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Episode 2: Directors, beware: Payment by director's loan account carries personal risk

Stephen Downie	Hello and welcome to another podcast from Francis Wilks & Jones. My name is Stephen Downie and I am here today with Maria Koureas-Jones. We are both partners at FWJ dealing with commercial litigation and contentious corporate and insolvency matters.
Maria Koureas-Jones	And today we are here to talk about director's loan accounts. These are often referred to as director current accounts interchangeably so directors may hear either phrase used.
Stephen Downie	So, Maria, what are director's loan accounts and why is it important that a director or shareholders of a company know about these?
Maria Koureas-Jones	When directors are paid, there are two ways for the company to pay directors. Often directors don't realise this so one of the two ways involves payment via a director's loan account and, in our experience, directors who are paid via this method often do not appreciate either that they are being paid via the method or that it exposes them personally.
Stephen Downie	So, our goal today is to raise awareness on this for directors so that directors can ask the right questions of their accountants and also so that you guys can make informed decisions about how you are being paid, accepting that you are being paid as a loan that may be repayable and that you fully know the risk that are involved in being paid in this way.
Maria Koureas-Jones	Absolutely.
Stephen Downie	So, Maria, you mentioned two ways in which a director can be paid by a company. The first is obviously via a fixed salary which is paid monthly to directors as with everybody else who receives a salary, through the pay-as-you-earn system that the company operates and tax is deducted at-source. This is the conventional way in which most employees of a company are paid and, where the director is also a shareholder and where there is a net profit enabling a dividend to be declared, he / she will also receive a dividend payment at the end of the year in addition to their salary.
Maria Koureas-Jones	Payment via this route - so via the PAYE route - does not involve a director's loan account and where a company enters an insolvency process, as long as the salary is reasonable and where the salary is documented in a contract of employment, it is often difficult for an appointed liquidator or administrator to pursue a claim against the director personally for recovery of the salary paid to the directors.
Stephen Downie	Yes, it is important the employment contract. There is recent case law that says where you don't have an employment contract then you are arguing whether you are being paid the correct amount of money. But the second way for a director of

	course to be paid who is also a shareholder, is via the dividend process. This can occur alongside their small monthly salary payment which is paid to them through the PAYE system.
Maria Koureas-Jones	Steve, you're the trained accountant so you will know far better than I, but in my experience, it is often the case that accountants recommend payment via the director's loan account route firstly because the small monthly salary utilises the director's tax-free income allowance and secondly, because payment via dividends, rather than salary, often results in less income tax for the director?
Stephen Downie	Absolutely, that's correct Maria. The benefit of the dividend system is that there are also additional tax-free aspects, and a combination of the dividend and salary payments can really reduce the amount of tax directors have to pay out of their income received. However, this advice only tells half the story because what is frequently not communicated so that the director understands, is that they are personally exposed to a risk during the year in which they take a director's loan, and this will continue in subsequent years if the director's loan is not repaid by a dividend or otherwise.
Maria Koureas-Jones	So, a word of caution here, with the potential tax saving comes a risk to the director personally and, in our experience as we mentioned earlier, directors often do not appreciate the risk until it's too late and until they're at the receiving end of a claim by a liquidator or administrator who is claiming repayment of the director's loan account.
Stephen Downie	So how does being paid via dividends represent a potential risk to directors? Well, the Companies Act 2006 makes it crystal clear that a company can only pay a dividend where it has net distributable profits for the year ended or the year to date, including previous years. Where a company will have a net profit for the year or whether it is only known after the financial year has been completed is determined by the accounts.
Maria Koureas-Jones	So let's give an example perhaps to illustrate – if a company is trading and its tax year is April 2021 - March 2022, whether there is a net profit that is available to distribute you are only going to know that after March 2022 when trade has finished, you know what the turnover is, you know what the expenses are and therefore you are able to calculate both net profit and make an assessment regarding whether to declare a dividend.
Stephen Downie	Correct – the issue of course is that most directors need to be paid prior to that during the year to pay for their household expenses and not inexpensive living styles but in this example April 2021- March 2022 they can't wait until the end to find out whether they are allowed to be paid.
Maria Koureas-Jones	So, to accommodate a director's need to be paid throughout the tax year, what happens is a company tends to pay a director an agreed sum on a monthly basis?
Stephen Downie	Yes, that's right. That's what most companies do but the important bit - the payments to directors throughout the financial year - are payments on account of an anticipated net annual profit for the financial year so they are paid loans with the idea that the dividend will cancel out those previous loan payments at the year-end.
Maria Koureas-Jones	So, let's go back to our example, the payment would be made on account of a profit that could be declared after trading concludes in March 2022. So, for ease of math,

	let's assume that the directors receive £2,000 per month during April 2021-March 2022. So, they will receive a total of £24,000 during that year. How is this accounted for by the company?
Stephen Downie	Well, assuming again for ease that none of the payments are via the PAYE system which is a salary and therefore a tax-deductible process we are talking about the £24,000 as being after all the costs have been cleared and a sole net profit of the company. The company accountant would also record each of the payments to the director as a debit on the ledger called a director's loan account so they have been loaned this money during the year. In essence the ledger will record that the money taken by the director is a loan and is outstanding at the year end.
Maria Koureas-Jones	So, it's a loan because it's a payment on account of an expected annual net profit and distributable dividend in March 2022 which doesn't yet exist?
Stephen Downie	That's correct and there is no guarantee that that dividend is going to exist. The company has to be profitable during the year so you may take those payments during the year and, at the year-end, if there is no profit then there is no dividend, then you owe the company that money. So, going back to our example, the director's loan account will record that the director owes the company £24,000 as at the end of the year in March 2022.
Maria Koureas-Jones	So, let's assume that there is a net annual profit for the financial year, that a dividend can be declared and can be applied as a credit on the director's loan account?
Stephen Downie	Yes, so let's assume the net profit at the financial year-end is instead of the prior example just now bigger, let's say it's £48,000, but the director only has 50% of the company shares. So, if the dividend declared for the entire amount of that net profit -which can happen - he will only be entitled to 50% of that divided which is £24,000 representing his shareholding. That £24,000 will be applied against his director's loan to cancel out the loans taken during the year and because of that there will be a nil balance.
Maria Koureas-Jones	So, just to be clear, he won't owe the company anything as of March 2022 but he also will not receive any additional payment as a result of the dividend being declared? But if the director held all of the shares in the company, so going back to financial year end, profit of £48,000, if he has 100% shareholding, he would at that point of course receive £24,000 as a credit against the director's loan account so he would owe the company nothing and he would also be entitled to receive £24,000 into his bank as a result of the additional dividend declared?
Stephen Downie	Yes, spot on. So, what happens if the net profit is less than what was anticipated - as I have just discussed a minute ago - and the director has taken a loan during the year but the ability to declare a dividend at the year-end isn't enough to cover off that loan?
Maria Koureas-Jones	That's a good question and a question that directors are having to deal with time and time again. Recently, obviously, we have gone through the COVID pandemic and for many businesses the COVID pandemic was not foreseeable at the start of their financial year end so we have had restrictions that have led to a drop in turnover and therefore a drop often in the dividends that can be declared and often, however, the directors have had to continue taking or have chosen to continue taking the same payment to themselves on a monthly basis.

	So going back to our example, if the net profit was nil, the director / shareholder would not be able to declare a dividend, no credit can therefore be applied to their director's loan account and they would be left owing the company the sum of £24,000 as of March 2022.
Stephen Downie	And this might be in the scenario where the director only owns 50% of the shares this might be £48,000 for both directors or both shareholders. The one thing to stress here is that any director's loan that is outstanding at the year-end is also subject to HMRC taxes which may additionally be payable at the year-end so there are additional burdens putting further cash pressures on the company but, where the company continues to trade, in my experience most of the companies will not demand that the directors repay that sum and therefore the directors find themselves accruing an increasing director's loan account debt perhaps over multiple years if the company continues not to make the appropriate profits and the directors just don't understand how the payments that are received for the company are being accounted for or perhaps, they don't want to understand and secondly, because the company doesn't make any further profit sufficient to repay the director's loan account balance then there is a gradually increasing director's loan account balance due. Where the company continues to trade the company won't demand payment because it is owned by the same people who are owing this money and therefore the company becomes in an increasingly difficult position which can escalate.
Maria Koureas-Jones	So, the problem tends to arise where a company enters an insolvency process. Steve, you have just mentioned that often the company won't demand repayment obviously because it's the directors making the decision but the position changes where a company does enter an insolvency process because a company administrator or liquidator is under an obligation to collect debts and these include debts owed under a director's loan account.
Stephen Downie	But Maria, how would a liquidator or administrator know that there is a debt due to the company under a director's loan account?
Maria Koureas-Jones	So often in two ways - firstly, from the annual accounts and secondly, from the company's books and records.
Stephen Downie	So the company's accountant or the bookkeeper within the company will usually record the amounts advanced to the directors under a separate ledger called a director's loan account and this ledger will continue to accumulate during the year and, at the year-end the company's financial accounts reflect the balance on that director's loan account. This can usually be amalgamated under the debtor's asset in a financial statement. The financial accounts do usually expressly distinguish sums that are owing from directors because accounting rules require this.
Maria Koureas-Jones	And normally one of the directors will of course have signed the end of year accounts. So, it is often very difficult where a director has signed the accounts which expressly record the monies due and owing under a director's loan account, it is difficult for that director to argue that they did not know that money was owed under a director's loan account to the company.
Stephen Downie	So with any agreement or document if you signed it as authenticated you can't then as a director particularly deny that the information contained within was inaccurate. Once the liquidator or administrator is appointed, they will always demand

	repayment of a directors' loan account and this sum can be anything from a few thousand pounds to, as in my experience particularly with small and medium size companies that have been operating in this way for a number of years, it can extend to hundreds of thousands of pounds.
Maria Koureas-Jones	So, this is something we're seeing time and time again and directors are increasingly at the receiving end of a director's loan account claim.
Stephen Downie	Yes, so true and we are often seeing directors making a number of mistakes on receipt of a statutory demand or a demand for repayment. We thought we would share some of the common mistakes we are seeing along with the impact that these are having on a director's personal financial circumstances.
Maria Koureas-Jones	So the first mistake is common with all litigation and we like to call it the 'ostrich syndrome'. Directors simply ignore a demand for payment by an administrator or liquidator for repayment. Directors who have appointed an insolvency practitioner over the company often feel that they have a "good understanding" with the insolvency practitioner and assume therefore that the insolvency practitioner is not going to follow through with a claim against them. But this completely overlooks the fact that the insolvency practitioner has a statutory duty to collect in the company debts and this does include debts due and owing under a director's loan account.
Stephen Downie	So, seeking repayment of a director's loan account is a really straightforward claim for an insolvency practitioner to pursue and it will achieve or manage his obligations in the statutory appointment as an administration or a liquidator in increasing the return to creditors. In our experience, unless the debt is extremely low or the director presents a very strong and credible defence, an insolvency practitioner will pursue the claim against the director, initially in correspondence, but all the way then through to the courts because it is such a strong claim.
Maria Koureas-Jones	So, it's fair to say that in our experience, ostrich syndrome simply does not help a director's position. The insolvency practitioner's costs increase as they continue to chase the director and this only serves to increase the director's liability under the claim.
Stephen Downie	So that then moves to an equally lethal mistake 2 where the director decides to respond to any queries raised by a liquidator or administrator without taking any advice before doing so and without properly considering the impact of those responses and how they will have on the director's personal financial risk of being subject to these claims. Often soon after a liquidator is appointed, we see directors wrongly feel that the liquidator is "on their side" and this encourages the directors to respond promptly proactively without considering what the repercussions would be. I think you just spoke about this Maria, about the liquidators or the administrators being introduced with an arm around their shoulders assisting the directors and their company with restructuring or dealing with the winding up of their affairs but, soon after, the liquidator does have a statutory duty to look at such claims and, if required, pursue them regardless of the business relationship they had beforehand. There are of course a range of defences that are available in such circumstances where a director's loan account claim is presented but sometimes a director's answers to the initial correspondence can help nullify or make these defences very difficult to raise at a later stage. So, the first thing I would say is that caution is

	therefore necessary.
Maria Koureas-Jones	Directors are obviously under an obligation to help a liquidator with their enquiries. We are simply flagging here that they should respond to enquiries raised by a liquidator in a way that reduces their own personal risk.
Stephen Downie	But Maria, what if a liquidator is appointed, demands payment of a director's loan but the director doesn't have money to repay the debt?
Maria Koureas-Jones	Very good question and time and time again we are again faced with these circumstances. A liquidator will consider the costs of taking action against the director versus the likely recovery that they will make when having regard to the director's assets. If there is a genuine inability to pay argument i.e. there are simply not enough assets to pay the amount of the debt then it is often sensible to raise this with the liquidator early.
Stephen Downie	Yes, there is no point incurring legal costs or delaying the liquidator the time if you simply as a director don't have the money. It is best to just confess that and deal with it then from both sides. It is easier for them to both move away quickly because a liquidator won't pursue a director who doesn't have assets. But the problem is that most directors think they don't have assets but they will probably own a house which has got equity in it with or without a partner and it is important that the director doesn't overlook this as an asset because the liquidator certainly won't when considering making their assessment on the likely recovery for creditors.
Maria Koureas-Jones	Absolutely. So, for example, if you have got a director who owns a house that has £400,000 worth of equity, even though the director doesn't have a great deal of money in the bank or doesn't have an income because the company has closed and he doesn't have an income from a new entity, this alone is not going to be sufficient for the liquidator to simply not take any further action. If the director is sitting on £400,000 worth of equity where a claim is pursued and judgment is obtained the liquidator will be able to obtain a charging order over that director's share in the property and this is therefore something that the liquidator or administrator will assess when trying to decide what a reasonable sum is for settlement of the claim.
Stephen Downie	Yes, directors often overlook these assets and the fact that it will be taken into consideration when deciding on whether to pursue or continue with the claim and the amount of those assets is going to make a liquidator and administrator reach the decision more easily. At Francis Wilks & Jones we are well versed in assessing how viable an inability to pay argument is given such circumstances and when to present any such defence to the liquidator, administrator or their lawyers.
Maria Koureas-Jones	Steve, you mentioned earlier that there are some defences that can be run by directors. Let's talk about those. Are the defences available complete defences?
Stephen Downie	It largely depends on the circumstances of the case. It is different for each and every case. We have successfully run a complete defence against claims by liquidators or via their lawyers or in proceedings. We have won at trial many times but equally we have to be aware that, if there is a strong claim by a liquidator, then a better approach to adopt is to try to narrow that or to seek some sort of settlement for directors. I have got a quick note here of just a handful of the types of defence that would be most common. For example, there is something called quantum merit which no director listening to this will probably be interested in in terms of the Latin phraseology, but it just means that they have a claim to set off the work they have

	done if they are being pursued for a director's loan where they haven't been paid for the work they have done. There is an ability to set off the work they have done against the amount they would be paid. It doesn't always mean that it is an easy exit but it is one of the defences. There are several others. 'Set-off' refers to other claims against the company that director may have. There are also limitation defences, particularly where a director's loan account is quite aged and there is also the practical aspects. Most of these sort of claims are based on accounting evidence which is perhaps not correctly prepared or is just management accounts or, even worse, just notes on paper or ledgers compiled by a bookkeeper within the company and it may be that such records have been prepared but are not in an adequate form or are incorrect. And for cases where these defences are not viable or credible and where running them will merely increase costs for directors, then our job is to look at ways of narrowing the issues or reaching settlement for the directors but it is often the case that there are many more defences available for directors than they or their accountants or particularly the liquidator or administrator will really understand.
Maria Koureas-Jones	So, the key take-home for directors from today? Well firstly, talk to your accountant, understand how you are being paid, understand whether, bearing in mind the risks that we have discussed today, this is the right method for you and your family. Secondly, review this regularly so, as and when the financial position of the company changes, so should the method of payment switch from PAYE to director's loan account or switch the other way. Thirdly, where a director does receive a claim for repayment of a director's loan account, don't ignore it. Take early advice so that you can look to decrease personal exposure. It is often better to pay a small amount in legal fees and this can often have a material impact on the amount that will be paid to an administrator or liquidator under a director's loan account. The risk if you don't do that is that there will be significant liquidator costs, legal fees will be incurred and therefore that the exposure for your personally is substantially higher as a result of burying your head in the sand at the outset.
Stephen Downie	Absolutely Maria. We regularly see this and directors often balk at the initial legal things thinking they can deal with matters but then it leads to a claim and they either pay off the whole claim for many hundreds of thousands of pounds or they just leave it and the ostrich syndrome resurrects itself and the claim is issued and the amounts being pursued are then paled in comparison with the liquidator's or administrator's legal fees, their own costs, interest and significantly higher costs that really escalate the cost of exit in respect of these matters for directors.
Maria Koureas-Jones	Interest is a big one actually. You don't realise how quickly interest can materially increase the amount due so the longer you leave it the increasingly liability really does have a big bearing on the overall payment due. So forewarned is forearmed?
Stephen Downie	Absolutely!
Stephen Downie	Well, thank you for listening to this podcast. I think that concludes it. You have been listening to Maria Koureas-Jones and Stephen Downie discussing

	director's loan accounts. I hope you have enjoyed it and if you have any queries relating to these matters, please do not hesitate to contact us. More podcasts will follow. And it's goodbye from me.
Maria Koureas-Jones	Goodbye from him.