UNIT 1– Company and Partnership Law

Suggested Answers – June 2010

Note to Candidates and Tutors:

The purpose of the suggested answers is to provide students and tutors with guidance as to the key points students should have included in their answers to the June 2010 examinations. The suggested answers do not for all questions set out all the points which students may have included in their responses to the questions. Students will have received credit, where applicable, for other points not addressed by the suggested answers.

ILEX is currently working with the Level 3 Chief Examiners to standardise the format and content of suggested answers and welcomes feedback from students and tutors with regard to the ‘helpfulness’ of the June 09 Suggested Answers.

Students and tutors should review the suggested answers in conjunction with the question papers and the Chief Examiners’ reports which provide feedback on student performance in the examination.

Section A

Question 1

The doctrine of the maintenance of capital, outlined by Lord Watson, effectively requires that once a company has received payment for the shares it has issued, that consideration cannot be returned to the members except in the proper course of a distribution of assets (Trevor v Whitworth (1887) 12 App Cas 409). In light of the maintenance of capital rule, there are strict controls in respect of transactions and/or decisions that have the effect of returning capital to a member. Initially there appeared to be an absolute prohibition on returning capital to shareholders, however a number of exceptions to the maintenance of capital rule have been developed and the rule relaxed. These exceptions are set out in the Companies Act 2006. Several exceptions to the maintenance of capital rule are discussed below.

Reduction of capital

The Companies Act 2006 allows a company to reduce its capital in “any way”, providing it complies with the detailed rules set out in the legislation. There are detailed provisions enabling a company (public or private) to reduce its issued share capital with the consent of the court, or a private company by the passing of a special resolution. The requirements and procedure is set out in sections 641
to 648 Companies Act 2006. A reduction of capital is legal if carried out in accordance with the statutory provisions.

Any company can apply to the court to confirm a reduction of capital. The court’s role is to protect the interests of the creditors and the interests of the shareholders (who will need to give their consent to the reduction by passing a special resolution), it will need to be satisfied that the creditors have consented to the reduction and that the company is able to pay its debts after the reduction. A private company, on the other hand, can take advantage of a simplified procedure under sections 641 to 643 Companies Act 2006. As with the court procedure the shareholders must pass a special resolution, however instead of the court then confirming the reduction, the process is undertaken by the company’s directors. The director must make a statement of solvency providing that essentially the company will be able to pay its debts for the next year.

Ability of a company to purchase its own shares

Generally a company is forbidden to acquire its own shares because the capital, once raised, must be maintained for creditors. However, a company can buy back its own shares provided that various conditions are satisfied. The provisions are set out in sections 690 to 723 and differ depending on whether it is intended to be an on or off market purchase. A company can only acquire its own shares if it has distributable profits or funds resulting from a fresh issue of shares (S692 Companies Act 2006), however a private company can also, as a last resort, acquire its own shares out of capital providing that the additional conditions in sections 713 to 720 are satisfied.

Financial Assistance

The general rule used to be that a company could not give a prospective or an actual member financial assistance to enable him to purchase shares in the company. Following the enactment of the Companies Act 2006, this restriction was removed in respect of private companies. S682(1) Companies Act 2006 provides that private companies are expressly excepted from the provisions on financial assistance under sections 678 and 679 Companies Act 2006, therefore enabling private companies (subject to the directors satisfying themselves that they are acting in accordance with their duties) to assist in the acquisition of their own shares.

Whilst the above examples illustrate that Lord Watson’s statement is not a true reflection of the law in respect of maintenance of capital, nevertheless the concept of maintenance of capital cannot be ignored and is still supported by statute. This can be illustrated by the rules on the payment of dividends and the issuing of shares.

Payment of dividends

A company may only pay a dividend to shareholders to the extent that there are profits available for the purpose. S830 Companies Act 2006 provides a definition of profits being all the realised profits less all realised losses. Where directors approve dividend payments other than out of distributable profits i.e. capital, it would be an unlawful distribution. Shareholders may be required to repay the dividend (S847 Companies Act 2006) and directors may be liable to account to
the company for any loss suffered (It’s a Wrap v Gula (2006) 2 BCLC 634, Bairstow v Queen’s Moat Houses plc (2001) 2 BCLC 531)

Issuing shares at a discount

Shares may not be issued for less than their nominal value (S580 Companies Act 2006, Oreogum Gold Mining Co of India v Roper (1892) AC 125), subject to a very limited exception that a company may pay an underwriting commission (S553 Companies Act 2006) thereby supporting the maintenance of capital rule.

It is not disputed that the maintenance of capital rule is a principle of company law, however statute has developed and it is acknowledged that there are accepted exceptions meaning that Lord Watson’s statement in Trevor v Whitworth in 1887, that capital cannot be paid out of a company, is no longer a true reflection of the law in relation to the maintenance of capital under the Companies Act 2006.

Question 2

As a person in its own right, albeit artificial, a company can own assets and hold shares in another company. Therefore groups can be created between parent company and subsidiaries, this is acknowledged by S399 and S1159 Companies Act 2006.

Each company in a group has a separate legal personality (Salomon v A Salomon and Co Ltd (1897) AC 22, J H Rayner (Mincing Lane) Ltd v Department of Trade & Industry (1990)) from its shareholders and directors. Following the case of Salomon, where the House of Lords explored the legal relationship between a company and its major shareholder, the principle was established that the shareholders are distinct from the company itself. This principle is recognised in S16(2) Companies Act 2006 which defines a registered company as a body corporate.

From the shareholder’s perspective, the shareholder is afforded limited liability (S3(1) and S3(2) Companies Act 2006 and S74 Insolvency Act 1986). This means that the liability of the shareholders is to the company and is limited to the amount that the shareholders had agreed to pay for their shares.

Adopting the traditional explanation of separate legal personality and limited liability, this means that the parent company is a separate legal entity to each of its subsidiaries and that its liability is limited to the amount, if any, unpaid on the shares it owns. Each company in the group is a distinct legal entity and even though a subsidiary’s shares may all be owed by one other person (the parent company) the principle of separation and limited liability means that despite the economic connection in a group of companies, they remain separate at law and consequently as the only direct remedy available to a creditor of a company is against the company itself, not the shareholder.

Therefore, despite the economic connection in a group of companies, the companies remain separate at law. Groups of companies have recognised the legal principles of separate legal personality and limited liability of shareholders and used these as forms of protection. By implementing a group structure, companies can use it to their advantage. Each business in the group can be put into a separate company, meaning that organisations can guard against the risk of sound businesses being placed at risk by the financial plight of others by isolating each in a separate company.
Despite the obvious economic connection between companies with the same corporate group, does the law treat them as separate legal entities as discussed above? The separate legal personality may be ignored by the courts in certain circumstances. In these cases, the company and its shareholder (i.e. parent and subsidiary) have been treated as one. The consequent effect is that the traditional principle of limited liability of the shareholder may be lost and the shareholder/parent company will become liable for the debts of the company. This disregard for the tradition principles of company law is known as piercing the veil of incorporation.

It is important to note that piercing the veil of incorporation is the exception rather than the rule. Examples of where the court has been prepared to pierce the veil were in Daimler Co Ltd v Continental Tyre and Rubber Co (Great Britain) Ltd (HL 1916) 2 AC 307 for national interest and in both Gilford Motor Co Ltd v Horne (1933) Ch 935 and Jones v Lipman (1962) 1 WLR 832, where the court held that a company structure had been used as a façade to enable the evasion of pre-existing obligations.

The courts have also considered piercing the veil in respect of matters affecting groups of companies. The approach is sometimes authorised by statute and sometimes adopted by the courts of their own accord, however clear rules have not been developed. It is interesting to note the occasions where the courts have pierced the veil of incorporation in respect of groups of companies and recognised separate companies with the effect of creating one entity. The courts have pierced where special circumstances exist indicating that the company is a mere facade concealing the true facts. In Smith Stone & Knight Ltd v Birmingham Corporation (1939) 4 All ER 116 and DHN Food Distributors Ltd v Tower Hamlets London Borough Council (1976) 1 WLR 852 the courts did look behind a subsidiary to its parent and held the parent liable for acts of the subsidiary, thereby ignoring the principle of separate legal personality and limited liability.

These cases have not always been followed and the piercing of the veil often depends largely on the judges’ view of the merits of the case. In contrast in Woolfson v Strathclyde (1978) SC (HL) 90 and Adams v Cape (1990) Ch 433, the courts did not follow the decision in DHN Food Distributors Ltd.

In Adams v Cape the claimants had been awarded damages by a Texan court for personal injuries suffered as a result of exposure to asbestos dust. The defendants included one of Cape’s subsidiaries. The court held that the judgment could not be enforced against the parent company, Cape. It was rejected that Cape and its subsidiaries should be treated as a single economic unit, that the subsidiaries were a façade and that an agency relationship existed.

The Adams v Cape decision promoted much discussion. Following this case, it appears that the courts will not disregard the Salomon principle simply because justice requires and that subsidiary companies should be considered independent of its parent unless special circumstances dictate otherwise.

Whilst Adams v Cape may be considered a strict interpretation of Salomon, the cases decided since it indicate that it is now very unlikely that the courts will agree to a piercing of the veil in a group context. This is supported by the decisions in Ord v Bellhaven Pubs Ltd (1998) 2 BCLC 447 and Polly Peck International plc Re (No. 3) (1994) 1 BCLC 574.

Case law suggests that it is the exception for the courts to treat groups of companies as a single legal entity.
Question 3(a)

Historically, a company was required to include within its memorandum an objects clause. This clause defined the purpose for which the company was incorporated. The effect being that if a company concluded a contract which was beyond the company’s objects, it was ultra vires and therefore void (Ashbury Railway Carriage and Iron Co Ltd v Richie (1875) LR 7 HL 653).

As a reaction to the effect of the ultra vires doctrine rendering acts outside the company’s objects as void, companies introduced more extensive objects clauses in order, so far as possible, to cover every activity in which the company might become involved. Companies began to draft lengthy objects clauses providing that each object was a separate and independent object (Cotman v Brougham (1918) AC 514) or including a very wide objects clause enabling the company to carry on a main object and “any other trade or business whatsoever.”

During the 20th century there was reform of the effect of a company’s objects clause on outsiders. The Companies Act 2006 sets out the current position.

Section 31 Companies Act 2006 states the revised position on objects clauses: Unless a company’s articles specifically restrict its objects, its objects are unrestricted. Therefore any company that is incorporated after 1 October 2009 will have unlimited capacity and the doctrine of ultra vires will not apply to such a company, unless a restriction is imposed on its objects in the articles of association. For existing companies (i.e. those incorporated before 1 October 2009), the objects clause previously set out in the memorandum is now deemed to be in the company’s articles (S28 Companies Act2006).

The ultra vires doctrine will still continue to have effect to the extent that a company has an objects clause. However what is the effect of the objects clause on outsiders dealing with the company?

Pursuant to S39 Companies Act 2006, the validity of an act done by a company vis a vis outsiders shall not be called into question on the ground of lack of capacity by reason of an objects clause. Further, S40(1) Companies Act 2006 further provides that, in favour of a person dealing in good faith, the power of the directors to bind the company shall be deemed to be free of any limitation in the company’s constitution. Therefore, to the extent that the company has entered into an arrangement, it cannot avoid liability on the ground that it is outside its objects. In most cases, it seems that for existing companies the objects clause will have little (if any) relevance, and new companies are unlikely to be formed with any objects clause. Outsiders are protected and the external effects of the ultra vires doctrine have effectively been abolished.

Nevertheless, even though the doctrine of ultra vires may be dead as regard outsiders, directors are still obliged to act within their powers (S171 Companies Act 2006) and the articles (which include any object clause) form a contract between the shareholder and the company. Therefore the doctrine is still preserved internally.
Question 3(b)

A limited company is permitted to allot new shares under S617 Companies Act 2006.
When issuing new shares, a company and its directors must have regard to the following:

Any restrictions on its authorised share capital ("ASC")

Under the Companies Act 2006 the concept of authorised share capital ("ASC") has been abolished, the ASC is no longer stated in a company’s memorandum (S8 Companies Act 2006). For companies incorporated after 1 October 2009, ASC will not be relevant. However for companies incorporated pre 1 October 2009, S28 Companies Act 2006 means that the ASC requirement will become a restriction in the articles. This can be removed by passing an ordinary resolution.

The requirements for directors’ authority to allot relevant shares pursuant to S549 CA2006

Subject to any restriction in the company’s articles, no authority will be required if the company has only one class of shares (S550 Companies Act 2006, subject to this provision being activated by companies incorporated pre 1 October 2009 under the transitional provisions). For all other companies, authorisation is required either in the articles or by passing an ordinary resolution (S551 Companies Act 2006). S551(3) Companies Act 2006 sets out the requirements for the contents of the resolution.

Pre-emption Rights

When allotting equity securities (defined in S560 Companies Act 2006) directors must consider existing shareholders pre-emption rights under S561 Companies Act 2006 and/or the articles. There are exceptions under S564 - 566 Companies Act 2006, for example where shares are to be allotted other than wholly for cash (S565 Companies Act 2006). Pre-emption rights can be disapplied by special resolution under S570/571Companies Act 2006.

In addition to the statutory requirements set out above, following the issue of the shares, Companies Act 2006 requires both internal and external paperwork to be completed. In particular, the directors are required to file a return of allotment (SH01) with the Registrar of Companies (S555 Companies Act 2006) and register the allotment in the company’s register and issue a share certificate (S554/769 Companies Act 2006)

Question 4

The directors are the agents of a company and take decisions and make contracts on the company’s behalf. The directors are in a position of trust to the company and as such they owe certain duties to the company.

These duties originally come from common law and equity and have recently been codified in sections 171 to 177 of the Companies Act 2006. This discussion deals with a director’s general duties, rather than the administrative and restrictions under the Companies Act 2006. These duties include, amongst others, the duty to promote the success of the company (S172), the duty to exercise reasonable care, skill and diligence (S174) and the duty to avoid
conflicts of interest (S175). Directors owe their duties to the company, not the shareholders (Percival v Wright (1902) 2 CH 421 codified by S170).

The consequences of a director breaching these duties are initially set out in S178 Companies Act 2006. This section preserves the existing remedies and therefore the director may be liable to account to the company for any profits or indemnify the company for any loss arising from the breach of his duty or pay damages.

Because the duties are owed to the company, it is the company itself that is the proper claimant in any legal action for breach of duty (Foss V Harbottle (1843) 2 Hare 461). This means that generally it is for the directors to institute legal proceedings in the name of the company. This can prove problematic: boards of directors may be reluctant to take the decision to bring an action against another director, or indeed, themselves.

As the directors do not owe their duties to the company’s shareholders, it is not possible for the shareholders to bring a personal action against a director in breach of duty. Therefore disgruntled shareholders are in a difficult situation where the majority of the board of directors refuse to take the decision, on behalf of the company, to bring an action against a director in breach of his duties. The Companies Act 2006 recognises this difficulty and provides that a shareholder can bring a derivative action, meaning that he can sue the director(s) on behalf of the company, without the need for a directors decision. There are strict rules for this and Sections 260 to 264 Companies Act 2006 introduced a new procedure for bring a derivative action.

The statute now requires a two stage process to bring: the shareholder bringing the claim must apply to the court for leave to proceed before proceeding to a full hearing of the matter. At this first stage the court will consider the application. It must refuse leave if continuing the claim would not be for the company’s benefit or if the breach in question was authorised or has been ratified by the company under S239 (S263 Companies Act 2006). This can be an end to a shareholder’s application, if the other shareholders decide to ratify the breach of duty by passing an ordinary resolution (s239(2) Companies Act 2006)

An alternative to bringing a derivative action is for any member of the company to petition the court for relief against unfair prejudice. Section 994 Companies Act 2006 enables an individual shareholder to bring an action in his own name (rather than the company’s name under S260 Companies Act 2006) on the ground that the company’s affairs have been conducted in a manner that is unfairly prejudicial. A successful action for unfair prejudice would result in a personal remedy for the shareholder, as opposed to the company. This remedy is often an offer to acquire the aggrieved shareholder’s shares in the company.

In addition to a derivative action or an action for unfair prejudice, aggrieved shareholders can explore other routes to deal with a director in breach of his duties. At its most basic shareholders can seek to appoint new directors to the board, thereby altering the decision making ability of the current board. This would require a decision to be taken at a general meeting or by way of written resolution, assuming that the board itself was not prepared to make the additional appointments.

Members always have the right to remove a director from office at any time under S168 Companies Act 2006 by passing an ordinary resolution. There are requirements to be satisfied in respect of the notice and meeting requirements and the member must bear in mind any weighted votes rights held by the
director (Bushell v Faith (1970) AC 1099) and any financial consequences of terminating a director’s service contracts.

The ultimate sanction is to report a director to BERR with a view to instigating an investigation into the company and/or an action for disqualification under the Company Directors Disqualification Act 1986.

Where a director is in breach of his duties, there are routes for relief. Despite being in breach of duty, a director may be spared the consequences if the breach is ratified by an ordinary resolution of the shareholders under S239 Companies Act 2006. In addition it is possible for the board to authorise, in advance, conflicts of interest with directors under S175(6) Companies Act 2006. Finally the court has the power to relieve a defaulting director from liability where it believes the director has acted honestly, excusing the director under S1157 Companies Act 2006.

Section B

Question 1(a)

Garden Games Limited (“GG”) cannot be a party to, and therefore liable on, any contract made or purported to be made on its behalf before it came into existence (S51 Companies Act 2006, Kelner v Baxter (1866), Phonogram Ltd v Lane (1981)). It does not have the capacity to enter into a contract at that time. As the contract with Accounting4You Limited (“Accounting4You”) was entered into on 28 April 2010, 2 days before GG was incorporated, the contract is deemed to be between Accounting4You and Robert.

Therefore, Robert is liable for any termination costs or breach of contract claim as the promoter “subject to any agreement to the contrary.” In order for Robert to be released from liability, after incorporation of GG the contract should have been novated, and GG should have entered into a second contract (or deed of novation) with Accounting4You on the same terms as the pre-incorporation contract.

Question 1(b)

GG is an artificial person so cannot act for itself. A company will act collectively through those who have the authority and power to act on its agents: directors (Salomon v Salomon (1897), Percival v Wright (1902)). The board has wide powers of management: Art 3 of the Model Articles, as the company was incorporated after 1 October 2009, subject to restrictions in the articles (although a third party acting in good faith would have the benefit of S40 Companies Act 2006 protection).

WoodCo Limited wants to deal with the directors as it knows that a collective decision of the board taken at a properly convened meeting will bind the company.

WoodCo will require that the contract is executed by the company (S43(1) and S44 Companies Act 2006) or on behalf of the company by an authorised signatory.
Question 1(c)

The board must ensure that Mark satisfies the requirements pursuant under the Companies Act 2006 to be a director (S20 Companies Act 2006): in particular, the company must have at least one natural person as a director (S55 Companies Act 2006), Mark must be over 16 years old (S57 Companies Act 2006) and he must not have been disqualified from acting (S1 Company Directors Disqualification Act 1986).

The appointment will be pursuant to Article 17 Model Articles. As Robert, Sue and Terry are all director shareholders, the appointment is likely to be taken by a decision of the directors Article 17(1)(b). The decision will be taken by a majority of directors, all appear to be in favour so this should not be problematic.

Following Mark’s appointment, notice of the appointment must be given to be given to the Registrar of Companies (S67 Companies Act 2006) and the company must update its Register of Directors (S162 Companies Act 2006) to include the details specified in sections 163 and 165.
Question 2

The law provides for businesses to be operated through different forms of partnership. Mike has been offered the choice to invest in commercial property through either an ordinary partnership i.e. a partnership governed by the Partnership Act 1890 or a limited liability partnership i.e. a partnership governed by the Limited Liability Partnership Act 2000. When advising Mike on which form of partnership to consider investing through, several issues will influence his choice. He will need to consider the advice carefully.

Formation

Each of the two partnerships are formed with varying degrees of formality. An ordinary partnership will exist as soon as Mike and the other investors satisfy the S1 of Partnership Act 1890, no intent to form a partnership is required. All that needs to be shown is a “relation between persons carrying on a business in common with a view to profit”. This could be satisfied very early in their business relationship. To form a limited liability partnership, an incorporation document and fee (£95) must be filed with the Registrar of Companies (S2 Limited Liability Partnership Act 2000), this is a more formal formation that for a partnership under the Partnership Act 1890. Details of the partners (members) (names, addresses, dates of birth etc) will be publicly available from the Registrar.

Liability

Mike is particularly concerned about liability given the value of his investment. Mike should be advised that if he invests in an ordinary partnership, he would be liable without limit for debts and obligations of the firm having joint and several liability with the other partners (S9 and 12 Partnership Act 1890). Each partner of the partnership will have the ability to bind the partnership either through actual or ostensible authority, in the event that partnership is bound, a third party will have the right to sue any or all of the partners for the whole amount of the debt. As Mike does not necessarily want to be involved in the management of the partnership, he should be aware that the other partners could expose him to personal liability.

A limited liability partnership is, like a limited company, a separate legal entity to its members/partners (S1(2) Limited Liability Partnership Act 2000) and therefore third parties would pursue the partnership rather than the individual partners. Mike would have the benefit of limited liability, pursuant to S1(4) Limited Liability Partnership Act 2000, in the event of a winding up, he would only be liable to contribute up to what has been agreed between the partners (Limited Liability Partnership Regulations 2000 Reg 5: S74 Insolvency Act 1986 modification)

Ability to exit

If, following his investment, Mike wanted to leave the partnership, he would be able to do so, however the nature of the partnership will affect his ability to realize his investment.

With an ordinary partnership (under Partnership Act 1890, the default position under the act, is that Mike’s departure would constitute retirement. Providing that the partnership had not been established for a certain period of time and was therefore a “partnership at will” his retirement would result in dissolution of the partnership (S26 Partnership Act 1890). The partnership assets would be
distributed pursuant to the statutory order set out in S44 Partnership Act 1890, this distribution is likely to result in a loss of goodwill. This would reduce the value of the partnership assets to be distributed. It is possible for Mike and his fellow partners to vary this provision by providing that a partner can exit the partnership by giving notice and imposing an obligation on the remaining partners to purchase the outgoing partners shares (S19 Partnership Act 1890).

In a limited liability partnership, Mike’s ability to exit is subject to the consent of other members (Limited Liability Partnership Regulations 2000 Reg 7), unless there is an alternative agreement. It would be sensible for Mike to agree an express provision on exit when joining the partnership.

Management

Both types of partnership would allow Mike to participate in the management if he wishes, although he is not obliged to participate in management of any form of partnership. Whether or not he participates in the management of an ordinary partnership, as partner he will still be liable for the actions/debts of the partnership (S9 and 12 Partnership Act 1890). If he participates in the limited liability partnership, he will be liable as discussed above. The Limited Liability Partnership Act 2000 will require two designated members who will be responsible for filings etc.

As Mike is keen to limit his personal liability, he should consider investing a limited liability partnership incorporated under the Limited Liability Partnership Act 2000. Whichever form of partnership he chooses, he should be advised to enter into a written partnership agreement to provide for his exit and protect against liability.

Question 3(a)

First should be advised that a number of forms of security over N&N’s assets are available to it. From the bank’s perspective, the loan agreement will constitute a debenture (S738 Companies Act 2006/Levy v Abercorris (1887) 37 Ch D 260).

First should be advised to take a charge by way of legal mortgage (S87 Law Property Act 1925) over the freehold factory premises. This is also known as a legal mortgage and is the best form of security available to a creditor. The heavy mixing equipment is likely to constitute a fixture and if so, will be covered by the charge by way of legal mortgage over the factory. If not, a fixed charge should be taken as for the freestanding equipment.

The charge by way of legal mortgage, unlike mortgages of all assets other than land, will not transfer legal title to First, but will provide the bank with rights equivalent to those under a 3000 year lease and will allow it to sell the factory if N&N defaults under the loan agreement or the security documents.

A company can also give a fixed and floating charge over other assets. A fixed charge is a charge on a specific asset owned by the company which it cannot deal with at all unless the charge consents. A floating charge, in contrast, is a charge on a class of assets, usually those which are not covered by a fixed charge i.e. the current assets (Re Panama, New Zealand and Australian Royal Mail Co (1870) LR 5 Ch App 318, Re Yorkshire Woolcombers (1904) 2 Ch 284). As N&N does not own the remaining plant and machinery or the delivery vans, it cannot grant security over these assets. However, it could grant security over its leasehold interests in these assets by way of an equitable assignment. It also
has the ability to grant a floating charge over stock and over all of the undertaking. As the stocks of raw materials, packaging materials and completed products will all fluctuate over time, a floating charge is the most practical form of security to take over these assets, as it will allow N&N to deal with assets until crystallisation. On crystallisation (which is when First enforces the charge by appointing an administrator/receiver) the floating charge becomes a fixed charge over the assets of the class owned by N&N at the time of crystallisation.

First could take legal or equitable assignment over all the rights N&N has under the lucrative contract, subject to any restrictions on assignment in the contract.

In theory, a fixed or a floating charge could be taken over the book debts owed to N&N (Re New Bullas (1994) BCC 36; Re Spectrum Plus Ltd (2005) 2 AC 680, although following the decision in re Spectrum Plus Ltd it is difficult to create a charge in practice). However, as book debts would need to be paid into a blocked account over which N&N had control for a fixed charge to be created (following Re Spectrum Plus Limited in the House of Lords), First should be advised that a floating charge would be more practical for both it and N&N as N&N will need freedom to withdraw cash from its account in times of very tight cash flow.

Before entering into the loan and taking security, despite the protection from s40 Companies Act 2006, First should be advised to review N&N’s constitution to ensure that it has the capacity to borrow and grant charges and there are no restrictions on the directors to do the same. Whilst First, subject to dealing in good faith, would have the protections under sections 39 and 40 Companies Act 2006, it is preferable to check the ability of the directors to enter into the loan agreement and grant the security.

**Question 3(b)**

All the security referred to above (except arguably the assignments over book debts) falls within S860(7) Companies Act 2006 and the prescribed particulars of each security document must therefore be registered with the Registrar of Companies within 21 days of the date of creation. Failure to do so within the time limit will make it void against other creditors and/or a liquidator or administrator of N&N (S874 Companies Act 2006). First will require a negative pledge to be granted in respect of the floating charge.

The charge by way of legal mortgage must also be registered at HM Land Registry to give priority over any subsequent mortgagee. The registration acts as notice to them and to any subsequent purchaser of the property.

Notice of assignment must be given to the other contracting party in order for the assignments to be legal assignments in accordance with S136 Law of Property Act 1925. If N&N does not want the retailer to be aware of the assignment, for relationship reasons, and therefore not to be served with notice, it may seek to negotiate that the assignments will remain equitable pending any event of default.

An equitable assignment of book debts may not be registerable at Companies House: notice of the assignment must be given in any event under the rule in Dearle v Hall.
Question 4

Edbury is at risk of compulsory winding up by the court pursuant to S122(f) Insolvency Act 1986 as a company unable to pay its debts. If the statutory demand is not satisfied within 21 days of its service (2 weeks have already passed), Edbury will be deemed unable to pay its debts under S123(a) and a petition by the landlord for Edbury to be wound up would be successful. It appears that Edbury is already unable to pay its debts as they fall due given the refusal of the bank to honour more cheques (S123(e) Insolvency Act 1986).

The sale of office premises for £325,000 could be challenged by a liquidator as a transaction at undervalue (S238 Insolvency Act 1986). A company enters into a transaction with a person at an undervalue if the company receives significantly less consideration in money or monies worth than the consideration it is providing in money or monies worth (S238(4)(b) Insolvency Act 1986). If the office premises are sold for £325,000 this could be a transaction at an undervalue provided that the transaction takes place within the relevant time, that is within the two years immediately prior to the date Edbury’s winding up commences (S240(1) Insolvency Act 1986) (Assuming that the company was unable to pay its debts at the time of the transaction or became insolvent as a result).

There may be a defence if Edbury entered into the transaction in good faith for the purpose of carrying on the business and there were reasonable grounds for believing that the transaction would benefit the company (S238(5) Insolvency Act 1986). If the court deems it a transaction at an undervalue, the consequences are specified in S241(1) Insolvency Act 1986 i.e. returning property to the company.

If Edbury continues to trade and goes into insolvent liquidation, the liquidator will most likely have grounds to seek an order against James for wrongful trading (S214 Insolvency Act 1986/Re Produce Marketing Consortium Ltd (No.2)(1989) 3 All ER 1). A director is liable for wrongful trading when, before the company goes into liquidation, he knew or ought to have concluded that there was no reasonable prospect that the company would avoid insolvent liquidation. (S214(2) Insolvency Act 1986). Liability could be avoided if James took every step with a view to minimising the potential loss to Edbury’s creditors he ought to have taken (S214(3) Insolvency Act 1986). When considering the matter the court will take into account both the objective and subjective tests set out in S214(4) Insolvency Act 1986). The fact that James is the finance director will be relevant (Re Brian D Pierson (Contractors) Ltd (1999) BCC 26). James may have a possible liability to contribute to the company’s assets (S214(1) Insolvency Act 1986).

In addition, James may also be liable of fraudulent trading (S213 Insolvency Act 1986), although there would need to be intent to defraud creditors. The director’s conduct may give rise to liability under S212 Insolvency Act 1986 on the basis that they have misapplied, retained and become accountable for the property of the company.

James will also be at risk of disqualification under s1 Company Directors Disqualification Act 1986

Finally all directors are subject to the duties under sections 171 to 178 Companies Act 2006, by acting in the manner proposed, James may be at risk of breaching his duties to the company, in particular in breach of his duty to act with reasonable care, skill and diligence pursuant to S174.