CHIEF EXAMINER COMMENTS WITH SUGGESTED ANSWERS

JANUARY 2019

LEVEL 6 – UNIT 16 - THE PRACTICE OF COMPANY AND 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 2019 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

This paper is a Level 6 paper and was appropriately demanding. Congratulations to those candidates that have passed this Unit.

Overall those candidates that performed well reflected their abilities to apply their understanding to the facts and thereby produce good solid answers deserving of a higher mark. Fortunately (and unusually) the majority of candidates had taken little time to consider the documents provided in the case study materials and thereby sought to use the facts imparted and apply the documents as they progressed through the paper.

General performance:

Much of what is set out below in this section has been stated before, but it still needs to be stated – particularly in response to requests for feedback.

Unsuccessful candidates need to be able to relate their own performance to what was being required of them and to be able adapt their approach to this topic, revision and the assessment so that they are able to be successful in

the future. Candidates are strongly encouraged not to just focus on the answer, but their overall approach.

It is worth a general observation that the performance by candidates was generally reflected by those who had fully and carefully prepared and reviewed the case study materials, were prepared to answer any change in the facts presented. As in previous papers, this paper relied on a good understanding of a set of facts set out in the Case Study materials. As per previous papers, the application of the mechanics of the document together with statute was key. There is always a marked differentiation in that such well performing candidates applied themselves according to their ability to tackling the questions such that they used their knowledge to provide sound advice taking into the facts supplied, as required by the questions. Those candidates that sought only to demonstrate knowledge of reading and imparting all that was known on a subject did not score as well.

General Advice:

In terms of approach and technique for examinations at this level, candidates must bear in mind that the intention is for the candidates to be able to apply their understanding of the practice of partnership and company law such they are able to advise clients in a practical manner. In order to achieve this, candidates must resist the urge to write all that they know about a subject, which in this paper was all too often a problem; understandably there is a natural desire to demonstrate all that the candidate has read and know. However, that approach will not work at this level. As has been stated before, application to the facts when answering questions is extremely important and often carried marks that candidates who only impart knowledge do not give themselves the opportunity to be awarded.

Additionally, as before, candidates whilst revising should not then be doing so in such a manner that they are rehearsing pre-prepared questions and answers. Less so in this paper than before, there remained instances where pre-prepared answers appeared to be relied upon with little consideration to the need to remain flexible and to be able to answer the questions as posed, rather than as desired.

Common weaknesses:

As has been said before, many candidates failed to appreciate that it is important. when tackling problem questions, to answer in the context to the issue raised by the question. Often the answers set out the law on a topic in issue without any great reference to the facts of the scenario, and often with no attempt being made to apply the principles that were actually relevant. This would then be followed by only a cursory discussion of the facts of the problem, often with only scant reference to the previous explanation of the law. A proper conclusion can only be demonstrated after careful application of the relevant principles of law to the facts of the scenario, and that demonstration is all the better made if the marker is then taken through the issues on a step-by-step basis with each step applied to the facts – candidates are strongly recommended to review the Suggested Answers for further guidance on how they may achieve the intended aims.

Review of Case Study Materials:

Candidates are recommended to consider the manner in which they prepare following the release of the Case Study materials. Candidates should try not to anticipate the questions following a review of the case study materials; rather analyse the facts to fully understand what is going on and then consider all the issues surrounding those facts, identify issues only and identify where problems may arise, or where there is uncertainty.

It is also worth repeating advice given in the past. Namely that candidates must not, when reviewing the Case Study materials, make assumptions about the facts or attempt to question spot – what the candidate may consider as a certain in terms of the type and wording of the question will invariably not be the question actually posed. Review the Case Study materials with an eye to be adaptable and fluid, come the examination; remember the facts can be developed further come the examination, this can then alter the assumptions that may have been considered. Those candidates that do question spot invariably come to the examination with a pre-rehearsed answer which will not fit the question posed or be capable of incorporating additional or changed facts. Candidates should treat the examination as they would meeting a client for the first time, what you know from a brief telephone call or attendance note could change immediately when the client walks in the room.

15 Minutes Reading:

Candidates should also make appropriate use of the 15-minute reading time at the start of the examination. It is during this period that the candidate can read through the additional information provided in the examination paper, and how this relates to and moves on the pre-released Case Study materials. Candidates should pay particular attention to the wording or facts of the questions and discuss the relevant law, connecting their arguments to the actual issues raised by the questions. The candidate should always bear in mind that when tackling questions, the candidate must be able to demonstrate why the law he/she is writing about is relevant to the question, i.e. make sure that as you identify the relevant fact, that demonstrates why it is so. It is the latter aspect that some candidates fail to do. Accordingly, it may be useful during this period to make notes on the key points of the law to be used and applied and the key facts to employ in giving a fully reasoned and considered piece of advice.

Examination technique:

When tackling the questions posed in the examination, it is important to keep in mind the IRAC approach to answering question - Issue, Rule, Application, and Conclusion. This approach will help you structure your answers, and as you do you will be demonstrating to the examiners how you have reached your conclusions by leading them through your thought process and step-by-step analysis:

(1) *Issue*: read the questions carefully and identify that which is relevant from the facts, state exactly what the question of law is;

(2) *Rule*: identify and cite the applicable cases, statutory provisions or procedures that will help you make a correct legal analysis of the issue at hand - briefly, explain their requirements, identifying any key tests that must be applied;

(3) *Application* (or *Analysis*): this is the most important section of an IRAC because it develops the answer to the issue at hand. It requires you to apply the applicable statutory law or procedures identified to the facts – this is the provision of the advice. It is important in this section to apply the rules to the facts of the case and explain or argue why a particular rule applies or does not apply in the case presented; and finally,

(4) *Conclusion*: by summarising what you have set out above and for problem questions whether the client can or cannot achieve their intended aims, or in the case of an essay question whether you agree or not with the statement you have been set to discuss. It is important that your conclusion does not introduce any new rules or analysis; restates the issue and provides the final answer.

Statute book:

Although previously stated, candidates are reminded that they are able to take with them into the examination room the prescribed statute book, a valuable resource if used correctly – if used correctly when studying, during revision and then in the examination itself, is a source to rely upon for all answers. Candidates should seek to use the statute book as a means by which to support their answers, in that the statute books will provide the necessary statute references, the correct terminology, clarification of the necessary procedure that is being applied and the resource to flick through to identify additional points for inclusion. Candidates must learn how to use this resource effectively in the exam room, and this starts with revision – when revising a topic, locate and identify the correspondence statutory provisions, read and understand the manner in which they operate. The effective use of statute in the exam will only see to embellish answers and candidate performance.

CANDIDATE PERFORMANCE FOR EACH QUESTION

Question 1

The first part of this question looked at the consequences for the directors in the event that the company in able to pay its debts. This required consideration of the onset of insolvency under s122-123 Insolvency Act 1986, and then wrongful trading. Whilst most candidates were able to identify these issues, the discussion as it applied in these circumstances was not necessarily well done. More particularly, this discussion required the need to identify and apply the various tests and liability arising for the debts of the company to two directors that had been relatively absent from the running of the company. More application was possibly required in relation to identifying liability for each director and the requirements to contribute funds in the event of insolvency.

The second part of the question looked at the consequences of being declared bankrupt for one of the directors. This required the application of article 18 of the model articles and issues dealing with the disqualification of a director under the Companies Directors Disqualification Act 1986. On the whole this question was answered with mixed results, but generally with little detail applied nor a full discussion of the CDDA.

Question 2

This question required the candidates to advise the company on the steps it would be required to undertake in order to allot both ordinary and preference shares. In relation to the issue of shares, most candidates covered the basic requirements for the allotment of shares well, although generally application and the use of statute was lacking. Whilst most candidates identified that requirements under the right of pre-emption (and the means by which this could be either disapplied or waived – the latter being most appropriate given that the facts suggested that the current shareholders were most likely to agree the investment) this was only covered in a cursory manner; the detail and application was lacking by most candidates and the answers were then in general terms relating to the allotment of shares – too many candidates only sought to outline the procedure with little reference to the particular circumstances in hand.

When addressing the procedural requirements, only a few candidates covered this addition well, and only a few identified the need to credit the share account in respect of that sum representing the nominal value of the shares.

The greatest failing of candidates was the failure to consider those involved. In this instance, all the directors who were in post at this point in time would be required to declare their interests in the share allotment. This consequently required the issue of s177 and Article 14 to be addressed – and given the provisions of s177(6) and Art 14(4) which have permitted exclusions, nothing further was required, i.e. there was no issue associated with quorum. Only occasionally was this identified. Candidates are referred to the Suggested Answers for further guidance; the means by which the answer is demonstrably applied to the facts should also be noted.

Question 3

The first part of this question asked candidates to both appoint and then award a long-term-service contract to a director. Whilst the requirements to cover the need to seek members' approval was generally well done (although more was required in terms of the disclosure requirements of the term of the contract to members covered), only a few candidates fully covered the need for the director to make a declaration of interest under s177 and Art 14.

The need to make a declaration of interest and to be precluded from voting arises in a number of questions but is still not covered by candidates well. Note, s177 is a declaration of interest only, not a precluding of voting as many candidates stated. It is Article 14 that potentially precludes a director from participating in quorum.

When addressing the procedural requirements, only a few candidates covered this well, and only a few identified the need to credit the share account in respect of that sum representing the nominal value of the shares.

The second part of the question looked at the tax consequences arising for the individual director in terms of a salary and dividend payment and the company from making such a dividend payment – although a number of candidates applied the incorrect law on the tax rates, the question was generally answered well. In relation to the transfer of shares as a gift, candidates are reminded that both CGT and IHT are applicable; those candidates that did identify both then proceeded to apply this well.

Question 4

The first part of this question looked at identifying terms that could be included in a possible partnership agreement and on the formalisation of the partnership. This required consideration of the facts as they applied in the circumstances, and how they could be implemented to be best effect. The question did not require, as some candidates sought to do, a list of all possible terms that an agreement could include, rather more consideration was required. Those that related both the facts and the applicable provisions of the Partnership Act 1890 did well. Too many candidates did seek to state the position of the law only, without application – it is important to continually seek to apply the law to the facts and draw conclusions that provide the necessary advice that is sought.

The second part of the question looked at the dissolution of the partnership and the settling of the debts. This required the careful consideration of how, in this instance, the partnership could be brought to a close, rather than a consideration of all possible means of dissolving a partnership. It then required the application of section 44 of the partnership Act 1890.

Candidates are referred to the Suggested Answers for further guidance; the means by which the answer is demonstrably applied to the facts should also be noted.

SUGGESTED ANSWERS

JANUARY 2019

LEVEL 6 – UNIT 16 - THE PRACTICE OF COMPANY AND PARTNERSHIP LAW

Question 1(a)

A director is not ordinarily liable for contracts entered into by the company. However by virtue of s214 Insolvency Act 1986 the court may hold that any person is liable to make such contribution to the company's assets as the court thinks proper if the company goes into insolvent liquidation; at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation; and that person was a director of the company at that time.

The criteria against which a director's knowledge and actions is measured is the knowledge possessed and the action that would have been taken by a reasonably diligent person, having both the general knowledge, skill and experience to be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and the general knowledge, skill and experience that that director actually has (s214(4) Insolvency Act 1986).

A company is deemed to be unable to pay its debts, *inter alia,* if a creditor for more than £750 has served a statutory demand and remains unpaid for three weeks or if it is proved to the satisfaction of the court that it is unable pay its debts as they fall due (s123 Insolvency Act 1986).

There is a defence to wrongful trading but only if the director concerned can prove to the satisfaction of the court that after he concluded there was no reasonable prospect of the company avoiding going into insolvent liquidation, he took all reasonable steps to minimise the loss to the company's creditors.

If found guilty of wrongful trading the court may, on application of the liquidator, order the delinquent directors to make such contribution to the assets of the company as it thinks proper. In the circumstances, it may well be that Jenny Collins' liability will be greater than the other directors, given her knowledge that invoices have been left unpaid.

1(b)

Should Jenny be served with a bankruptcy petition by her creditors and be unable to settle her debts, she is liable to be declared bankrupt. If that were to happen, she would no longer be able to continue in office as a director of Party Children Party Limited (PCP).

As PCP has adopted the Model Articles, Jenny will automatically lose her office of director on the making of the bankruptcy order (Article 18 MA).

In addition, the Company Directors Disqualification Act 1986 provides for the disqualification of directors on a number of different grounds.

Under s10 Company Directors Disqualification Act 1986 where the court orders that a person make a contribution to a company's assets on its winding up under s214 Insolvency Act (as may be the case here), it may also make a disqualification order for a maximum period of 15 years.

Under s11 Company Directors Disqualification Act 1986 it is an offence for an undischarged bankrupt to act as a director or take part in the management of the company without leave of the court.

If Jenny continues to act as director (or manager) in contravention of a disqualification order, she would be personally responsible for the debts and liabilities of the company incurred during the period when she so acts s15 Company Directors Disqualification Act 1986.

Question 2(a)

The directors of PCP have no explicit authority to allot shares under the articles of association.

To allot the new shares to the existing shareholders, Kempston Children's Care Institute (the 'Institute') and Professor Paul Long, PCP will first need to create the preference shares and then authorise the directors to allot all the preference and ordinary shares, in accordance with s551 CA 2006.

The directors of PCP must be authorised (s549-551 CA 2006). Section 550 CA 2006 provides that where a private company, such as PCP, has only one class of shares (classes of shares defined in s629 CA 2006) the directors may exercise any power to allot shares, except to the extent that they are prohibited by the company's articles. However, as the proposal includes the allotment of preference shares, the directors will need to be authorised under s551 CA 2006. In addition, to attach the rights to the preference shares, the articles will need to be amended by special resolution (s21 CA 2006).

The requirements as to the terms of the authority to allot shares are directed by s551 CA 2006. Under s551(2) CA 2006, PCP can seek from its members the authority to give its directors the power to allot, either generally or for a particular allotment. However, there are requirements laid down regarding the maximum number of shares to which the authority may relate and the time scale for the authority. When requesting the authority, s551(5) CA 2006 requires that it states the maximum amount of shares that may be allotted under that authority, in this case a minimum of 265,000 ordinary shares of £1 each and 300,000 preference shares of £1 each. s551(5) CA 2006 also specifies that the authority must state the date on which it will expire, which by reference to s551(4) CA 2006 must be not more than five years from the date of the resolution.

As the company is proposing to allot the ordinary shares ('equity securities', under CA 2006) for cash, the existing members should be offered the shares first (s561 CA 2006), in proportion to their existing holdings. This allows those shareholders to preserve their percentage holding after the issue, provided that they have sufficient funds available to subscribe for the new allotment. The preference shares will not be 'equity securities' and therefore not subject to rights of pre-emption for the existing members.

On the presumption that the new investment is with the agreement of PCP and its members, all shareholders will need to waive their pre-emption rights as either the shares they are buying are not in proportion to their existing holdings, or they are not buying new shares.

Alternatively, a member's special resolution disapplying the pre-emption rights could be sought under s570 CA 2006. Any member who objects to the issue may attempt to bring an action under s994 CA 2006, unfair prejudice. It is likely that the members will be willing to waive their pre-emption rights.

2(b)

The procedure for the allotment of new shares is to first call a board meeting to resolve to alter the share capital of the company and seek the members' permission for the directors to allot a minimum of 265,000 ordinary shares of £1 each and 300,000 preference shares of £1 each. The members' general meeting may be called on 14 clear days' notice or on short notice procedure (s307 CA 2006 and Article 48 Model Articles). The members will vote on the ordinary resolution granting directors' power to allot shares (ss549 and 551 CA 2006), the special resolution under s570, and the special resolution (s21 CA 2006) amending the company's Articles to include the rights attached to the preference shares.

Following the passing of the shareholder resolutions, the board meeting will then re-convene. The board will then receive and resolve to allot new shares following receipt of the applications from the current shareholders, the Institute, and Professor Paul Long at the agreed price.

Alternatively, PCP could use the written notice procedure under s288-300 CA 2006.

All the current directors will have to declare their interest under s177 CA 2006 in relation to the allotment of shares at the board meeting. Given the interest in the allotment of the shares each director will be prevented from voting on board meeting resolutions relating to the allotment, meaning that the board

meeting will not be quorate. However, Article 14(4)(b) Model Articles and s177(6)(b) may be relied on, therefore no need to amend or suspend by Article 14 prior to any allotment.

Administration: the directors will then need to resolve to allot the shares and affix the company's seal (if it has one) to the share certificates, update the register of allotments, members and PSC register and prepare minutes of the board meeting and members meeting. A statement of capital and notices of new class of members will need to be sent to the Registrar together with the s21 and s551 resolutions, amended articles of association and Form SH01 of the allotment of shares for cash consideration.

The nominal value of the preference shares, £300,000, and the ordinary shares, £300,000 will be credited to the Called-up share account. £265,000 representing the market premium on the issue of the preference shares will be credited to the share premium account.

Question 3(a)

Professor Paul Long may be appointed a director of PCP either by the directors in accordance with Article 17(1) MA in a Board Meeting or by members in a General Meeting by ordinary resolution.

To appoint by GM, directors will need to call a GM on 14 clear days' notice (s307 CA 2006 and Article 48 MA). Alternatively, PCP could use the written resolution procedure under s288-300 CA 2006.

However, Professor Long is also to be awarded a director's service contract of five years. As this is for a fixed term exceeding two years, it must be approved by an ordinary resolution of the company (s188 CA 2006). A copy of the proposed agreement or a memorandum of its terms, including the term which requires members' approval, must be available for inspection by the members of the company at the company's registered office for not less than 15 days (s188(5) CA 2006), or attached to any Written Resolution (if used). If such a term is granted before the members' approval is obtained, it is void and the agreement terminable at any time by the company on giving reasonable notice (s188(5) CA 2006).

Accordingly, as an ordinary resolution is required, the appointment and approval of the contract should be deferred to a General Meeting of the company. Professor Long need not declare his interest in the grant of his service contract under s177(6)(c) CA 2006 but should be advised to do so as a matter of good practice. Paul may not however vote or be counted in the quorum at the board meeting called to approve his service contract (Article 14 Model Articles).

Administration: a number of documents will need to be prepared, namely, Board Meeting minutes and resolutions (to first decide on the appointment, then to hold the required General Meeting to approve the term and finally the subsequent Board Meeting to authorised and grant the service contract), Notice of General Meeting (or Written Resolution) and minutes, the necessary Ordinary Resolution, the proposed agreement or a memorandum of its terms will need to be prepared, and letters noting the declaration of interest on the part of the director, updating of the registers of directors and Form AP01 to be completed and filed with the Registrar.

3(b)

Tax implications for Professor Long in respect of any salary and any dividend received are as follows:

- Remuneration under a service agreement is income subject to income tax and taxable under Income Tax Earning and Pensions Act 2003. Under the PAYE scheme, tax is deducted at source by the employer, i.e. the company. Paul's income tax liability will be calculated by taking his income, deducting his personal allowance and then applying the income tax rates. The basic rate is 20 percent and thereafter the balance will be taxed at the higher rate of 40 percent and then at the additional rate of 45 percent.

- Any dividends paid to Paul will amount to taxable income, taxable under Part 4 Income Tax (Trading and Other Income) Act 2005 and are paid gross and have the benefit of annual tax-free allowance. The allowance exempts the first £2,000 of a taxpayer's dividend income but does not reduce total taxable income. As a result, dividends within the allowance count as taxable income when determining how much of the basic rate band or higher rate band has been used. Dividend income in excess of the tax-free allowance are taxed at the following rates 7.5% (basic rate taxpayers), 32.5% (higher rate taxpayers) or 38.1% (additional rate taxpayers).

Tax implications for Jenny Collins if she gifts his shares:

- Tax implications for Jenny if she gifts his shares to Alison within the next few years are that the gift is a disposal for capital gains purposes. The basic gain is calculated by deducting the original purchase price paid by each and the incidental expenses of acquisition plus the cost of disposal from the market value at the date of the gift.

- The gain arising is then subject to capital gains tax at Jenny's basic rate of capital gains tax of 10%, rising to 20% should he be deemed a higher or additional rate taxpayer.

- Jenny can also claim her annual exemption.

- The reliefs that Jenny could claim, in the following order, are: Entrepreneurs' Relief on the basis that the shares were a business asset of Jenny. Jenny will have held more than 5 per cent of the shares and have been an officer and employee of the company, and if the relief applies the gain will be taxed at 10% up to the lifetime limit of £10 million.

- Alternatively, provided both Jenny and Alison elect, hold-over relief may be claimed (s165 TCGA 1992). Jenny's shares would have to qualify as business assets. If hold-over is claimed Alison will be deemed to have acquired the assets at Jenny's original purchase price and Jenny's will not be liable for any tax. If claimed, hold-over relief may not be claimed in conjunction with any other form of relief.

- The gift may also be subject to Inheritance Tax; treated as a lifetime transfer of value, which means that there would be no immediate Inheritance Tax implications. It would be a potentially exempt transfer

(PET) for Inheritance Tax purposes. If Jenny dies within seven years of making the PET, the value of the gift will be subject to IHT when the individual dies. The value of the gift of the share would be established at the time of transfer. However, Entrepreneurs' Relief would be available.

Question 4(a)

The provisions that should be included into the agreement to ensure Krystal devotes herself to the business will be positive obligations and should be such that she is required to use best skills and endeavours to promote/ carry on business and conduct herself in a proper and responsible manner. Krystal should also be required to devote the whole of her time and attention to the business. This is a useful requirement to include given that no obligation under the Partnership Act 1890 requires a partner to devote time to the business (the only obligation is under s30 Partnership Act 1890, namely to account for profits made through competing with the firm). All partners should be required to show good faith to the other partner(s) and give true account of, and full information about, all things affecting the Partnership. They should also be required to inform the Partnership, without delay, of any legal proceedings; punctually to pay and discharge debts and to account to the partnership for any profit derived from any business, office or appointment, or any personal benefit derived from the business, the use of the name, Partnership property or business connections of the Partnership.

In addition, Krystal should be required not, without the prior (written) consent of the other partner(s), to engage or be concerned directly or indirectly in any business other than the Partnership business or accept any office or appointment. The agreement should state that partners should not derive any benefit from the use of the name, Partnership property or the business connections of the Partnership or engage in any contract or commitment on behalf of the Partnership, except under the name of the partnership.

The partnership in this instance should seek to include restrictive covenants preventing Krystal establishing a competing business. The clause in the agreement needs to be a careful balance to ensure that it is not a restraint of trade. It must therefore not be an unreasonable restraint but reasonable between parties (e.g. as to the geographical area covered, and the duration of the restriction). Balance is essential.

(b)

In the absence of any agreement to the contrary, this partnership can be dissolved by serving notice of dissolution on the other partners (s32(c) Partnership Act 1890). This brings the business to an immediate end pursuant to the provisions of Partnership Act 1890.

As there is no formal partnership deed, or any other evidence of any contrary agreement between the partners, the provisions of the Partnership Act 1890 apply. Should Martin serve such notice, it brings the business to an immediate end.

S44 Partnership Act 1890 sets out the specific rules for the distribution of assets from the partnership. A final account has to be drawn up. Once an account has been drawn up, the order of dissolution would be:

- all losses must be paid first (first out of profits, then out of capital);

- any balance of losses outstanding must be met by the partners individually in the proportion in which they are entitled to share profits;
- capital is repaid pro-rata to the partners;
- payment to a partner for advances as distinguished from capital;
- any money left over is then divided between the partners in the proportion in which the profits are divisible.

After dissolution, the authority of the partners is limited to doing such things as are necessary for the winding up of the affairs of the partnership and completing unfinished transactions. Accordingly, Martin, Sophie and Krystal as partners must give notice of dissolution of the partnership by giving actual notice to those who have dealt with the firm and by placing a notice in the London Gazette (s36 Partnership Act 1890). Additionally, a notice would usually be placed in the local press to make sure that third parties (i.e. outsiders, particularly suppliers) are aware of the limit on the authority of partners from the moment of dissolution.