Collas Crill explains... Disguised or unintended distributions under Jersey law

September 2019

This guide is one in a series of 'Collas Crill explains...' in which we examine areas of Jersey law that frequently arise in practice.

Jersey is a popular place to establish an asset holding company because the **Law** is modern, flexible and modelled on English companies legislation.

This guide looks at the key things you need to know about the payment of disguised or unintended distributions by a **company** under Jersey law.

Words in bold text are defined at the end of this guide.

Distributions

The **Law** defines the term distribution widely as any distribution (whether in cash or otherwise) of a **company's** assets to its shareholders in their capacity as shareholders other than payments that are specifically excluded.

The **Law** also sets out a small number of rules that apply to the payment of distributions.

For more information on the provisions of the **Law** relating to distributions, see our guide *Distributions by a Jersey company* (click here).

Disguised or unintended distributions

Under English common law, a company may only distribute its assets to its shareholders in accordance with specific statutory provisions which allow it to do so. A distribution that is not made in accordance with those provisions is unlawful and invalid.

Historically, the unlawful distribution rule was an extension of provisions in the English companies legislation which implemented the maintenance of capital rule. This rule sought to preserve the capital of a company to ensure that it would be available to satisfy the claims of its creditors.

Although decisions of English courts are not binding on the Jersey court, it will frequently look to English decisions for guidance and it is generally thought that it will follow the cases in this area.

Today, the maintenance of capital rule has been significantly relaxed and the **Law** allows distributions to be paid from a far wider range

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of sources. Despite this, the unlawful distribution rule is still capable of applying to invalidate a transaction which:

- is structured to appear as though it is an arm's length transaction, but which is in substance, a disguised distribution; or
- although not intended to be a distribution, is in substance a distribution that has not made in accordance with the provisions of the **Law**.

In most cases, a distribution is clear. A **company** intends to make a distribution to a shareholder by paying it money, transferring an asset or forgiving a debt.

However, in some cases, a transaction may not be intended to be, or may not appear to be, a distribution. Examples of transactions which have been held to be unlawful distributions include:

- an exorbitant rate of interest payable under a debenture issued to a parent company;
- the transfer of an asset between commonly owned companies at less than fair market value; and
- the payment of remuneration to a person who was a director and shareholder of a **company** where the person had done no work at all for the company.

The courts have said that, in considering whether a transaction constitutes an unlawful distribution at common law, it is necessary to examine all of the relevant facts and look at the purpose and substance of the transaction rather than its form. If the transaction is:

- genuine and made at arm's length, then it will be valid, even if it is a bad bargain; and
- an attempt to improperly extract value from the **company** on the pretence of an arm's length transaction, it will be invalid.

Related party transactions

The context in which the rule frequently comes into play is related party transactions.

The two most common situations where the rule applies is when a **company** wishes to:

- lend money to its parent company or another company in same group on interest free terms or at an artificially low interest rate; or
- transfer an asset at less than fair market value to another company in same group or under common control.

In these situations, there will be an unlawful distribution even though the shareholder of the transferor does not directly receive the distribution.

Where the rule may apply, it is necessary for the **company** to treat any element of a transaction that would otherwise constitute an unlawful distribution (eg the difference between the book value and the market value of the asset) as a distribution and authorise it in accordance with the requirements of the **Law**.

For information on the authorisation process for a distribution, see our guide *Distributions by a Jersey company* .

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Terms used

company means a Jersey company that is not an open ended investment company.

Law means the Companies (Jersey) Law 1991.

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We are a leading offshore law firm. We are easy to do business with and give practical advice to overcome tough challenges. Through our network of offices, we practise British Virgin Islands, Cayman Islands, Guernsey and Jersey law.

About this guide

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