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Business law untangled podcast

Director's loan accounts: how accountants can protect their clients and themselves

Maria Koureas-Jones	Hello and welcome to a podcast from Francis Wilks & Jones. I'm Maria Koureas-Jones and I'm here today with Sue Brumby. We're both lawyers at Francis Wilks & Jones dealing with commercial litigation and contentious corporate and insolvency matters.
Sue Brumby	So, we're here to talk about director's loan accounts. This podcast is especially for accountants who advise directors of SMEs, following the recent trend of increasing claims against directors, based on overdrawn loan accounts.
Maria Koureas-Jones	The claims Sue mentions have tended to follow an insolvency process and, as advisers for SMEs, we hope that our clients will not end up in an insolvency process. But of course we realise that some of them will. We've witnessed, during the Covid pandemic, a large number of insolvencies arising from unforeseen circumstances, which perhaps accounts for why we are seeing some relatively large unpaid director loan accounts which form the basis for claims by administrators or liquidators.
Sue Brumby	Surprise is a common theme amongst a large percentage of the directors we advise. Consistently, directors with different advisors, across different locations, report that they were not made aware of the risks they faced when being paid via dividends and a director's loan account. For most SMEs the director may be a little unwary and either nervous about asking you questions on how they should be running the financial side of the business, or they simply don't realise that there are options and that each has its own implication. Directors tend to overlook where they might stand should the business fail and, while you may not wish to do tread on a director's toes by questioning their wisdom, directors need careful and clear expert guidance early on – it will pay dividends – no pun intended! I often get asked the question from clients as to why they were recommended to use a more tax efficient vehicle which carried so much personal risk to them, their families and their homes, when in fact the company had funds to pay the additional tax payable where they received pay via a salary and PAYE.
Maria Koureas-Jones	And this is always a difficult question to answer. It is of course often asked with the benefit of hindsight and, understandably, the advisers will no doubt query whether in fact, had the directors been given the options clearly with all risks explained, whether the directors would *still* have chosen to be paid via a dividend and director's loan account.
Sue Brumby	Most of the directors we advise seem to have been unaware that they had such an option regarding the way in which they were paid.

	All too often we hear a director say, “We just relied on our accountant”. In some cases, the directors had been paid in the same way since their company was incorporated some years earlier and their position is that the options had not been the subject of a conversation or review with their accountant, either at incorporation or as the company evolved. In some cases, directors had been accruing overdrawn loan account balances over a number of years and their position is that they were not told this would be repayable by them personally if the company went into an insolvency process. It’s not just about how a director is being paid either, but, very often, we find that the director hasn’t really understood how a director’s loan account operates in relation to cash withdrawals and expenses. Poor record keeping is definitely a recurring theme when it comes to formulating responses to a liquidator who has produced an itemised schedule of payments and withdrawals for a director who claims these were expenses incurred on behalf of the company. These withdrawals are often allowed to accumulate over lengthy periods of time and, the longer the period of withdrawals, the less likely that receipts are kept to justify the expenditure. And of course, as with all of us, memories fade.
Maria Koureas-Jones	So our goal is to raise awareness on the need to ensure that directors are being fully and regularly advised both on incorporation and during the lifecycle of a company, regarding the way in which they can be paid, the pros and cons in relation to the remuneration options and, specifically, the risk to the director personally where they are paid via the dividend and director’s loan account route where the company enters an insolvency process. There can be no doubt that accountants need to ensure that a director is fully advised on the options surrounding remuneration, and it is our view that this advice should be recorded (ideally in an email or letter of advice) and that it is the director’s role to choose which remuneration option is most suitable for them given their appetite for risk and their own personal circumstances.
Sue Brumby	As a firm, we assist claimants who have suffered loss due to professional negligence and, given the unfortunate increase in claims against directors flowing from unpaid director’s loan accounts and the concerns being raised by directors time and time again surrounding the absence of advice on this subject, it seems likely that we will see an increase in claims against accountants where a director faces a DLA claim by a liquidator and the director’s position is that they have not been advised of their remuneration options. Additionally, a director may deploy the not uncommon defence that they were acting on the advice of their accountant, which may assist us in helping a director reach a financial settlement with the liquidator, but unfortunately this is not always sufficient to defeat a claim
Maria Koureas-Jones	We expect most of the advisers listening to the podcast to have a good understanding of the remuneration options available to a director/shareholder of an SME and also to fully understand what a director’s loan account is and therefore, we do not propose going into this in huge detail here. We will touch on the different remuneration options briefly. We will not however look at the tax savings associated with each or these options.

Sue Brumby	Maria, you referred to remuneration options and what we mean by this is how a director/shareholder is paid through their own company. There are two options we see regularly: The first is where the director is paid via a fixed salary which is paid via equal instalments, via the PAYE system and where tax is deducted at source. In this situation, where there is also an entitlement to a dividend because there is a net profit, he or she will also receive a dividend payment in addition to their salary. The second option is for the director to receive payment via dividends or dividends and a very small annual salary, and this happens via a director's loan account.
Maria Koureas-Jones	Payment via the first option does not involve a director's loan account and where a company enters an insolvency process, as long as the salary received by the director is reasonable and documented in a contract of employment between the company and director, it is difficult for an appointed liquidator to pursue a claim against the director personally to recover the salary that the director has received. This is therefore arguably the lowest risk option to a director.
Sue Brumby	Where the salary isn't recorded in a contract of employment and the company later enters an insolvency process, the director will not be able to simply point to a contract of employment which records his contractual right to be paid the amount received. He is therefore left with having to justify the legal basis for receipt of the annual salary. Ideally, and to reduce a director's risk of a claim by a liquidator for repayment of monies received, a director should have a contract of employment between him/her and the company which then justifies the annual salary paid.
Maria Koureas-Jones	This only needs to be a short form contract of employment but, given that a liquidator can seek to recoup monies paid to a director in the six years prior to insolvency, ensuring that there is a contract of employment is definitely a worthwhile exercise.
Sue Brumby	But, more commonly, we see directors being paid via the second option because the small monthly salary utilises the director's tax-free income allowance and because payment via dividends rather than salary often results in less income tax for the director.
Maria Koureas-Jones	A word of caution here though: with the tax saving comes a risk to the director personally and to his or her family home. In our experience, directors often do not appreciate or understand this risk until it's too late and until they are at the receiving end of a claim by a liquidator for repayment of their director's loan account.
Sue Brumby	So, briefly, how does being paid via dividends represent a potential risk to a director? Well the Companies Act of 2006 makes it crystal clear that a company can only pay a dividend where it has a net profit for the year. Whether a company will have a net profit for the year is only known after the financial year has been completed.
Maria Koureas-Jones	Okay, so let's give an example to illustrate – where a company's tax year is April 21 – March 22, whether there is a net profit available to distribute will only be apparent after April 22 when the annual net profit is calculated.

Sue Brumby	So, the issue of course is that most directors need to be paid at regular intervals during the tax year (like in our example between April 21 – March 22) and, in most cases, they simply can't wait until after the 12-month trading period has completed before they are paid.
Maria Koureas-Jones	So, to accommodate a director's need to be paid throughout the tax year, a company tends to pay a director an agreed sum which tends to be monthly. But here's the important bit: the payment to the director throughout the financial year is a payment on account of anticipated net annual profit for the financial year end.
Sue Brumby	Using our example, the payments would be on account of a net profit that could be declared after trading concludes in March 2022. For ease of the sums, let's assume that the director receives £2,000 per month, so a total of £24,000 received. How is this accounted for by the company?
Maria Koureas-Jones	Assuming that none of the payments are via PAYE, these payments will be recorded as a debit on the director's loan account. So you will end up in March 2022 with a loan to the director of £24,000. It has to be a loan because it's payment on account of a net annual profit that doesn't yet exist.
Sue Brumby	Where there is a net annual profit for the financial year, the director/shareholders' portion of this profit will of course be applied as a credit on the director's loan account.
Maria Koureas-Jones	Absolutely. Again, using our example, let's assume that the net profit at the financial year end in March 2022 is £48,000 and our director has 50% of the company's shares. The director will be entitled to a dividend of £24,000 which will simply be applied as a credit on the directors' loan account because they have already received the £24,000 during the financial year.
Sue Brumby	So he or she will at that point owe the company nothing, but also not receive an additional payment further to the dividend declared. If, however the director held all the shares in the company, for example, and there was a profit of £48,000, £24,000 would be applied as a credit on the director's loan account, they would owe the company nothing because their director's loan account would be cleared and they would also receive an additional £24,000 by way of a dividend.
Maria Koureas-Jones	But the issue of course is where the net profit is less than originally anticipated and less than the director/shareholder has received from the company during the financial year.
Sue Brumby	And this is the situation in which many directors have recently found themselves – particularly given the recent COVID pandemic which was totally unforeseeable at the start of most businesses' financial years and where restrictions led to a drop in turnover and net profit. Using our example again, if the net profit was nil, the director/shareholder would not be entitled to any dividend payment, no credit could be applied to their director's loan account and the director would be left owing the company £24,000.
Maria Koureas-Jones	While a company continues to trade, a company tends not to demand from its directors repayment of the director's loan account balance.

	Many directors accrue an increasing director's loan account debt over multiple years because firstly, the directors often do not understand how the payments they receive from the company are accounted for and, secondly, because the company does not make a profit sufficient for the credit to the director's loan account to be made at year-end.
Sue Brumby	Where, however, a company enters an insolvency process, an administrator or a liquidator is under an obligation to calculate and collect the debts of the company and this will of course include any debt owed under a director's loan account. Given that the statutory accounts will record the DLA because of the obligations in section 413 of the Companies Act 2006 and FRS 102 and 105, the insolvency practitioner will know of the debt and demand payment under the DLA as soon as they take office. Given that the directors have normally signed off the accounts, it makes it far more difficult for them to feasibly argue that they were unaware of the director's loan account. It all makes for a claim against the director for his or her outstanding loan account, one of the easiest claims brought by a liquidator, and certainly one of the first targets in any insolvency.
Maria Koureas-Jones	As a team we have seen an increase in the number of claims for repayment of a director's loan account balance from liquidators. This has often been because a company has found trade difficult during the Covid pandemic and because a director has continued to receive the same payment from the company that they were accustomed to pre-Covid but, of course, often we have seen that the profit was not there and that meant that the company was unable to declare a dividend and therefore a credit could not be applied to the director's loan account. The general value of the director loan account balances that we are seeing ranges from between £50,000 to £1 Million so they can be fairly sizeable.
Sue Brumby	In these cases, we often see directors making a number of mistakes on receipt of a demand for payment by an insolvency practitioner. We thought it would be helpful to our listeners if we shared some of the common mistakes we see with our clients and explain the often-serious impact that these issues are having on a director's financial exposure.
Maria Koureas-Jones	Common mistake 1: Ostrich syndrome: Many directors simply *ignore* a demand from a liquidator hoping that the liquidator will not take any further action. Directors who have appointed an insolvency practitioner often feel that they have a "good understanding" with them and assume therefore that the insolvency practitioner will not follow through with a claim against the director. But this overlooks the fact that the insolvency practitioner has a statutory duty to collect in the debts of the company to increase the return for the company's creditors.
Sue Brumby	Seeking repayment of a DLA is an easy claim for an insolvency practitioner to pursue with a view to increasing the return to the creditors and therefore, in our experience, unless the debt owed is extremely low or perhaps the director presents a credible defence, an insolvency practitioner *will* pursue the claim against the director.
Maria Koureas-Jones	So, the summary is that ostrich syndrome does not help a director's position. The

	insolvency practitioner's costs will increase as an IP continues to chase a director and all this serves to do is increase the director's financial liability under the claim.
Sue Brumby	The second mistake we often see is that directors will respond to queries raised by a liquidator or administrator without first taking any advice and without properly first considering the impact that those responses may have on the director's position. Often, soon after a liquidator's appointment, we see directors or their accountants feeling that the liquidator is "on their side" and this encourages the director to respond a little too quickly and without considering properly what the answers are and how these answers may prejudice their own position. There are a range of defences that can be considered where a DLA claim is presented and sometimes a director's answers to an insolvency practitioner at this stage can materially reduce the director's ability to rely on some of those defences. Caution is therefore necessary.
Maria Koureas-Jones	We all know that directors are under an obligation to help a liquidator with their enquiries. What we are flagging here, however, is that a director should respond to enquiries in a way that reduces their own personal risk. We often act as a post box between liquidators and directors so that we can advise a director as to why questions are being asked, analyse what the legal position is and help a director to phrase an answer in the best possible way to reduce their financial risk. While this does carry a cost for the director, in our view this materially reduces the number of claims a director faces, the value of those claims, and helps settlement occur at a sooner stage while reducing the overall legal costs.
Sue Brumby	So Maria, what if a liquidator is appointed, demands payment of a director's loan account and a director doesn't have any money to pay the debt?
Maria Koureas-Jones	A liquidator will consider the costs of taking action against a director versus the likely recovery. So, when making this assessment, the liquidator will consider a director's assets. If there is a genuine inability to pay argument, it is often sensible for a director to raise this early. However, directors who own a property need to be alive to the fact that the equity in that property will be factored into an assessment regarding what is a reasonable level of settlement. We mentioned that there are some defences that can be run by directors. Sue, are these complete defences?
Sue Brumby	Well, that depends on the circumstances but for some clients, we've successfully run a complete defence meaning that they have not paid anything to a liquidator where a DLA exists. For others though, the circumstances did not allow a complete defence, but we have been able to run valid defences that materially reduce the sum to be paid by a director. That "I relied on the advice from my accountant" is a regular feature of viable defences put forward by directors and goes back to the professional negligence health warning we talked about earlier. For cases where defences are not viable or credible and where running them will simply serve to materially increase costs for the director, our job is to ensure that a director is made aware of their exposure early on during our instruction. This enables them then to make informed decisions regarding strategy going forwards.

Maria Koureas-Jones	What are the key points then for accountants who are advising directors and SMEs? 1. Make sure you are advising as to the different remuneration options, the benefits of these, but also the risks. We would recommend that the advice is recorded in either an email or in writing to reduce your exposure to a professional negligence claim. We would recommend that the directors themselves are encouraged to decide which remuneration option is best for them when having regard to their *own* risk appetite and their personal circumstances. And, of course, the director's instructions and reasons should be noted on the file. 2. We recommend that the advice surrounding remuneration be reviewed regularly, so, as the company grows, as turnover increases, as more directors join a company board of directors. Again, the advice provided and the instructions from the directors should be recorded on the accountant's file to protect their position. 3. Where a director does receive a claim for repayment of a director's loan account and the accountant becomes aware of it, we would recommend that they are encouraged to take early advice. Your counsel as to the fact that taking early advice could help them avoid some of the common pitfalls we discussed earlier will no doubt assist you in providing real value to your client.
Sue Brumby	We regularly see this and the legal costs that need to be incurred at that point are then significantly higher, the insolvency practitioner's costs are significantly higher and often things have been said by directors which reduce the defences available to them. We are always happy to have an initial call with a director faced with a claim. This can be perhaps with the accountant or separately, depending on preference. We are equally happy to speak to accountants who have received enquiries from an insolvency practitioner but are unsure as to what their obligations are in responding to those and what they must disclose.
Maria Koureas-Jones	Thank you for listening to our podcast. You have been listening to Maria Koureas-Jones and Sue Brumby discussing director's loan accounts. For more information on this subject, and many others, visit our website fwj.co.uk where you will find a number of guides, blogs and FAQs for both you and your clients. We hope you've enjoyed our podcast. If you have any queries relating to the matters we have discussed, please do not hesitate to contact us.