CHIEF EXAMINER COMMENTS WITH SUGGESTED ANSWERS

JANUARY 2021

LEVEL 6 - UNIT 1 - COMPANY & PARTNERSHIP LAW

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 2021 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

Please note, this information will be made available to Candidates and Centres:

The Chief Examiner commends those who produced strong answers for the following reasons:

- Clear, accurate and detailed answers to the actual question set
- Comprehensive and relevant reference to statute and case law where required
- Careful use of time – with a balance of content across all questions
- Accurate and thorough application to the facts in the part B questions.

As has been said before, it is vital to read each question carefully, answer all elements accurately – do what the question tells you to do. All answers must be supported by as much relevant and up to date case law and statute as possible.

It is not sufficient to merely regurgitate the legal issues without directly addressing the elements of the question. The Chief Examiner remains surprised that candidates continue to learn prior answers by heart. There is a real danger that the actual question is ignored or not answered adequately as candidates get distracted by recitation, and miss elements of the question set, as with B1 – where section 994 CA 2006 alone was for discussion whereas some candidates revisited a prior answer and merely compared s994 with derivative actions.

Many candidates gave limited reference to case law and statutes. These are essential and demonstrate understanding and accuracy in knowledge as well as application to a question or scenario.

As said before, candidates need to plan their questions carefully to ensure they address methodically all elements of each question – and any facts and relevant statutory provisions (eg section 1 PA 1890 or s238 IA 1986), while checking for a particular focus or instruction as to the angle to be taken.

Rather than trying to second-guess what the questions will be, for example by learning prior answers, candidates need to ensure they know and understand the key points, statutory provisions and cases for each topic that could be assessed, to enable them to adapt their answers appropriately to the questions in front of them.

CANDIDATE PERFORMANCE FOR EACH QUESTION

Section A

Question 1

The corporate veil question is always a popular one, but candidates need to appreciate that a greater level of analysis is required and an overall conclusion would be beneficial. I found the answers overall this session much less detailed then in previous ones.

Question 2

Less popular than expected but then the question asked for more than mere regurgitation of directors' duties generally. A range of marks were achieved but the good answers analysed the duties well with an eye on the issue of avoidance of abuse as the question asked.

Question 3(a) and (b)

Answers to this question were less good overall. In both parts, candidates did not generally adequately address the actual question. They needed to give more thought to what was actually being asked. (b) was on the whole the better answered part but for this, case law was usually lacking.

Question 4(a) and (b)

This was the second most popular question and reasonably well answered. Candidates worked methodically through the elements on s1 of the PA 1890, and provided some logical discussion of the benefits of a partnership agreement for (b).

Section B

Question 1

It was noticed that a few candidates had clearly learned a previous answer on this topic (s994 CA 2006) and merely recited this. This was not a good strategy as half of the answer repeated related to another topic that was not required for this question. See the comments above on learning by heart. Marks ranged in this question and again the strong answers applied the facts well, analysed and provided case law as evidence.

Question 2(a to c)

There were some good answers, but candidates did not always really think what the questions were asking for and check what the facts said, so answers often contained irrelevant or inaccurate points. This was regularly the last or penultimate question answered and it was clear candidates were struggling with timing. No individual element of the question seemed to cause any particular problems. Answers lacked detail on the application of s245 IA 1986.

Question 3

This topic, allotment of shares, always seems to be avoided. Answers were, unfortunately, generally poor,

Question 4

One or two answers were very good, with a methodical and detailed approach taken. Others clearly suffered from timing issues, it being the last question.

Candidates need to be encouraged to work through statutory provisions methodically to cover all elements and ensure correct and detailed application to the facts or question.

SUGGESTED ANSWERS

LEVEL 6 - UNIT 1 - COMPANY & PARTNERSHIP LAW

SECTION A

Question 1

It is a fundamental principle of company law that a company has its own legal personality 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 owns the entire share capital of its subsidiary, it is not responsible for the contractual or tortious liabilities of its subsidiary.

However, the courts have, exceptionally and on restrictive grounds, been prepared to 'pierce' or 'lift' the corporate veil, and thus disregard a company's separate legal personality. The key case that established these grounds is Adams v Cape Industries Plc (1990), a case which 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 restrictive approach.

Originally in Adams, three grounds were suggested on which the veil might be pierced. Following Prest, however, it is suggested 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 pierced.

The other situations noted in Adams and Prest where the court might intervene and produce an outcome that looked very similar to veil piercing, but which would technically not involve a true piercing of the corporate veil tend to focus 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. 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. The Court of Appeal in Adams stressed, however, that courts should ordinarily only find an agency relationship between a subsidiary company and its parent where there was an express agency agreement between them. Such a relationship should not be implied merely because, for example, the parent wholly controlled 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 the 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 pierced. As with the agency relationship ground above, the court in Adams took a more restrictive approach in relation to 'single economic entities' than in earlier cases (see for example DHN Food Distributors Ltd v Tower Hamlets London Borough Council (1976)).

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

Adams and Prest, then, require courts to adopt a restrictive approach to veil lifting. Another recent decision of the Supreme Court has also approved this restrictive approach, and the limited grounds on which the veil might be pierced, namely VTB Capital v Nutritek International (2013).

Occasionally however, the courts have sought to be less restrictive than Adams, where injured employees of subsidiaries have sought to sue the parent as a joint-tortfeasor. 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 in Thompson v the Renwick Group Plc (2014) and Okpabi v Royal Dutch Shell Plc (2018), this condition was held not satisfied, because the parent was a "pure" holding company, merely owning shares in subsidiaries which themselves carried out all the business activities of the group;
- the subsidiary's operations must be unsafe, and the parent must either know 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 Vedanta Resources plc v Lungowe (2019) accepted that the duty might extend to other claimants apart from employees of the subsidiary. It is also worth noting that in Vedanta the court seemed to suggest that a parent would only be held liable for injuries caused by its subsidiary if the parent had either 'taken over the management' of the activity causing the injury, or had 'given relevant advice to the subsidiary' about how to manage the risky activity. In other words, Vedanta seems to suggest that parents will be liable only for their own *mis*feasance.

Whilst 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 piercing of the corporate veil.

In conclusion therefore, although there are circumstances in which the veil of incorporation may be pierced, such circumstances are rare and restricted.

Question 2

The authority of the directors to act on behalf of and to bind the company is usually very wide (see, for example, the general power of management under Article 3 of the Model Articles) and may be conferred on them either expressly by the company's articles or by implication.

It is because of this wide general power that a number of duties have been imposed on company directors in order to try to prevent them from abusing their position as managers of a company.

These duties were originally developed over many years in numerous common law cases, such as Aberdeen Railway Company v Blaikie Bros (1854) on conflicts of interest. They have now been codified in Chapter 2, Part 10 Companies Act 2006 (CA 2006), although the equitable principles on which the common law 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 of the duties (s178 CA 2006).

The statutory duties are set out in Chapter 2 include:

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)). This introduces a more objective (and therefore, perhaps, more easily enforced) element into s171, in comparison with the subjective test found in s172 (below).

The next duty - to promote the success of the company (s172 CA 2006) - 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, or if insolvency is likely, the interests of the creditors as a class will become paramount (GHLM Trading Ltd v Maroo (2012)) in preference to those of the members.

Moreover, directors must, under s414CZA CA 2006, include in their company's annual strategic report a statement explaining how the directors have had regard to the matters set out in s172(1)(a) to (f). This requirement was inserted by the Companies (Miscellaneous Reporting) Regulations 2018.

The directors must also 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). This 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 for failing to register for and collect VAT.

The duty to avoid conflicts of interest and duty is found in s175 CA 2006. 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. The rigour of this duty is evident in the fact that it is generally immaterial whether or not the company could itself benefit from the property, information or opportunity. Cases include Industrial Development Consultants Ltd v Cooley (1972) and, more recently, Thermascan Ltd v Norman (2011).

Note that the duty to avoid conflicts of interest, in s175, does not extend to transactions entered into by the company in which a director has an interest. In that case, the interested director is instead only under a duty of disclosure, either under s177 CA (Duty to declare interest in proposed transaction or arrangement) or s182 CA 2006 (Duty to declare interest in existing transaction or arrangement).

Whilst the content of the duties does impose a reasonably comprehensive and demanding set of obligations on directors in their management of the company, their effectiveness is nevertheless arguably undermined by difficulties over the enforcement of the duties. The duties themselves are owed to the company (s.170(1)). Ordinarily, therefore, it must be the company that sues to enforce any breach of duty (the so-called Rule in Foss v Harbottle (1832)). The case of London & Suffolk v Breckland (1989) held that, for a company that gives directors the power to manage the company (as does, for example, regulation 3 of the Model Articles) the board alone would have authority to decide whether the company would sue a director for breach. Unsurprisingly, boards are reluctant to take such a decision.

Shareholders can try to overcome that barrier to enforcement by commencing a derivative claim. Such claims are now governed by Part 11 CA 2006. This introduction of a 'statutory' derivative claim was intended to make it easier for shareholders to bring such claims, and in at least one respect, it has done so. A shareholder can now sue for breach of *any* duty (under the old law, derivative proceedings were possible only for breaches of duty that amounted to 'fraud', which did not include ordinary negligence). However, a shareholder must still get permission to continue a derivative claim under Part 11, and section 263 identifies a number of criteria the court must apply in deciding whether to grant such permission. Some of these criteria operate as 'mandatory bars', requiring the court to refuse permission. Overall, courts have been fairly reluctant to grant permission. Often, permission is refused because the court feels that the company will likely secure little benefit from continuing the claim (see eg Kleanthous v Paphitis (2011)), or because the court feels the shareholder bringing the claim would be better off pursuing an action for unfair prejudice under s994 (Franbar Holdings v Patel (2008).

Question 3(a)

There is in fact minimal express limitation in the Model Articles (MA) on the exercise of the general power of company directors under MA 3. 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, MA 14 imposes a more stringent restriction: 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 to exclude the article altogether.

A company need not however adopt the Model Articles in full and therefore may impose stricter procedural restrictions on its directors in the articles. Indeed a company may create its own tailor-made set of 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 the capacity of the company itself. Such a clause indirectly also limits the authority of its directors – directors do not have the authority to do things which are beyond the capacity of the company itself. Accordingly, directors who act outside the company's capacity will thereby be acting outside their own authority. Such an objects clause is more likely to be found in the constitution of a company incorporated prior to 1 October 2009; for any company incorporated after that date, section 31 CA 2006 effectively abolished the requirement for an objects clause.

A contract entered in to by the directors, and for which they lack authority, would ordinarily be void. However, provisions in the Companies Act 2006 act to override limits on directors' authority which are found in a company's articles. 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(a)

It is necessary to begin by examining the different elements of the definition of a partnership in s1 of the Partnership Act 1890 (PA 1890), and in particular the phrases 'carrying on a business in common', and 'with a view of profit'. If these elements are in place, then a partnership is formed.

In relation to the first phrase, s45 PA 1890 defines a business as including 'every trade, occupation or profession'. This is a wide, if imprecise, 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, including the collection of rent.
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, tenancies in common, joint property and common property – do not of themselves create a partnership, even where the co-owners share profits arising from such property.

It would also appear that the business must be carried on as an ongoing activity. A one-off venture may well not amount to a partnership (Mann v D'Arcy (1968)). Further, in Keith Spicer v Mansell (1970), it was held that two people preparing to carry on business through a company did not amount to a partnership. On the other hand, 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, it is the issue of sharing of profits which may, or may not, lead to the partnership relationship that requires more detailed consideration. For an individual to be regarded as a partner of another (or others), is it necessary, or sufficient, that she be receiving a share of the profits of the business?

S2(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. This section confirms the decision in Cox v Hickman (1860) – that receipt of a share of profits implies partnership, but might be outweighed by other contrary factors. 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:

1. the repayment of a debt by instalments, or otherwise, out of profits (see Kilshaw v Jukes (1863));
2. a contract for remuneration of a servant or agent by a share of profits (confirming the decision in Walker v Hirsch (1884));
3. the receipt, by the widow or child of a deceased partner, of an annuity out of profits;
4. where a lender of money to a business receives payments which vary with the rate of profits of the business, provided that the loan agreement is in writing and signed on behalf of all the parties.

On this last point, it may then be asked whether, if the agreement is not in writing, the lender is in fact therefore a partner: see Re Fort, ex p Schofield (1897). Another interpretation would be that the lender merely loses the benefit of the presumption that he is not a partner, but it would still be open to the lender to show that, taking account of all the factors of the case (including the intention of the parties) he was nevertheless not a partner.

The discussion and examples above illustrate how the receipt of profits provides strong, but not conclusive, evidence that a partnership is formed. If a person does not receive a share of profits, that can be strong evidence to the contrary (Geary v Rankine (2012)). However, this can again be rebutted by other circumstances.

A final illustration of the fact that receipt of a share of profits is not a necessary precondition to the existence of a partnership is given by Hodson v Hodson (2009). In that case a solicitor sold her practice, but since the purchaser had not been qualified for long enough to practise alone, the vendor agreed to retain a 1% share of the practice. In fact, the vendor never drew the 1% share of the profits to which she was entitled. The court held that she was, nevertheless, in partnership with the purchaser as the failure to draw profits to which she was entitled was irrelevant. Further, an entitlement to a share of profits was not a precondition to the existence of a partnership.

4(b)

It should be noted that a written agreement is not necessary to form a partnership. Moreover, in the absence of such an agreement, the PA 1890 also provides a number of 'default rules' that will govern the partners' ongoing relationship. However, there are numerous benefits to having such an agreement, rather than relying on the default rules found in the PA 1890. For example, a written agreement will provide greater clarity and certainty about the terms of the partnership relationship. Other advantages include the following:

The partners can define clearly different roles and management positions and procedures that are not covered by PA 1890. This provides that profits and losses will be shared equally, but a written agreement can set alternative profit-sharing ratios and capital input requirements. Further the PA 1890 does not allow expulsion of a partner by the majority of the partners unless there is an agreement permitting such expulsion (s25 PA 1890). An agreement can state that a partner can be expelled by some specified majority of the other partners. Finally, an agreement can exclude s33 PA 1890, which causes a partnership to dissolve on the retirement of a partner. The agreement can provide that the partnership will continue in such a case. This is of great benefit as it removes the inconvenience of having to dissolve the partnership and effectively create a new one on retirement.

SECTION B

Question 1

Section 994 CA 2006 allows a member of a company to petition the court in relation to conduct that is 'unfairly prejudicial'. To succeed in a claim, a shareholder must show that the way in which the affairs of the company have been conducted, or some act or omission of the company, was unfairly prejudicial to his interests as a member.

A first point to consider, then, is whether the matters that Jack is complaining about would amount to either 'the conduct of the company's affairs', or 'acts or omissions of the company'. The essential point here is that we must distinguish between, on the one hand, matters concerning the running of the company and, on the other hand, conduct which is merely 'private'. Lauren's aggression to the employee might be argued to be a private matter – further information on the background to the dispute should be sought. Lauren's other behaviour does however appear to involve the conduct of the company's affairs: her absences and failing to be involved in the management, as well as the use (or rather misuse) of company funds, likewise involves the conduct of the company's affairs.

Next, we need to ask whether these different issues affect Jack's interests as a member. First, he must show that his interest is being prejudiced, which is more than merely showing that he would like to be treated in a different way. In terms of how the interests might arise, the courts have made it clear that 'interests' here include the member's formal rights, such as those found in the company's constitution, or in the Companies Act. The difficulty here, however, is that it does not seem that any of Jack's formal rights have been infringed. However, the courts have interpreted s994 more widely and held that a member's interests are broader than his strict formal rights. In particular, the courts have accepted, at least in so-called quasi-partnerships, that a member's interests may derive from informal understandings between the members. This developed out of the case law on a just and equitable winding up of the company, especially <u>Ebrahimi v Westbourne Galleries Ltd</u> (1973), which also defined a quasi-partnership. This was a company in which there was a close personal relationship between the members, some or all the members expected to participate in management, and there were restrictions on the transfer of shares to outsiders – as is the case here in the company's articles. The court does also consider if the relationship has changed (<u>Re AMT Coffee Ltd</u> (2019)).

It would appear that, following <u>Ebrahimi</u>, there is a quasi-partnership as Jack and Lauren have a close relationship as father and daughter, have run the business together for a number of years, initially as a partnership, and more recently as a small company; there is also a restriction on transfer of shares.

Next, Jack would have to show that his interests specifically as a member were being prejudiced. It is true that the courts have not applied this 'qua member' requirement in a strict or rigid way: see eg <u>Gamlestaden v Baltic</u> (2007). They have accepted, for example, that removal from one's position as a director, although perhaps in one sense affecting the member in his capacity as a director, can be unfairly prejudicial to his interests as a member. The departure of the employee is likely to be more problematic. Even if the departure were to be regarded as part of the conduct of the company (for doubts about this, see above) it might nevertheless be suggested that any harm suffered is in Jack's capacity as an employee of the company (in that he has to work much harder), and not as a member of the company.
If Jack were successful in his claim, the court can, in theory, make any order it thinks fit to address the unfair prejudice. However, in practice the order made, in the overwhelming majority of cases, is that the majority shareholders buy out the shares of the petitioner, which would mean that Lauren buys out Jack. This is not what Jack wants.

However, the court certainly could order that Lauren sell to Jack. The court made such an order in <u>Oak Investment Partners XII v Boughtwood</u> (2009). The court was influenced by the misbehaviour of the respondent, which amounted to mismanagement of the company. The misuse of funds and Lauren's long and unexplained absences could amount to mismanagement and thus constitute unfair prejudice. The court might also feel he ought not to continue as a member of the company for these reasons. This view might be reinforced by the fact that Jack has been largely running the company over the last couple of years.

Normally, when the petitioner is selling their shares, they will be valued by an independent valuer (which would exclude the company's own auditors), on a pro-rata basis (O'Neill and Another v Phillips and Others (1999)). Grace v Biagioli (2005) confirmed this was normally the appropriate order for the court to make. These buy-out terms have now been fairly well settled by case law. The application of a pro rata basis has more recently been confirmed in for example Re Addbins Ltd (2015), at least where the company is a quasi-partnership (Estera Trust (Jersey) Ltd v Singh (2018)).

Thus, the petitioner does not have any discount applied to his shares to reflect the fact he does not have control of the company. It might be argued that, where the respondent is selling her shares, and she has been guilty of misconduct, then a discount might be more appropriate, to reflect the fact of her misbehaviour. However, in Re Home and Office Fire Extinguishers Ltd (2012), the court declined to impose any discount, even though the selling shareholder was responsible for the breakdown of the shareholders' relationship. In valuing the shares, the value of the funds Lauren took from the company would be factored into the calculation, to ensure that she did not benefit from that.

Question 2(a)

It is worth noting that a floating charge can only be created by a company and is an equitable charge created over a generic class of assets (such as the stock in trade of the company): Re Panama, New Zealand and Australian Royal Mail Co (1870). In other words at the date of its creation, it does not attach to specific items within that class of assets. The charge attaches to particular assets only when it 'crystallises' into a fixed charge: Illingworth v Holdsworth (1904). This means that until crystallisation, the chargor company is free to deal with the assets under the charge without reference to the chargee: Re Yorkshire Woolcombers Association Ltd (1903). Here the charge will be granted over the company's undertaking. It is most likely here the lender would have little control over the charge or assets secured by it but would have other protections.

Sally can be advised about the possible difficulties of creating a fixed charge over the company's book debts – ie the debts owed to the company and payments received in respect of such debts. Creation of a fixed charge over book debts is in theory feasible, but the decision in Re Spectrum Plus Ltd (2005) makes this difficult. This revolves around whether there is the necessary control for the lender over the charged assets to give rise to a fixed charge and whether the borrower (ie Treadstone) is able to use the moneys received to carry on the business. The House of Lords in Spectrum overruled previous cases (Siebe Gorman (1979) and Re New Bullas (1994)), holding that for a fixed charge to be created over book debts a lender must exert a high degree of control over the charged assets – for example requiring the borrower to pay sums received into a specified account, and from which the borrower could withdraw sums only with the consent of the lender.

2(b)

As the charge would be a 'qualifying floating charge' (ie one created on or after 15 September 2003), it gives the charge holder, Sally, the right to appoint an administrator over the company. Such administrator will have rights to take control over the company's undertaking to protect the interests of the charge holder.

Sally would also enjoy a degree of priority over other, in particular unsecured, creditors regarding the proceeds of sale of the assets subject to the charge, in the company were to be wound up. However, this priority, and thus creditor protection, is restricted by rules (i) governing the registration and priority of different charges over the same asset, and (ii) designed to ensure a fairer treatment of unsecured creditors. The board's charge would rank behind the bank's fixed charge, as fixed charges generally rank above floating charges.

Sally will need to ensure that company register the charge with Companies House within the relevant time period after its creation. If a floating charge is not registered within the specified time limit (21 days of the creation of the charge: s859A(4) Companies Act 2006 ('CA 2006')), then it is void against an administrator or liquidator or any creditor of the company.

However, even if the charge is properly registered, it takes effect subject to any earlier (and properly registered) equitable charge over the same asset. Also, and perhaps more importantly, any later legal charge that is properly registered will take priority over the floating charge. To try to reduce the risk to the priority of the floating charge, Sally, as the charge holder, can impose an obligation on the chargor not to grant, over the same assets, a later charge which would take priority over it: a 'negative pledge'. This however will only prevent the priority of a later fixed charge where that charge holder has actual notice of the earlier floating charge and the relevant negative pledge.

(c)

Any floating charge is at risk of being set aside under s245 IA 1986, when the company goes into insolvency, if the charge was given to secure a 'pre-existing debt' owed by the company. Clearly, the original loan of is a 'pre-existing debt'. However, the new additional loan could also be treated as a pre-existing debt if that additional loan is made to the company before the floating charge is *actually* created: see <u>Re Shoe Lace Ltd</u> (1992). The board should be advised that the lender will want to ensure that the new loan is only made *after* the floating charge has been created. If that were done, then the floating charge would be valid insofar as it provides security for the additional loan of £100,000, but would be potentially void insofar as it provides security for the existing loan of £150,000.

To be set aside under s245, the charge given to secure the earlier loan must also be created within a certain period prior to the onset of insolvency. This period depends on whether the charge is created in favour of a person connected with the company. Here as the charge is being granted to a connected person, the wife of a director of Treadstone, the relevant period is two years. The charge could be void but only if the company is unable to pay its debts at this time (or becomes unable as a result of creating the charge).

Question 3

Under s549 Companies Act 2006 (CA 2006) the directors of a company may not exercise any power of the company to allot shares (including both ordinary and preference shares) except in accordance with s550 CA 2006 or pursuant to an authority granted pursuant to 551 CA 2006.
Section 550 applies to issues of shares by a private company where there will be only one class of shares in issue before and after the proposed issue. In

view of the proposals to allot both ordinary and preference shares it is not available in this case.

Under s551 the directors may be granted authority to allot shares either by the company's articles or by ordinary resolution of the members. A company can amend its articles by passing a special resolution (s21 CA 2006). In either case the authorisation must state the maximum number of shares that may be allotted and the date on which it will expire, which must not be more than five years from the date of the resolution.

The allotment of the ordinary shares here will also require the statutory pre-emption rights of the existing shareholders under s561 CA 2006 to be disapplied. Section 561 provides that a company may not allot "equity shares" unless it has first made an offer to each person who holds ordinary shares to allot on the same or more favourable terms a proportion of those securities pro rata to their existing holdings of ordinary shares.

Equity securities are defined as meaning ordinary shares or rights to subscribe or convert securities into ordinary shares; ordinary shares are all shares other than shares which carry a fixed entitlement to dividends and capital (s560 CA 2006). The statutory pre-emption rights do not therefore apply to the proposed issue of preference shares.

Where directors are generally authorised for the purpose of s551 statutory pre-emption rights can be disapplied in the case of a private company or a public company by a provision contained in the articles or by special resolution (s570 CA 2006). Alternatively in the case of a private company (whether or not the directors are generally authorised for the purpose s551) pre-emption rights can be excluded by a provision contained in the company's articles (s567 CA 2006). The Model Articles however contain no such provision, and the Company will therefore need to pass a special resolution either to amend its articles (s21 CA 2006) or to grant the directors power to disapply pursuant to s570.

The rights attaching to the preference shares to be issued will need to be included in the Company's articles. This can be done by passing a special resolution (s21 CA 2006) to amend the existing articles or to adopt new articles.

The new clause preventing removal will also require a change to the articles, and again this must be approved by special resolution. Therefore as there are to be two changes to the articles, it would be sensible to adopt new articles.

Finally, a company with Model Articles may appoint a new director either by board resolution or by ordinary resolution of its members (Art 17 MA). If the Company elects to appoint AIL's nominee by resolution of the members therefore this will require an ordinary resolution.

The shareholders' resolutions could be passed either at a general meeting (GM) of the Company or by written resolution (WR) of the members.
A GM requires not less than 14 clear days' notice (s307 CA 2006), i.e. excluding the day of delivery or deemed delivery and the day of the meeting (s360 CA 2006). Absent any contrary provision in the articles, a document sent by post is deemed to be delivered 48 hours after posting (s1147 CA 2006). A GM may be held on less than 14 days' notice if a majority in number

of members holding not less than 90% of the voting rights so agree (s307 (4) – (6) CA 2006).

Unless a poll is demanded, voting at a meeting is by a show of hands. Resolutions are validly passed if, in the case of an ordinary resolution, more than 50% of those present entitled to vote and voting cast their votes in favour; in the case of a special resolution the requisite majority is not less than 75%.

Private companies may alternatively use the WR procedure. A WR may be proposed by the company or its members. A copy of the proposed resolution must be sent to every "eligible member" informing them how to signify agreement to the resolution and the date by which, if not passed, the resolution will lapse (s291 CA 2006). Eligible members are all those who are entitled to vote on the date the resolution is circulated (s289 CA 2006).

A WR is passed as an ordinary resolution if more than 50% of eligible members vote in favour and a WR is passed as a special resolution if not less than 75% of eligible members vote in favour (ss282 and 283 CA 2006).

Question 4(a)

The order of priority for payment of debts in liquidation is set out in s175, s176ZA and 176A of the Insolvency Act 1986. In an insolvent liquidation it is important that the liquidator follows the strict statutory order; otherwise he may face claims from aggrieved creditors.

The order is as follows:
1. The expenses of the winding up i.e. the costs of the liquidator and his professional advisers
2. Preferential creditors e.g. payments to occupational pension schemes, some employees' remuneration, and taxes collected by the company on behalf of HMRC (such as PAYE and VAT).
3. Unsecured creditors.

It is important to recognise that the assets available for realisation out of which to pay these debts are those assets not subject to a fixed charge. The holders of fixed charges, so here the bank, are paid out of the proceeds of sale of the assets over which the fixed charge is held. If there is a surplus this will be paid to the liquidator; if there is a deficiency the fixed charge holder may prove for the shortfall in the liquidation as an unsecured creditor. If there are insufficient funds out of which to pay the expenses of winding up, the deficiency must be paid out of the proceeds of sale of assets subject to any floating charge (s176ZA IA).

In the scenario posed the liquidator should follow the statutory order for payment of debts.

As an unsecured creditor, Charlotte should be concerned that she will not be repaid her debt, at least in full. There are however ways in which the liquidator might seek to recover sums for unsecured creditors such as Charlotte.

4(b)

The part re-payment of the bank loan in 2020 could amount to a preference under s239 IA 1986, following Re M Kushler Ltd (1943).

A company gives a preference to a person if that person is one of the company's creditors or guarantors and at a "relevant time" the company does anything which has the effect of putting that person in a better position than would have been the case if that thing had not been done (s239 (4) IA 1986). The company is effectively improving the guaranteeing director's position by reducing the amount of debt guaranteed. In addition, the part payment was at the relevant time

For this purpose, a relevant time is the period of either 6 months ending with the onset of insolvency or, where the preference is given to a person who is 'connected with' the company the period of 2 years prior to the onset of insolvency (s240 (1) IA 1986)). A person is connected with a company if, inter alia, he is a director of the company (s249 IA 1986). Accordingly, the company had to be put into liquidation by the end of March 2022 for this to constitute a preference; in fact, this occurred well before then, in December 2020.

However, it is also necessary to consider the case of Re Hawkes Hill Publishing Co Ltd (in Liquidation) ((2007)), where it was held that, where a bank's debt is fully secured anyway (as here by a fixed charge), the guarantor's position is not improved because the bank will be fully paid out of the company's assets on liquidation under the charge. In other words, the guarantor would never be liable.

Early repayment of the outstanding amount of the loan to Frida Watts may also constitute a preference within s239 IA 1986. Watts is also connected with the company, for the reasons given above. The preference was made in August 2019, and thus if the company were to go into liquidation by August 2021, the preference would have been made within the relevant time

Where a company gives a preference at a relevant time the liquidator may apply to the court to make an order for restoring the position to what it would have been if the company had not given the preference (s239(2) and (3) IA 1986).

However the Court may not make such an order unless it is satisfied that the company was influenced in deciding to give it by a desire to prefer the person concerned over other creditors and not merely responding to commercial pressure to keep the company afloat (Re MC Bacon ((1990))). In the case of a preference given to a person connected with the company, such a desire is presumed unless the contrary is shown (s239(6) IA 1986. It is perhaps unlikely that Frida could rebut this presumption. Although we are told that Frida had been putting pressure on the company, there seems no objective reason for early repayment of the loan to Frida. A transaction cannot be challenged if, at the time it is given, the company was solvent (and did not become insolvent as a result of the preference): s240. It is unclear here whether the Company was insolvent when the preference was given.

In relation to the sale of the design arm, this could be a transaction at an under value under s238 IA 1986, and again the liquidator could apply to have this set aside. A transaction at an undervalue occurs if at a 'relevant time' the company enters into a transaction with a person for no consideration or for a consideration the value of which in money or money's worth is considerably less than the consideration provided by the company (s238(4) IA 1986). The design arm was sold for less than half its value, so should satisfy the undervalue element.

For transactions at an undervalue, the 'relevant time' is the period of two years ending with the onset of insolvency (s240(1)(a) IA 1986). This period applies irrespective of whether the transaction is with a 'connected person'. This transaction took place only five months ago. However, at that time the company must also have been be unable to pay its debts or become so as a result of the transaction (s240(2) IA 1986). This is presumed where the company enters into the transaction with a connected person unless the contrary is proved. Here the local competitor does not seem to be a connected person under sections 249 and 435 IA 1986, but it would be sensible to check if there are any links with the company or its directors.

Whether a company is unable to pay its debts is to be ascertained by the tests contained in s123 IA 1986. These include where it is proved to the satisfaction of the court that the value of its assets is less than the value of its liabilities including contingent and prospective liabilities (s123(2) IA1986). We do not have precise information on this but the facts suggest that the company was in financial difficulties.

The court may not make an order under s238 if it is satisfied the company entered into the transaction in good faith and for the purpose of carrying on its business and that at the time it did so there were reasonable grounds for believing the transaction would benefit the company (s238(5) IA1986). On the facts it seems unlikely this test would be satisfied as there seems to be no proper motive for the company selling the unit at such a low price.