheme and reversed the credits on her loan account for the 2012 and 2013 Schemes, all of which could have been done in satisfaction of a call by the Company on the E and F Shares.

268. In relation to the discount and commission issues, if the payments and credits are, contrary to my findings above, an unlawful discount on the E Shares, then s.580(2) of the Act imposes an obligation on the allottee to pay to the company an amount equal to the discount plus interest. This does not therefore depend on the knowledge or fault of the allottee.

269. If, alternatively, the payments and credits are, contrary to my findings above, unlawful commissions under s.552 of the Act, there appears to be no statutory remedy as such. The Company submitted, and HMRC conceded, that such unlawful commissions are recoverable by the Company either in reliance on the authorities of *Dominion of Canada Trading and Investment Syndicate v Brigstocke* [1911] 2 KB 648 and *Andreae v Zinc Mines of Great Britain, Ltd* [1918] 2 KB 545; or by analogy with the above authorities on the recovery unlawful distributions. Alternatively, there may be a claim in restitution. This would probably be a fault or knowledge based liability.

I. MISTAKE

270. The Company submitted that the parties therefore entered into the E Shares scheme on the basis of a fundamental common mistake. It said that there are two aspects to this:

(a) Ms Stoneman, Mr Ralph and the Company entered into the E Shares scheme on the assumption that the payments and credits would be treated in accordance with what the documents stated, namely as an "*employment expense*" and would not be regarded as a distribution; otherwise the E Shares scheme could not achieve its tax avoidance purpose; they were therefore taking a risk on the tax treatment of the E Shares scheme but not on its lawfulness from a company law perspective, the result of which would render the intended tax treatment impossible;

(b) it was essential to the structure of the E Shares scheme that the payments and credits made to Ms Stoneman and Mr Ralph would be "*non-refundable*" and this was expressly stated in the Agreement to subscribe for the E Shares; if they do have to be repaid by Ms Stoneman and Mr Ralph on the bases set out above, they would have been exposed to double liability because they would still be liable to a call on the E and F Shares.

271. I have some difficulty understanding the first aspect; and the second does not on the face of it strike me as a particularly compelling assumption for the purposes of the doctrine of common mistake. I did not find the Company's pleading on this helped. In the Re-Re-Amended Particulars of Claim in the first action against Mr Ralph and HMRC, the Company pleaded this assumption, by way of amendment:

> "7.A1 for the purposes of any legal analysis of the nature and consequences of the payments made by the Claimant pursuant to the Agreement, the said payments were to be characterised and treated simply as contractual consideration provided by the Claimant in return for the First Defendant's agreement to be bound by his obligations under the Agreement: i.e. the payments were to be characterised simply as they were described on the face of the Agreement;"

In the Amended Particulars of Claim in the second action against Ms Stoneman and HMRC, the Company pleaded the same words as set out above and then expanded on it as follows (in the unusual circumstances of this case, the First Defendant, Ms Stoneman, signed the Statement of Truth for this pleading on behalf of the Company):

> "16.1 …The Claimant and the First Defendant assumed that labelling the arrangements in accordance with the scheme documentation would be determinative for tax purposes, such that the expense in the profit and loss account of the company, which the Claimant was advised would result from the arrangements, would be deductible for tax purposes. The Claimant and the First Defendant also assumed and proceeded on the basis that since the amounts which would be paid to the First Defendant or credited to her account under the Subscription Offer Agreements were not described as dividends or distributions in the Agreement, they would not be treated as such as a matter of law."

272. Mr Ralph's Amended Defence denied that he or the Company had that assumption:

> "22A. Paragraph 7.A1 is not agreed. Without prejudice to the fact that it is unclear what this paragraph means, it is denied that the Claimant and/or First Defendant gave any thought to the characterisation of the payment "for the purposes of any legal analysis of the nature and consequences of the payments", let alone made a positive assumption as to that characterisation for the purposes of "any legal analysis". Furthermore, the Claimant and/or the First Defendant and/or Ms Stoneman believed that the payments would be characterised as employee remuneration for corporation tax purposes so as to enable a deduction to be claimed."

273. There is an immediate problem with the Company's case, if the two protagonists, Ms Stoneman and Mr Ralph, do not agree on the alleged shared assumption on entering into the E Shares scheme arrangements. Furthermore, it would be relevant to determine whose knowledge should be attributed to the Company, given that it was Ms Stoneman's evidence that she left all the negotiating and discussions in relation to the 2011 Scheme to Mr Ralph. Also Ms Stoneman's alleged assumption at the time of entering into the E Shares scheme can be contrasted with her evidence at the trial that she did not regard the payments to her as remuneration (which was what was stated in the documents); rather she regarded them as payments to her as a shareholder.

274. It is common ground that the conditions under which a contract may be rendered void for common mistake are set out in Lord Phillips MR's judgment in the Court of Appeal decision in *Great Peace Shipping Ltd v Tsavliris Salvage (International) Ltd* [2003] QB 679, 703 para 76:

> "…the following elements must be present if common mistake is to avoid a contract: (i) there must be a common assumption as to the existence of a state of affairs; (ii) there must be no warranty by either party that that state of affairs exists; (iii) the non-existence of the state of affairs must not be attributable to the fault of either party; (iv) the non-existence of the state of affairs must render performance of the contract impossible; (v) the state of affairs may be the existence, or a vital attribute, of the consideration to be provided or circumstances which must subsist if performance of the contractual adventure is to be possible."

I will take each element in turn.

(i) <u>Common assumption as to a state of affairs</u>

275. As stated above, I think it is difficult on the evidence to find a common assumption, because of the apparently divergent positions of Ms Stoneman and Mr Ralph. I know that Mr Ralph did not give evidence at the trial but I cannot ignore the fact that his knowledge will be relevant in assessing the Company's attributed knowledge.

276. Furthermore, the pleaded assumptions that are relied upon seem to me to be very contrived and are essentially assumptions as to the legal consequences of the Agreements that were entered into. It is reasonably clear that no one, including the Company's advisors, ever turned their minds to the company law issues that I have determined in this case and I query therefore whether it is right to say that any such assumptions were made. The doctrine of common mistake implies a positive or conscious assumption to have been made and ignorance is not enough – see paras. 108 and 109 of Lord Walker's judgment in *Pitt v Holt* [2013] 2 AC 108, 151.

(ii) <u>No warranty by either party</u>

277. There was no warranty that the assumptions existed. The reference to the payments and credits being "*non-refundable*" in clause C.1 of the Agreement to subscribe for the E Shares cannot amount to such a warranty.

278. However, this element is really about allocation of risk between parties to a contract. In this case there was no arm's length transaction between independent and commercial parties. It was effectively the same people on both sides of the transaction, given that Ms Stoneman and Mr Ralph owned and controlled the Company. In such a situation, there is clearly no real allocation of risk within the terms of the transaction and it is possible for an alleged shared mistaken assumption to be manipulated to support the interests of one of the parties concerned.

279. I therefore question whether the doctrine of common mistake can be applicable to a situation such as this. In any event, as stated above, there are difficulties with establishing the Company's assumption because of the divergences now between Ms Stoneman and Mr Ralph.

(iii) No fault of either party

280. The Company submitted that fault cannot be laid at the door of the Company, Ms Stoneman or Mr Ralph as they took all reasonable care before entering into the E Shares scheme and were entitled to rely on all the professional advice that they received from Blackstar, FPSS and Mr Leigh.

281. HMRC submitted that there is a serious inconsistency in the Company's case on this because: on the one hand, to establish that the payments and credits are repayable under s.847(2) of the Act it has to show that Ms Stoneman and Mr Ralph knew or had reasonable grounds for believing that the payments and credits were in breach of Part 23 of the Act; whereas on the other hand, for the purposes of mistake, it has to show that they were not at fault. I believe that HMRC have a point and that the Company cannot have it both ways.

282. The remedy for an unlawful distribution is provided for in s.847(2) of the Act and there may be other remedies also available such as against the directors for breach of fiduciary duty. I think it would be odd for the law to provide a further remedy in mistake that is itself dependent on establishing entitlement to the primary remedy. I consider that the remedy for common mistake is an extreme one – that the contract is declared void *ab initio* – and it should not be available where there are satisfactory less extreme remedies available in respect of a contract that has become impossible to perform. That is particularly justified in this case where there is palpable tension between the remedies in having to establish fault for the purpose of the repayment remedy while having to prove that there was no fault for the purposes of the mistake remedy.

(iv) The mistake must render performance impossible

283. The requirement to render performance "*impossible*" has been softened a little in later cases to "*performance of the contract in accordance with the common assumption impossible*" – see *Apvodedo NV v Collins* [2008] EWHC 775 (Ch) and also *Triple Seven MSN 27251 Ltd. V Azman Air Services Ltd* [2018] EWHC 1348 (Comm). As the Company submitted, if the payments and credits were actually unlawful distributions

and repayable, it fundamentally affected the whole point of the arrangements and the intended tax purpose.

(v) Vital attribute of the consideration

284. I agree with the Company that the payments and credits were the consideration provided by the Company and, if they were unlawful and repayable, the Company's consideration lacked any value.

285. Therefore, in my view, the Company can establish elements (iv) and (v) but I doubt if it can establish (i), (ii) and (iii). As expressed above in relation to elements (ii) and (iii) I have serious reservations about the availability of a remedy in mistake in the circumstances of this case, where there is not an arm's length transaction and there are other adequate remedies available to deal with the consequences of the payments and credits being unlawful.

J. DISCRETION ISSUE

286. I now turn to the final issue before me, if the Company is otherwise entitled to the relief that it seeks. That means of course that I have to assume that it has also succeeded on the mistake issue dealt with above.

287. HMRC submitted that both the power to make a declaration[8] and the power to rectify the register of members[9], which is the only relief sought by the Company, are discretionary and, in the circumstances of this case, the court should decline to exercise its discretion. This was put on two bases: (i) that the claim is tainted with illegality; and (ii) that such relief would be prejudicial to the interests of the Company's creditors including HMRC. As Marcus Smith J said in *Bank of New York Mellon, London Branch v Essar Steel India Ltd.* [2018] EWHC 3177 (Ch) para 21:

> "The power to grant declaratory relief is discretionary. When considering the exercise of the discretion, in broad terms, the court should take into account justice to the claimant, justice to the defendant, whether the declaration would serve a useful purpose and whether there are other special reasons why or why not the court should grant the declaration…
>
> (6) In all cases, assuming that the other tests are satisfied, the court must ask: is this the most effective way of resolving the issues raised? In answering that question, the court must consider the other options of resolving the issue."

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[8] Which derives from s.19 of the Senior Courts Act 1981.

[9] This is provided for in s.125 of the Act where "*the name of any person is, without sufficient cause, entered in or omitted from a company's register of members*".

288. My initial reaction to this argument on discretion was that it would be very strange for the court to have concluded that the E Shares scheme was unlawful because it breached various provisions of the Act and that, as a result, it was void for common mistake and yet decline to make a declaration to such effect. While I now think that the issue is more finely balanced than that, I would still be inclined to make the declarations and to rectify the register of members if I had found for the Company on all of the substantive issues. That is so for the following reasons.

289. On the illegality question, HMRC submitted that if the Company had succeeded on its case, that would necessarily have involved wrongdoing on the part of Ms Stoneman and Mr Ralph, and therefore the Company as well, by dressing up the E Shares scheme as remuneration when they knew all along that it was a means of distributing the Company's assets unlawfully to the shareholders. HMRC referred to *Patel v Mirza* [2017] AC 467 showing the doctrine of illegality is grounded in the public interest. However, in this case the illegality is the unlawfulness of the E Shares scheme, and it seems to me that it is in the public interest for unlawful transactions to be declared as such. Even though an unlawful discount might be a criminal offence, I do not think that Ms Stoneman and Mr Ralph have acted illegally as opposed to wrongly. I agree with the Company that this behaviour does not constitute a "*special reason*" to refuse a declaration.

290. HMRC also submitted that, following Lord Sumption's judgment in *Bilta (UK) Ltd v Nazir (No. 2)* [2016] AC 1 at paras 89-92, HMRC and indeed other creditors were "*innocent outsiders*" and therefore the "*wrongdoing*" of Ms Stoneman and Mr Ralph should be attributed to the Company. A declaration and rectification of the register would prejudice those "*innocent outsiders*"[10] because HMRC might be denied tax that they would otherwise be entitled to and creditors might have acted on the basis that the Company's share capital was as stated on the public register, ie including the E Shares. However HMRC's denial of tax will only have been because the contracts on which tax might have been payable have been found to be void *ab initio*, meaning that there never was a tax liability. In relation to the creditors, as I understand the position, the Company has not traded for some time, it has no assets save perhaps the right to call for payment on the E and F Shares and possibly a claim against the directors for breach of duty, and it has no creditors save for HMRC. Therefore I do not think there is much substance to HMRC's point about prejudice suffered from a falsely disclosed share capital.

291. The point that has most troubled me is whether the declarations and rectification of the register are the most effective remedy for resolving the issues in this case if the Company had been successful. HMRC submitted that the more appropriate way for the Company to have proceeded would have been to bring an action for the return of the unlawful payments. Such an action would have no impact on HMRC or any third parties. However from the Company's perspective that still leaves it potentially liable to be taxed on the basis that the E Shares scheme has not been set aside and from Ms Stoneman's perspective, this would still leave her exposed both to HMRC and also to a call on the E and F Shares. The Company submitted that this would be unfair and unjust as Ms Stoneman has already repaid the money she had and reversed the credits on her loan account. As I have said above, she could have just done this pursuant to a call instigated by her on behalf of the Company for the unpaid amount of the E and F

[10] Lord Sumption referred to an "*innocent but negligent outsider*" but in this case both HMRC and other creditors are without fault and so in a stronger position.

Shares. Instead she repaid the money to support her case that the money was repayable because it had been paid to her as part of an unlawful E and F Shares scheme.

292. On balance, I do think that this would be an unjust outcome for Ms Stoneman having successfully established the basis for her repayment of the monies. If I did not make the declarations and rectification of the register, this would not only leave Ms Stoneman potentially liable twice over for the payments and credits she received but also it would leave the FTT in a difficult position of having to work out the effect of my judgment without any final resolution of it in the form of a declaration. Therefore, if the Company had succeeded on all the substantive issues before me, I would not in my discretion have declined to make the declaration or to rectify the register of members.

K. DISPOSITION

293. For the reasons set out above, I dismiss both actions.

294. I will hear counsel on costs and any other consequential matters should that be necessary at a time convenient to all and probably remotely in the current circumstances.

295. I am very grateful to all Counsel for their clear and helpful submissions, both oral and in writing.