CILEx CHARTERED INSTITUTE OF LEGAL EXECUTIVES

LEVEL 6 - UNIT 1 – COMPANY AND PARTNERSHIP LAW

CHIEF EXAMINER COMMENTS WITH SUGGESTED ANSWERS

JANUARY 2020

Note to Candidates and Learning Centre Tutors:

The purpose of the suggested answers is to provide candidates and learning centre tutors with guidance as to the key points candidates should have included in their answers to the January 2020 examinations. The suggested answers set out a response that a good (merit/distinction) candidate would have provided. The suggested answers do not for all questions set out all the points which candidates may have included in their responses to the questions. Candidates will have received credit, where applicable, for other points not addressed by the suggested answers.

Candidates and learning centre tutors should review the suggested answers in conjunction with the question papers and the Chief Examiners' **comments contained within this report** which provide feedback on candidate performance in the examination.

CHIEF EXAMINER COMMENTS

As in previous sessions, the candidates who had performed well had carefully read the question and answered its different elements accurately. They applied the law and case law, with good references and analysis. Statutory provisions and case law were up to date. Credit was given for well-reasoned answers.

Candidates performed less well where they had failed to answer the question. Some candidates had clearly memorised, or tried to memorise, answers from prior papers. As has been said in previous reports, this is not good practice as it is vital to address the precise question. Candidates need to be ready to adapt their answers. They should also be discouraged from quoting the manual and certainly should not give page references (as in one script). Primary sources and case law should be applied directly. When answering the problem questions, it is essential to apply the facts thoroughly. It is not just a question of regurgitating the relevant law, with no reference to the scenarios.

Candidates should consider planning their answers in the exam carefully, to identify the issues as the questions require. This may assist with avoiding merely rewriting learned answers. It is essential to read each question and think about what it is actually asking.

It is of concern also that in a small number of cases, candidates were citing out of date and therefore incorrect law – for example the requirement for shareholder approval of a share buy back out of profits is an ordinary resolution, not a special. Second, a few papers did not refer to the most up to date case law – particularly in A2, the veil of incorporation question.

There seemed to be fewer timing problems in this session, but candidates are encouraged to plan their time carefully

CANDIDATE PERFORMANCE FOR EACH QUESTION

Section A

Question 1

Partnerships – a popular question (18 answers). The good answers methodically addressed the different elements of the question, talking about the formation of the different types of partnership and then liability issues, and addressed relevant statutory provisions and case law accurately and thoroughly. The weaker answers failed to compare the two types of partnership, and significantly lacked case law, which was an issue across most questions.

Question 2

Corporate veil – a popular question (19 answers). As mentioned above the good answers (highest score was 20) covered the relevant and up to date case law and presented analytical arguments. The weaker answers (lowest was 5) failed to address the issue with reference to case law. It was concerning that a few answers also did not refer to the most up to date case law that has slightly developed the approach of the courts since Adams v Cape.

Question 3

Companies' articles, directors' authority and s33 CA 2006. There were 12 responses to this question and again with mixed results (between 8 and 20 marks). The stronger answers carefully addressed each element of the question, with good references to the statute (e.g. s40 CA 2006) and case law as relevant. The less strong answers did not, for example, cover the legal effects of limitations (under (a)) but merely listed the limitations.

Question 4

Powers of an administrator. There were only 3 attempts at this question, and they were quite reasonable. The strongest examined the powers in detail, with good statutory references. The other two presented more superficial answers. To score well with this type of question, it is vital to reference statute in detail.

Section B

Question 1

Investment options and enforceability of a floating charge (9 answers). Generally, this question was answered somewhat poorly. Candidates concentrated too much on the loan and, in particular, the charge referred to and did not address the fact that investment by share capital was an option. A few answers were an example of where candidates seemed to have learnt a prior answer about charges and merely repeated this, whereas in fact this question was looking much beyond those issues. Further, there was a lack of application to the facts of the scenario.

Question 2

Transfer of shares and buy back (6 answers). The same comments apply as to questions above in relation to the stronger answers: thorough and accurate statutory and case references, and clear application to the facts. The poorer answers reflected a lack of grasp of the legal issues; for example, the difference between transfer of shares and the issue of shares and associated pre-emption rights. Candidates should review these issues, as the CA 2006 pre-emption provisions (from s361) only apply to issue of shares. In relation to the buy back, again this suffered from poor application in most cases. One or two candidates did however refer to the facts correctly identifying that the company could buy the shares back out of profits, without resorting to capital. Candidates should avoid answering a scenario question merely by regurgitating everything they know, in this case on buy back.

Question 3

Director's appointment and duties (13 answers). There were some excellent answers to this question, and as above, they were the ones that clearly and thoroughly set out the legal points and applied them accurately to the facts. A few answers oddly missed the different options for appointing a director, but they were rare. Duties were generally addressed well across all questions, recognising the key issues from the facts.

Question 4

Section 994 and derivative actions (14 answers). As this was often the last question to be answered, some answers clearly suffered from limited time. The better responses, as above, addressed the facts in the relation to the legal issues (with adequate statute and case law references) and assessed the likelihood of success of the two claims. Those who answered less well did not provide case law (which is essential particularly with regards to s994) and did not analyse the position for the client.

Question 1(a)

There are no statutory requirements for formal registration of an unlimited partnership, whereas limited liability partnerships (LLPs) are formed by a statutory process of registration of documents with the Registrar of Companies. The Limited Liability Partnership Act 2000 governs LLPs.

An unlimited partnership exists if it satisfies the statutory test of two or more persons carrying on business with a view of profit (s1 Partnership Act (PA) 1890). It is worth considering the elements of this provision further to assist the comparison.

The definition of a partnership in s1 of the PA 1890 contains the phrases 'carrying on a business in common', and 'with a view of profit'. S45 PA 1890 defines a business as including 'every trade, occupation or profession'. This is a wide definition and should cover most commercial activities. However, certain activities would be unlikely to fall within this definition, such as the mere ownership and management of land.

Further the business must be carried on 'in common', but this part of the test is not satisfied by the mere 'co-ownership' of an asset. S2(1) PA 1890 makes this point clear, declaring that a variety of forms of co-ownership – including joint tenancies and common property – does not of itself create a partnership, even where the co-owners share profits arising from such property.

Further a one-off venture may well not amount to a partnership (Mann v D'Arcy (1968)). Activities undertaken in order to prepare for the commencement of the business of a partnership may themselves amount to the carrying of a business in common: Khan v Miah (2001), while a mere agreement to form a partnership would be insufficient (Ilott v Williams (2013)).

The second part of s1 PA 1890 requires that the business be carried on 'with a view of profit' – or a profit motive. A partnership set up effectively to avoid tax would not for example fulfil this part of the definition (Newstead v Frost (1980). However, the issue of sharing of profits may, or may not, lead to the partnership relationship.

Section 2(3) PA 1890 states that the receipt by a person of a share of profits is *prima facie* evidence that that person is a partner, but receipt of such a share does not of itself make that person a partner (Cox v Hickman (1860)). The facts of each case and the intention of the parties will be relevant. S2 also identifies a number of specific situations which, although involving a person receiving a share of the profits of a business, do not of themselves make the recipient a partner. These include the repayment of a debt by instalments, or otherwise, out of profits (see Kilshaw v Jukes (1863)), or a contract for remuneration of a servant or agent by a share of profits (confirming the decision in Walker v Hirsch (1884)).

The formation of an LLP is explained more simply. It is akin to that of a private limited company in that the LLP must be registered with the Registrar of Companies. The relevant form submitted must contain for example the proposed name of the LLP (that must include LLP or limited liability partnership as part of the name), the registered office and importantly the members signing and thereby agreeing to be members on incorporation (LLP Act 2000 section 2).

There is however a similarity with unlimited partnerships in that there must be at least two people carrying on a business with a view to a profit.

It worth noting also there is ongoing regulation for LLPs, but not so for partnerships. The cost of compliance with the regulations described above can be relatively high for LLPs compared with operating through the medium of a partnership. However, most well-run partnerships of any size or complexity will have a bespoke partnership agreement - the drafting and negotiation of which may involve expensive legal costs.

Finally, documents filed at the Registrar of Companies for LLPs are open to inspection by the public; a partnership on the other hand is an entirely private affair. This means that if secrecy is an issue for the members, an ordinary partnership may be a more attractive option than a company or LLP.

1(b)

In terms of liability, in an unlimited partnership the individual partners are liable without limit for the debts and other liabilities of the partnership (s9 PA 1890). Partners face unlimited liability for a partnership's debts as there is no legal separation between the two. Section 9 PA 1890 and the Civil Liability (Contribution) Act 1978 provide that every partner is jointly and severally liable for all debts and obligations of the firm incurred while he is a partner. After his death, his estate is severally liable while such debts remain unsatisfied.

How partners bind the partnership and thus create the liabilities referred to in section 9 is governed by issues of express and implied authority. A partnership deed may contain limits on the authority of a partner to bind the partnership. If the partner breaches such a provision, she may find herself liable to indemnify the partnership for any loss should the partnership as a whole be found responsible for the debt incurred. Implied authority may arise through a course of dealings. Liability should only arise while the person is actually a partner of the firm (s17 PA 1890), but if a person is held out to be a partner (s14 PA 1890), liability may then be incurred.

The law of agency can also impact on a partner's liability, as applied by s5 PA 1890: partners act as agents of the firm when making contracts for the firm with third parties. The section begins with 'every partner is an agent of the firm and his other partners for the purpose of the business of the firm', and the acts of the partners will normally bind the firm. However, a partner may find herself liable for a contract with a third party if she has acted outside her authority.

In addition, if at the time a partnership is wound up or dissolved the partnership's assets are insufficient to meet its liabilities, a partner may be called upon to contribute to the shortfall from her personal assets.

In a limited liability partnership (LLP), the liability of the member partners is limited to the amount they have agreed to contribute to the assets of the partnership in the event of it being wound up (s74 IA 1986 as applied by Schedule 3 LLP Regulations 2001). This is because the LLP is a separate legal entity akin to that of a limited company.

LLP members know, in theory, that whilst they may lose the amount they have invested in the LLP, in the event of its insolvency, their other property is not at risk. On the other hand, for businesses conducted through an unlimited partnership, there is the risk of unlimited liability on the part of the owners for the debts of the business. If the business fails, the partners risk losing all their property.

An LLP, as a separate legal entity, is normally liable for its own contractual obligations and the tortious acts of its members and employees. Note however that partners of an LLP may incur personal liability in tort for negligence. This would include personal liability for negligent misstatements, provided that the partner assumed personal responsibility to the claimant for the statement made (see for example Williams and another v Natural Life Health Foods Ltd and another (1998)).

Question 2

It is a well-established principle that a company has its own legal personality that is separate from that of its members or shareholders (Salomon v Salomon & Co (1897)). Thus, there is a 'veil of incorporation' between the company and its members, meaning that it is the company alone that is responsible for its debts and liabilities. This applies for example to each member of a corporate group: even though a parent company can own the entire share capital of a subsidiary, it is not generally responsible for the subsidiary's contractual or tortious liabilities.

The courts have, however, exceptionally and restrictively, been prepared to 'lift' the corporate veil, and thus make a parent company liable for a subsidiary's debt. The key case that established these grounds is Adams v Cape Industries Plc (1990), a case which in fact involved the relationship between a parent company and some of its subsidiaries. A number of other cases, including Prest v Petrodel Resources Ltd (2013) have subsequently confirmed the *Adams* approach.

While in Adams, the court proposed three grounds on which the veil might be lifted, it was suggested in Prest however that in fact only one of these is the 'true' ground for veil piercing. This is where a company is a mere façade or sham, or is being used to perpetrate a fraud, reflecting earlier cases such as Gilford Motor Co v Horne (1933). The cases suggest that a company will be regarded as a sham or a façade where it is being used by the person who controls that company to 'evade an existing obligation' of the controller. Jones v Lipman (1962) is a good example of a company being used as a "mere façade", where an individual wishing to escape liability to complete a conveyancing contract transferred the property into the name of a company which he owned and controlled. If, however a subsidiary is used merely to shield the parent company from a potential future obligation, then this would not constitute fraud, would not render the subsidiary a mere façade, and would not lead to the veil being lifted.

Adams and Prest did note other situations where intervention of the court might produce an outcome very similar to veil piercing but not technically a true piercing of the corporate veil. These situations tend to centre on the relationship between a parent company and its subsidiary: for example, if there is either a specific statutory provision or a contractual document that requires a parent and subsidiary to be treated as a single entity. Similarly, occasionally a subsidiary may be treated as the agent of its parent company, but only, following Adams, where there is an express agency agreement between the companies. Again, this will not strictly involve piercing the veil, for the parent is still being treated as a separate entity. Nevertheless, as principal, it will be liable for things which its subsidiary does on its behalf. Such a relationship should not be implied merely because the parent wholly controls its subsidiary. Earlier cases had been less restrictive than this, with the courts seemingly willing to imply an agency relationship based upon a shareholder's control over a company (for example Re F G (Films) Ltd (1953)).

In Adams, the court also followed Woolfson v Strathclyde Regional Council (1978) in finding that the mere fact that a group of companies constitute a 'single economic entity' does not permit the veil to be lifted and find a parent liable for a subsidiary's debts. The court in Adams again took a restrictive approach in relation to 'single economic entities' than in earlier cases, such as for example DHN Food Distributors Ltd v Tower Hamlets London Borough Council (1976).

The court in Adams also expressly rejected the argument that there was a further ground for veil lifting where to do so was 'in the interests of justice'. The court declared that whilst the three specific grounds for veil lifting that it had identified might all be said to be based on what 'justice' demanded, nevertheless there was a difference between the specific grounds for veil lifting (interpretation of a statute, agency, façade) and the underlying purpose for that ground. If the court accepted 'justice' as itself an independent ground for veil lifting, this would give too much discretion to judges to lift the veil whenever, subjectively, they thought it desirable to do so. This would inevitably create much greater uncertainty in the law.

Following Adams and Prest, then, while it may not be true to say a parent company can never be held responsible for a subsidiary's liabilities, it would nonetheless be a rare occurrence. Another recent decision of the Supreme Court has also approved this restrictive approach, and the limited grounds on which the veil might be lifted, namely VTB Capital v Nutritek International (2013).

Fairly recently, in cases where injured employees of subsidiaries have sought to sue the parent as a joint-tortfeasor, the courts have sought to be less restrictive than in Adams. In Chandler v Cape Plc (2012), the court found that Cape, the parent, owed the employees of its subsidiaries a duty of care, because certain conditions were satisfied:

- the parent company and its subsidiary operated in the same business (here the asbestos industry). Note however if the parent is a "pure" holding company, merely owning shares in subsidiaries which themselves carried out all the business activities of the group, as in Thompson v the Renwick Group Plc (2014) and Okpabi v Royal Dutch Shell Plc (2018), this condition is not satisfied;
- the subsidiary's operations must be unsafe, and the parent either must know this, or ought to know this;

- the parent must know at least as much about health and safety issues in that industry as does the subsidiary;
- the employees of the subsidiary must rely on the parent company to safeguard their health and safety;
- Cape had assumed a responsibility for the health and safety of its subsidiary's employees, since it employed the manager who dealt with health and safety policy at its subsidiary.

Although Chandler identified when a parent might owe a duty of care to its employees specifically, the case of Lungowe v Vedanta Resources Plc (2017) accepted that the duty might extend to other claimants apart from employees of the subsidiary. While Chandler accepted that a parent company might owe a duty of care, it did nevertheless emphasise that parent and subsidiary are two separate legal entities and that each is responsible only for its own torts; imposing a duty of care on the parent thus does not, technically, amount to a lifting of the corporate veil.

In conclusion therefore, although there are circumstances in which the veil of incorporation may be lifted to find a parent responsible for a subsidiary's liabilities, such circumstances are rare.

Question 3(a)

The starting point here is that directors are in fact given a broad power by the articles to manage a company – see Model Article 3 - and it could be argued that there is minimal express limitation in the Model Articles on the exercise of those powers. For example, MA 7 provides that directors' decisions should be taken by majority vote in a meeting and MA 9 requires that usually there should be a quorum of two in a board meeting. On the other hand, directors may for example delegate their powers as they see fit (MA 5). However, a more stringent restriction is imposed by MA 14 in that a director is not permitted to count in the quorum or vote in relation to a matter in which s/he is interested, unless the articles provide otherwise. This restriction can be suspended by ordinary resolution of the shareholders, or the articles amended by special resolution.

A company need not adopt the Model Articles in full and therefore may impose stricter procedural restrictions on its directors, through amending the Model Articles. It may for example increase the required quorum for a directors' meeting. In addition, other company documents or decisions (shareholder agreements, board resolutions and the like) may create express restrictions on directors' actions.

In relation to the authority directors have to bind the company, the Model Articles themselves do not contain any specific restrictions on such authority, other than how powers may be exercised (as indicated above). A company may however impose express restrictions such as requiring shareholder approval of borrowing over a certain limit.

In addition, a company may have an objects clause which limits its capacity. Directors who act outside this capacity will be acting outside their authority. A contract entered in to by the directors for which they lack authority would ordinarily be void. Such an objects clause may be in place for companies incorporated before the 2006 Act which did away with the requirement for an objects clause.

However, provisions in the Companies Act 2006 act to override limits in a company's articles in relation to directors' authority. Section 40 CA 2006 states that 'in favour of a person dealing with a company in good faith, the power of the directors to bind the company, or authorise others to do so, is deemed to be free of any limitation under the company's constitution'.

Good faith is presumed (s40(2)(b) CA 2006), and that presumption is not displaced even where the third party is aware of the terms of the constitution (and thus knows of the actual limitation on the directors' authority). What may prevent the third party having good faith is rather unclear. It may be that it requires the third party to know that the directors are not themselves acting for the benefit of the company, or at least to be 'put on enquiry' that this is possible (see Wrexham Association FC Ltd (in Administration) v Crucialmove Ltd (2007)).

A further point is that the common law long held that a third party dealing with a company in good faith is not affected by 'internal irregularities' (directors failing to follow procedural requirements set out in the articles). This is the rule in Royal British Bank v Turquand (1856), but this has been largely superseded by the provisions discussed above.

Finally, directors must exercise whatever powers they are granted in accordance with the duties imposed on them. They must act for the purpose for which the powers were given to them (see s171 CA 2006) and they must also always act 'in good faith to promote the success of the company for the benefit of the members' (s172 CA 2006).

In conclusion therefore, while articles can expressly limit the power and authority of directors, this is in turn curtailed by statute and the common law.

3(b)

Section 33(1) of the Companies Act 2006 (CA 2006) states that 'the provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions'. The articles of association of the company form the basis of a contract and address the rights and obligations of the company and each member. This contract offers one form of protection for minority shareholders.

As a result of this contract, either party, not merely the members, may enforce the provisions of the articles. This has been established in case law: for example, in Hickman v Kent or Romney Marsh Sheepbreeders' Association (1915), the company enforced an arbitration clause in the articles against a member. Conversely, in the case of Pender v Lushington (1877), the court found in favour of a member whose rights under the articles had been breached.

The contract created by section 33 is unusual however in that it is for example not rectifiable in the same way as a 'normal' contract even if the articles do not express the true intention of the parties (Scott v Frank F Scott (London) Ltd (1940)). The articles can only be amended by special resolution of the company members under section 21 CA 2006, meaning that at least 75% of the shareholders must agree to the amendment. However, the courts have been seen to interpret articles using the 'reasonable person' test (Attorney General of Belize v Belize Telecom Ltd (2009)).

In addition, the nature of the contract means enforcement is limited to provisions concerning membership (Eley v Positive Government Security Life Assurance Co (1876)). A member cannot for example seek to enforce a provision that relates to directorship of a company (Beattie v E & F Beattie Ltd (1938)).

The courts also appear to have accepted an enforceable relationship between members (Rayfield v Hands (1958)), as well as between the company and each member, at least where there seems to be a form of partnership existing behind the corporate veil.

A limitation period of six years from breach applies to enforcement of rights under the articles as the covenants given under section 33 are not under seal.

Question 4

An administrator is given powers by the Insolvency Act 1986, for example in Schedule 1. Principally, the administrator is enabled to do anything necessary for the management of the affairs of a company in administration. Schedule 1 IA 86 lists specific powers that including being able to take possession of a company's assets, collect in company property and take such proceedings as he deems necessary. The primary goal is to secure the rescue of the company through the exercise of those powers.

In addition to exercising those specified powers an administrator is also able to challenge transactions that fulfil certain conditions at the 'onset of insolvency' of the company. Where a company is in administration this means the date on which a petition is presented, i.e. the date of presentation of administration petition that is followed by an administration order. The administrator can ask the court to set aside the said transactions.

Four relevant transactions fall to be considered here:

First, transactions at undervalue can be undone. Two different provisions allow transactions at an undervalue to be overturned: section 238 IA 1986 and section 423 IA 1986. Under each provision, a transaction at an undervalue arises where a company transfers an asset for no consideration or significantly less than consideration given by the company. The courts have taken a flexible approach to consideration (Phillips v Brewin Dolphin Bell Lawrie (2001)).

Under section 238 IA 1986, a transaction at an undervalue can be challenged where it was entered into in the two years prior to the company entering into administration. There is a defence where the transaction can be proved to have been entered into in good faith and there are reasonable grounds for believing it would benefit the company. Under section 423, the two-year time limit found in section 238 does not apply. However, section 423 can only be invoked if the transaction was effected with the purpose of putting assets beyond the reach of creditors, or otherwise prejudicing creditors' interests.

The second type of transaction to consider here is a 'preference' – a transaction to improve position of particular creditor, the administrator can again apply for this to be set aside. There must be a desire to prefer the creditor (Re MC Bacon Ltd (1990)), and this is presumed if the preference is given to a connected person (see for example Re Hawkes Hill Publishing Co Ltd (In Liquidation) (2007), Re Exchange Travel (Holdings) Ltd (1996) and Re

Fairway Magazines Ltd (1993)). A preference can include a company paying off an overdraft secured by director's guarantee (Re M Kushler Ltd (1943)).

The preference must have been entered into within six months of the onset of administration, or within two years if with a connected person. Connected persons include directors and certain members of a director's family (s249 and 435 IA). The company must be shown to be unable to pay its debts at the time of the preference.

A third transaction is the extortionate credit transactions under s244 IA. This must have been entered into in the three years of the company going into administration. Such a transaction arises where its terms for example require a grossly exorbitant payment to be made or the ordinary principles of fair dealing have been contravened.

Finally, an administrator may seek to overturn a floating charge under section 245 IA where the charge is taken over existing indebtedness. If successful, the charge will be deemed void. However, it is important to note that the charge is only void to the extent that it is taken over an existing debt and is entered into within 12 months of the company's administration. This is extended to two years if the charge is granted to a connected person. The same definition applies here as for preferences (see above). If a floating charge is granted in part over new debt incurred simultaneously for example with the charge, that element of the charge will be valid, especially if registered.

The date of the creation of the charge is key (Re Shoe Lace (1992)). It is immaterial how short a period there is between the incurring of the debt and creation of the charge (Power v Sharp Investments (1993)), unless *de minimis.*

It is worth noting that even if the charge is declared void, the debt remains but as an unsecured debt (Re Parkes Garage (1929)).

SECTION B

Question 1(a)

If Nicholas takes shares in the company, he will be a part owner of the company, but he should be advised that once he has paid in full for his shares, he will have no further liability to the company. Neither will he be liable for the company's debts. This is due to the separate legal personality of a company, and the concept of limited liability of its shareholders (Salomon v Salomon (1897)).

Holding ordinary shares will however entitle Nicholas to vote in shareholders' meetings (Borland's Trustee v Steel Brothers & Co (1901)), thus giving him a say in the running of the company, albeit in a limited way. He would have one vote in a shareholders' meeting on a show of hands, and one vote per share if a poll vote were called. Although Nicholas would have a vote, owning a 25% to 30% share in the company would mean he is minority shareholder. Shareholders make decisions by passing ordinary or special resolutions, depending on the reason for the decision. Respectively these require 50%+

and 75% majorities. If Nicholas were to hold only 25%, he would not be able to block either type of resolution. Having more than 25% of the shares would enable him to block a special resolution, for example to amend the articles of the company.

He will be entitled to any dividend income but only if the company has distributable profits available and indeed if a dividend is declared. There is no guarantee of this for ordinary shareholders. As a shareholder, he would be entitled to petition the court for relief under section 994 CA 2006 against 'unfair prejudice'. If the company were held to be a 'quasi partnership', this could prove a relatively effective protection for Nicholas.

If, on the other hand, he were to give a loan to the company, he would under contract be guaranteed an income in the form of interest at the rate agreed. If the company were to fail to pay this interest, this is likely to be an event of default or breach of contract which would give Nicholas a right to enforce repayment or sue the company. If he were to take a charge over company assets, if the company defaulted, he could enforce the charge to enable him to recover his money. He would however have no voting rights or say in the running of the company as a lender. He will be a creditor of the company, entitled to have the loan repaid, and he could petition for its winding up if for example the company failed to repay the debt when due. However, if he were to grant an unsecured loan, he would be an unsecured creditor and would run a much greater risk of not being repaid if the company got into financial difficulties and went into insolvent liquidation. Further as an unsecured creditor he would have no recourse to specific assets if the borrower fails to pay, and the borrower will have full control over its assets during the period of the loan.

1(b)

To ensure it is fully enforceable, the floating charge should be registered at Companies House by delivering a statement of particulars in the prescribed form, known as a 's859D Statement of Particulars' (s859D CA 2006), within 21 days of the creation of the charge (s859A(4) CA 2006). Registration is now voluntary, but it is in the interest of the charge (i.e. Nicholas) that the charge is registered. Otherwise, the charge is void as against a liquidator or administrator of the company in the event of insolvency. The underlying loan would however remain enforceable and would become immediately due and payable if the security is void for failure to register or failure to do so within the 21-day period (s859H CA 2006).

Registration may be effected by the company or 'any person interested in the charge' but it is in the Nicholas's interest to ensure registration takes place. On delivery of a statement of particulars within the 21 day period the Registrar must give a certificate of registration to the person who delivered the charge particulars; such a certificate is conclusive evidence that the charge has been properly registered within the period allowed for delivery (s859I(6) CA 2006). It would also be prudent to include registration of any negative pledge clause.

Nicholas should also be advised that, even if the floating charge were appropriately registered, the existing fixed charge over HOL's place of business would take priority over the subsequent charge. However, if the floating charge is granted over the company's undertaking, this would give Nicholas access on a winding up to assets other than the place of business.

Question 2(a)

In order to validly transfer shares in a company from one shareholder to another, the transferor, here Sona, must complete a prescribed form, under section 770 CA 2006. This is because FCL could not register the transfer of shares unless 'a proper instrument of transfer has been delivered to it'. This instrument is a stock transfer form (under the Stock Transfer Act 1963) which is delivered with the share certificate (if there is one) to Amit, the transferee.

The transferee is then normally responsible for getting the stock transfer form stamped at the Stamp Office and for paying stamp duty (50p per £100 of consideration). However, as Sona is giving the shares to Anit, no consideration is due and therefore, no stamp duty is due. The stock transfer form must still be stamped, but it would be certificated by Amit as exempt from duty. Once stamped the stock transfer form is delivered to the company along with any share certificate. The board of FCL must then resolve to approve the transfer, and to issue a new share certificate to Amit and add him to its register of members.

(b)

A company can impose restrictions in its articles on transfers of shares in a number of ways. The Model Articles that FCL has adopted do in fact already contain a discretion at Article 26 allowing directors to refuse to register a transfer. S771 provides that the transferee must be informed of such refusal, and given reasons for the refusal, within two months of the date of lodging of the transfer. Such a power does give the directors a means of controlling who becomes a member of the company with voting rights, but the transferee would still obtain the beneficial ownership of the shares.

The exercise of any such discretion is however subject to rules that have developed through case law. For example, directors must act in good faith in making a decision to refuse registration of the transfer (Re Smith v Fawcett Ltd (1942)).

Companies may also, and often do, include in their articles a requirement that shareholders must first offer their shares to existing shareholders before transferring to a person outside the company. There may also be a special article that a director must sell any shares she owns in the company to existing shareholders if she ceases to be a director.

Finally, as Danon and Lucy own 76% of the shares in the company, they would be able to pass the requisite special resolution to amend the articles under s21 CA 2006 as a special resolution requires a 75% majority.

(c)

In relation to the purchase of shares from Sona, there is a general prohibition on a company acquiring its own shares (s658 CA 2006), arising from the general maintenance of capital rule (Trevor v Whitworth (1887)). However, a company may purchase its own shares in accordance with s690 CA 2006. To do so, the shares must be fully paid – we are told the company's issues shares are all fully paid – and the company can use available distributable profits for the purpose. We are told they plan to do so and, on the facts, they have ample profits available. The right to repurchase the shares is also subject to any restriction or prohibition in the company's articles. Again, we are told that

FCL's articles are the Model Articles which contain no such restriction or prohibition.

As FCL is a private limited company, we can assume that its shares are not traded on any of the recognised investment exchanges, and therefore the purchase of Sona's shares will be an 'off-market purchase'. This will then be governed by ss694-700 CA 2006. A contract will have to be drawn up, identifying the parties to the transaction, and this must be approved in advance by the shareholders by ordinary resolution (s694(2) CA 2006). Sona cannot vote as a shareholder on the resolution to approve the purchase contract (s695 CA 2006). However, since both the other shareholders in the company (Danon and Lucy) approve the proposed purchase, they can ensure the resolution is passed. The contract must be available for inspection at the company's registered office for 15 days before the shareholders' meeting to approve it: s696(2) CA 2006.

The contract, if approved, can authorise the company to complete the deal with Sona, but this authority cannot last for more than five years. Once the transaction is completed, and the £228,000 is paid to Sona, the shares must be cancelled by the company.

Question 3

Joseph may be appointed under Model Article 17 either by the board of directors or by shareholders' ordinary resolution. He must give his agreement to his appointment by signing the relevant form (AP01) which will be sent to Companies House within 15 days of his appointment.

His service contract will need to be approved by both the board of directors and the shareholders as it contains a fixed term of more than two years. S188 CA 2006 requires shareholders to approve such a term in a service contract by ordinary resolution in general meeting or by written resolution. If the term is not approved, it (the term) will be void, but the rest of the service contract will remain but terminable on reasonable notice. A memorandum of the term requiring approval must be made available at least 15 days prior to the shareholders' meeting or provided to shareholders with a written resolution. In any event the contract will be signed by one of the other directors on behalf of the company and by Joseph himself.

Although as director Joseph will have a declarable interest in the service contract, he does not in fact need to declare this at the relevant board meeting as s177(6)(c) CA 2006 provides an exclusion.

In terms of the duties to which Joseph will be subject, directors are subject to a number of duties which they owe to the company, originally developed through case law, that seek to protect shareholders and ensure directors act with competence.

These duties, outlined below, are now embodied in the Companies Act 2006 (ss 170 to 180), although the equitable principles on which the cases were based remain relevant both to the interpretation and application of the statutory duties (s170 (4) CA 2006) and to the civil consequences of breach (s178 CA 2006).

- The duty to act within powers (s171 CA 2006): i.e. a director must act in accordance with the company's constitution and only exercise

powers for the purposes for which they were conferred. Generally, it is for the courts to interpret the purpose for which a particular power is conferred and then to decide whether the directors have acted outside that purpose (Howard Smith Ltd v Ampol Petroleum (1974) and Hogg v Cramphorn (1966)).

- The duty to promote the success of the company (s172 CA 2006): this is in some ways the most fundamental of the duties. A director must act in the way he considers in good faith would be most likely to promote the success of the company for the benefit of its members as a whole. Note the test is a subjective one – what the directors honestly believe (in good faith) would be most likely to promote the success of the company, and not what objectively might be most likely to do so. The Courts will not generally find a breach of this duty based solely on poor business decision making. Although the interests of the members generally are paramount, the section provides a long list of matters that directors are to 'have regard to' in reaching their decisions, including such matters as the interests of the company's employees and the impact of the company's operations on the community and environment. If a company becomes insolvent the interests of the creditors as a class will become paramount (GHLM Trading Ltd v Maroo (2012)) in preference to those of the members.

- The duty to exercise reasonable care skill and diligence (s174 CA 2006): This contains both a subjective and objective test; i.e. a director must exercise the degree of care, skill and diligence that would be expected of a reasonably diligent person with the general knowledge, skill and experience that can reasonably be expected of a person occupying that position (objective) and the general knowledge, skill and experience the director actually has (subjective). Here, Joseph may well be subject to the higher subjective standard as he has particular IT skills.

  This duty replaced the old common law subjective test of what could be expected of directors (see Re City Equitable Fire Insurance Company Ltd (1925) and contrast Re Barings Plc (1999)). See also Raithatha v Baig (2017) where directors had breached s174 by failing to register for and collect VAT.

  As a director, Joseph would not be required to attend every board meeting. However, he would be required to maintain a sufficient oversight over the 'governance' of the company, and in particular, over those managing the company on a full-time basis: see Lexi Holdings v Luqman (2009). He would, then, need to attend and participate in sufficient meetings to fulfil this obligation.

- The duty to avoid conflicts of interest and duty (s175 CA 2006) will be of particular significance for Joseph as he wishes to continue with his own business. A director must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts or may conflict with the interest of the company. The duty applies in particular to the exploitation for personal gain of any property, information or opportunity that a director obtains in his capacity as a director of the company. It is generally immaterial whether or not the company could benefit from the property, information or opportunity. Cases include

Industrial Development Consultants Ltd v Cooley (1972) and, more recently, Thermascan Ltd v Norman (2011).

Prima facie there is nothing to stop Joseph engaging in a non-competing business. The facts do not suggest any competition, given that Hurstwood is not engaged in an IT business, but we cannot be completely certain. Further enquiries would be prudent. In any event Joseph must ensure that he avoids any conflict of interest under s175. The fact that he sometimes provides materials to his own clients may conflict with his position as director in Cotton Lane. It would also be prudent for Joseph to obtain express authority from the other directors for him to continue with his business, and also insert a term in this service contract that he will only work four days a week for the company.

In addition, he should avoid taking for himself opportunities that would otherwise be available to Hurstwood (Regal Hastings v Gulliver (1942)), even if the company were informed of such opportunities. The duty to avoid a conflict is a strict one. If he were to exploit such an opportunity, he would be required to account for any profit arising (Boardman v Phipps (1967)).

However, section 175(4) CA 2006 now provides that conflicts of interest can be authorised by the board (although the conflicted director would not be allowed to vote, s175(6)). As there are 3 other directors, this should not pose any problems.

Note also the duty of a director to declare any interest in a transaction or arrangement with the company under s177 and s182 CA 2006, that is distinct from the duty under s175. However, there is no need to disclose an interest, under either s177 or s182, if the other directors either are aware of the interest, or ought reasonably to be aware of it.

Question 4

Under section 994 CA 2006 a member of the company can petition the court in relation to unfair prejudice suffered from an act or omission of the company or in relation to the conduct of company's affairs. The member must show however that the conduct of affairs of the company or the omission was unfairly prejudicial to their interests as a member.

It is necessary therefore to distinguish between matters concerning the running of company and matters that are merely 'private'. On the facts here, Philip's absences, and his mis-use of funds, appear to concern the company. His relationship with Theresa is perhaps more debatable, but could be seen as a situation of conflict of interest for the director.

Helen must show that her interests as a member have been prejudiced. The courts are clear that these include a member's formal rights, such as those found in the company's constitution or in the Companies Act. It is not certain that any of Helen's formal rights been infringed, but the courts have interpreted a member's interests to be broader than his strict formal rights – at least where the company concerned is a 'quasi-partnership'. In such a company, a member's interests can arise from informal understandings between members.

The case of Ebrahimi v Westbourne Galleries Ltd (1973) defined a quasi-partnership as a close personal relationship between members, where some or all the members are expected to participate in management and there exist restrictions on transfer of shares to outsiders.

Following Ebrahimi, we appear to have a quasi-partnership as Helen and Philip have a close relationship as cohabitees and have run the business together (including previously as a partnership).

In relation to Helen's interests as a member being affected, the courts have considered this widely. See for example Gamlestaden v Baltic (2007) and Re CF Booth Ltd (2017). In the latter case the courts found the directors (the majority shareholders) were in breach of a number of duties and that such conduct was unfairly prejudicial to the interests of the minority shareholders. It could be argued further that Philip has not avoided a conflict of interest arising (s175 CA 2006) by having a relationship with Theresa, and this could also be seen as unfairly prejudicial.

If Helen's claim is successful, the court can make any order it thinks fit. In the overwhelming majority of cases, majority shareholders will be ordered to buy out the shares of petitioner, but this is not what Helen wants. The court could however order Philip to sell to Helen (Oak Investment Partners XII v Boughtwood (2009)). The court may be influenced by the misbehaviour of the respondent. Here, for example, the misuse of funds and long and unexplained absences could be deemed to be mismanagement and thus unfair prejudice. Philip does not appear to have been carrying out his duties appropriately. Helen has also been running company alone.

If Philip were ordered to sell his shares, a discount on their value might be appropriate. However, in Re Home and Office Fire Extinguishers Ltd (2012), the court declined to impose a discount. In valuing the shares, the value of the funds Philip took from the company would be factored into the calculation, to ensure that she did not benefit from that.

A derivative claim on the other hand is an action brought by a shareholder, but on behalf of the company, and to enforce a right of action enjoyed by the company. If the claim is successful, the benefit of any remedy ordered by the court goes to the company. Such a claim can be brought under the provisions of Part 11 of the Companies Act 2006 ('CA 2006').

A derivative claim can be brought in respect of any 'negligence, default, breach of duty or breach of trust' by a director of the company': s260(3). Philip's conduct in using company funds to help pay the deposit for Theresa would seem to qualify. Helen must, however, obtain the court's permission to continue her claim: s261. The criteria the court must apply in deciding whether to give permission are set out in s263.

These criteria do not all carry equal weight. Three criteria, in s263(2), are 'mandatory bars': if any one or more of these exists, then the court *must* refuse permission to continue the claim. If, however, none exists, then the court must then proceed to apply and weigh up the 'discretionary' factors identified in s263(3). Two of the mandatory bars – prior authorisation or ex post ratification – do not seem to apply here. The third bar is where a 'hypothetical director', acting to promote the success of the company (in accordance with s172 CA 2006), would not continue the claim. Several cases have considered as to what matters a hypothetical or reasonable director

would take into account when deciding whether such a claim should be continued; see for example Iesini v Westrip Holdings Ltd (2010) and Cullen Investments v Brown (2015). Such matters include the strength of the claim against the director, the size of the claim, the likely legal costs, the company's ability to fund the proceedings, the defendant director's wealth, the likely disruption to the company's business, and any damage to the company's reputation or its relationships with key stakeholders, such as employees or suppliers. Here, the size of the claim is not inconsiderable, but beyond that, we do not have enough information to know how the court would judge the other criteria. However, in Iesini (above), the court ruled that only 'if no reasonable director' would continue the claim should the court refuse permission on this mandatory ground. So, it is probably unlikely Helen would be refused permission on this mandatory bar.

The court would then have to apply the various discretionary factors. These include, again, the importance a hypothetical director would put on continuing the claim, as well as the likelihood of ratification. Ratification here would not be likely. Any ratification must be passed without the votes of the wrongdoer (Philip) leaving Helen alone to vote (against) the ratification. However, two factors may count strongly against Helen. First, the court must consider whether the claimant (Helen) is acting in good faith. Here, it seems she is using the claim not to benefit the company, but instead to pursue a personal dispute with Philip. Second, the court must ask if the member could bring a personal cause of action in respect of the conduct complained of. Here, Helen could pursue an action under s994, for unfair prejudice. The court might well feel that is a better way for Helen to resolve her conflict with Philip. The court took this approach in Franbar Holdings Ltd v Patel (2008) and Mission Capital Plc v Sinclair (2008). The court might be particularly likely to do this where the claimant has already commenced a separate s994 action, showing that she too regards that as a way of dealing with her dispute.

It would appear that Helen has a good chance of success with both claims.