

UNLAWFUL DIVIDENDS, UNJUST ENRICHMENT,
AND THE DEFENCE OF CHANGE OF POSITION

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I. INTRODUCTION

Under ss. 263-281 of the U.K. Companies Act 1985, it is unlawful for a dividend to be declared in excess of distributable profits. Traditionally, a shareholder who received an unlawful dividend was not liable to return funds if he did not know that the dividend was unlawful.

Recently, a debate has arisen regarding whether under the English law of restitution an innocent shareholder should be strictly liable for the unlawful dividend as the result of unjust enrichment. J. Payne argues that the innocent shareholder should be strictly liable for the unlawful dividend because the shareholder has been unjustly enriched.¹ C.H. Tham, however, argues that the shareholder should not be liable for the unlawful dividend because the factor or factors for unjust enrichment are simply not present.² Both Payne and Tham recognize that under English restitution law the recipient shareholder would have the defence of change of position subject to the disqualification of bad faith. But they do not consider the consequences of the assertion of that defence.

The purpose of this paper is to analyse the effect of the defence of change of position on the question of whether a shareholder should be liable for an unlawful dividend as the result of unjust enrichment. To focus the analysis on the effect of this

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¹ "Unjust Enrichment, Trusts and Recipient Liability for Unlawful Dividends" (2003) 119 L.Q.R. 583.

² "Unjust Enrichment and Unlawful Dividends: A Step Too Far?" (2005) C.L.R. forthcoming.

defence, I assume that the factor or factors for unjust enrichment are present. In particular, I assume that the unlawful dividend has been declared by mistake.

P. K. Huber has applied economic analysis to mistaken money transfers under American, Austrian and German restitution law.³ In addressing the issue of whether the recipient shareholder should be liable for the unlawful dividend under unjust enrichment, I employ economic analysis. In particular, I look to Huber's analysis to see what insights it can provide regarding whether an innocent shareholder should be liable for unjust enrichment under English restitution law. Following Huber, I will first consider two simple rules: no restitution of the unlawful dividend and complete restitution of the dividend without the defence of change of position. I will then consider restitution with the defence of change of position under English restitution law. The paper concludes with a summary of the analysis.

II. NO RESTITUTION

Under the rule of no restitution, no claim is made against shareholders to return any mistakenly unlawful dividends they receive. This is the situation under U.K. company law with the exception that shareholders who know about unlawful nature are liable for restitution.

Under no restitution, the recipient of a mistaken payment, in general, has no incentive to take care regarding whether a the payment is mistaken.⁴ The shareholder, in particular, need not be concerned whether the dividend is unlawful. Once received, the shareholder can rely upon the receipt of money and take positions based on that receipt. No cost is imposed on the shareholder.

³ "Mistaken Transfers and Profitable Infringement on Property Rights: An Economic Analysis" (1988) 49.La. L. Rev. 71 at pp. 79-90.

⁴ See note 3 above at p. 80.

Transferors, in general, have incentives to ensure that payments are not made mistakenly.⁵ The company directors and officers, in particular, have incentives to take care because they know that a mistaken dividend that is not voluntarily returned will be lost. The company will invest in internal control mechanisms to reduce the probability of a mistaken payment. Indeed, they may have an incentive to over-invest in control mechanisms because they bear the liability while the company bears the expense of the mechanisms. Alternatively, the directors will take out director insurance to cover any liability that they may have. The insurance company will then set the standard of care commensurate with its provision of insurance coverage.

Hubert argues that precluding restitution, “creates a strong incentive for recipients to induce mistakes on the part of transferors” and that transferors, “in turn are induced to take preventative measures against such influence.”⁶ For outside shareholders there is little opportunity to induce an unlawful dividend by the company. However, for inside shareholders there may be the opportunity to induce mistakes. For insiders who are not liable under company law, there may be incentive to restrict expenditures on internal control mechanisms so that they may benefit from the mistakenly unlawful dividend. Knowing about the incentive to induce mistakes, outside directors, in particular, will have an incentive to enhance further the internal control mechanisms to prevent unlawful dividends.

Thus, under U.K. company law, there is no incentive for innocent shareholders to take care regarding the receipt of unlawful dividends. There is however, a strong incentive for directors, or for providers of insurance to directors, to take strong measures to ensure that unlawful dividends are not mistakenly declared. There is an incentive for substantial expenditures on internal control mechanisms. For inside

⁵ See note 3 above at p. 80.

⁶ See note 3 above at p. 80.

shareholders who are not liable under company law for unlawful dividends, there may even be an incentive to induce the distribution of unlawful dividends, for example, by restricting expenses on internal control mechanisms. Internal control mechanisms are not costless. While these control mechanisms serve the objective of maintaining the company's capital – be it debt or equity -- by reducing mistakenly unlawful payments, these mechanisms also increase the cost of obtaining this capital. If the marginal cost of achieving the maintenance of capital exceeds the reduction in the price of capital, then capital maintenance is not cost effective from the point of the company.

II. RESTITUTION WITHOUT DEFENCES

Under the rule of restitution without defences, a claim is made against the shareholders to return any dividends they mistakenly receive even if the shareholders did not know about the mistake. This appears to be the situation under U.K. restitution law in the 19th century.⁷

Under restitution without defences, the recipient incurs a loss if he relies on the payment not being mistaken and the payment is, indeed mistaken. “This loss can be monetarized by comparing the purchase price of the additional goods acquired (as a result of the increase in the recipient's supply of money) with the recipient's actual willingness to pay for the goods in the absence of the mistaken money transfer.”⁸ This reliance loss corresponds to Birks' measure of disenrichment: “if by reason of an event which would not have happened but for the enrichment the [recipient's] wealth is reduced”⁹ The loss is the reduction of wealth, after the return of the mistaken money transfer, in comparison with the wealth prior to the transfer. Thus, to the degree the shareholder is induced to spend his wealth in a manner he would have

⁷ P. Birks, *Unjust Enrichment*, 1st ed. (Oxford, 2003) at p. 5.

⁸ See note 3 above at p. 81.

⁹ See note 7 above at p. 189.

not otherwise have spent in the absence of the mistakenly unlawful dividend, he is disenriched.

Given the probability of a mistaken payment, the recipient incurs a reliance risk. In response to this risk, he will engage in precaution he would not have engaged in under the rule of no restitution. He will engage in precaution until his marginal cost of precaution equals the marginal decrease in the reliance risk. What this means in the case of mistaken unlawful dividends is the shareholder may hedge his bets. He can attempt to purchase insurance to cover this reliance risk. The cost of the insurance premium is a cost. The insurance company to control its risk will attempt to monitor the lawfulness of the company payments. Alternatively, the shareholder can self-insure and not completely rely on the dividend being not mistaken. This is also a loss because he would have preferred to engage in expenditures fully relying on the dividend payment. He can control this loss by gathering additional information regarding whether the dividend is mistaken¹⁰ It may be cost-effective for shareholders to purchase insurance so that the insurance company gathers additional information on behalf of all shareholders paying the insurance premiums.

While, in general, the transferor has a claim for complete restitution of the mistaken payment, assertion of the claim will not be costless.¹¹ The transferor has negotiation or litigation costs to recover the payment. The transferee may also be judgment proof by virtue of insolvency. What this means in the case of mistaken unlawful dividends is that the directors still have an incentive to employ internal control mechanisms up to the point where the marginal reduction in negotiation, litigation, and insolvency costs is offset by the marginal cost of the control mechanisms.

¹⁰ See note 3 above at p. 81.

¹¹ See note 3 above at p. 81.

Huber concludes that, in general, restitution without defences is preferable to no restitution.¹² Remembering that the latter corresponds to English company law without the exception for shareholders knowing the dividend is mistakenly unlawful, and that the former corresponds to 19th century English restitution law, this conclusion tends to support 19th century English law restitution over, or in addition to, English company law without the knowing shareholder exception. Huber bases this conclusion on the significant incentive for recipients to induce mistakes and on the expense of the response by transferors to respond to this inducement. However, as we have seen, there is a limited potential for shareholders to induce mistakes on the part of directors. Thus, the lack of an incentive under English company law for shareholders to incur precautionary costs to offset reliance losses -- because without restitution there are no reliance losses -- may more than offset the lack of mistake inducement under 19th century restitution law.

III. RESTITUTION WITH CHANGE OF POSITION DEFENCE

Under 21st century English restitution law, there is a defence of change of position. As we have seen, change of position may be specified as disenrichment, which corresponds to reliance loss. Under the defence, the recipient is liable only for the enrichment net of the disenrichment brought about by the reliance on the dividend payment not being unlawful. The defence has a disqualification for bad faith which, under English restitution law, does not include a concept of fault on the part of the recipient.¹³ Rather the disqualification requires subjective dishonesty, i.e., the recipient must be dishonest and know that he is being dishonest to be disqualified from the defence.¹⁴ Any debate about whether restitution law should supplement or

¹² See note 3 above at p. 82.

¹³ See note 7 above at p. 192.

¹⁴ See note 7 above at p. 193.

substitute for company law regarding liability for unlawful dividends must consider this defence.

Huber's analysis of a simple change of position defence is relevant here.¹⁵

The most significant effect of introducing the defence of change of position is that the defence, "creates a moral hazard on the recipient's part."¹⁶ The defence provides an incentive for the recipient to change his position simply to avoid the restitution. The recipient will engage in consumption or other expenditures that he would not otherwise carry out in the absence of the possibility of a mistaken payment. How much excessive change in position the recipient carries out depends on the probability of a restitution claim being made for a mistaken payment. The higher the probability of a claim being made, the higher the excess change in position by the recipient. The more likely the transferor is to make out a case of enrichment, the more the recipient will change his position to defend against the restitution.

Compared with restitution without defences, the change of position could be dramatic. Without the defence the recipient had to hedge his bets, reducing the change in position that he would have otherwise liked to have taken and, thereby, reducing his reliance loss. With the defence, he has the incentive to increase the change of position more than he would have otherwise done with no restitution. In the extreme, the recipient would engage in sufficient disenrichment to offset completely the enrichment of the mistaken transfer. In this case, it is as if there was no restitution from the perspective of the transferor. He must still engage in all the precautionary expense that he would incur under a true rule of no restitution. But the

¹⁵ Because English restitution law does not have a concept of fault, Huber's analysis of money transfers under fault-based restitution rules is not applicable to the liability for unlawful dividends under English law. See note 3 above at pp. 84-90

¹⁶ See note 3 above at p. 83.

recipient has engaged in excessive change of position and, thereby, incurred a loss in comparison with the rule of no restitution remedy

What this means for mistakenly unlawful dividends is that in the extreme, allowing a claim of unjust enrichment with a defence of change of position yields the same result as company law, except that the innocent shareholder incurs the loss associated with an excessive change of position. From a director's point of view, it looks like the company law result of no restitution because the defence of disenrichment has effectively negated the claim of enrichment. However, from the perspective of the shareholder the result of no reliance has only been achieved by incurring the loss associated with excessive change of position.

One can even imagine that the framers of the U.K. company law statute had this result in mind. Seeing the likelihood of moral hazard from the application of English restitution law to the issue of liability for unlawful dividends, they shaped a law of restitution for unlawful dividends that deals with bad faith but does not have the loss associated with excessive change of position.

IV. CONCLUSION

If the result of substituting or supplementing company law liability with a restitution law liability is the same for the directors but inferior for the shareholders, the restitution result is inferior. If the result is not the same for the directors, because the change in position under the restitution remedy is not so great as to cause the disenrichment to completely offset the enrichment, the cost of inducing mistakes under the no restitution of company law must be weighed against the cost of the moral hazard under the restitution remedy. As we have already seen in the case of unlawful dividends, the potential for shareholders inducing mistakes is limited. Thus, the scales may still tip against the restitution remedy as advocated by Payne.

If we believe that the U.K. parliament is aware of the restitution remedy, which we have no reason to believe they are not, then the scales may have already tipped against the restitution remedy. The company law provisions dealing with liability for unlawful dividends may be viewed as authorizing restitution whenever there is bad faith but otherwise precluding it to control the moral hazard of restitution with the defence of change of position. Thus, while Payne may be right that the unjust enrichment model can be applied to recipient liability for unlawful dividends,¹⁷ Tham may still be right that “further extension of unjust enrichment liability to cases of illegality should be resisted.”¹⁸

¹⁷ See note 1 above at p. 606.

¹⁸ See note 2 above.