CILEx CHARTERED INSTITUTE OF LEGAL EXECUTIVES

LEVEL 6 - UNIT 16 – PRACTICE OF COMPANY & PARTNERSHIP LAW
SUGGESTED ANSWERS – JANUARY 2017

Note to Candidates and Tutors:

The purpose of the suggested answers is to provide students and tutors with guidance as to the key points students should have included in their answers to the January 2017 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 students may have included in their responses to the questions. Students will have received credit, where applicable, for other points not addressed by the suggested answers.

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

Question 1(a)

The business that Paul Vastone has entered into with Gemma Burton is a partnership, i.e. a relationship which subsists between persons carrying on a business in common with a view to a profit (s1(1) Partnership Act 1890). s2 Partnership Act 1890 states that the sharing of profits of the business is *prima facie* evidence of being a partner. However whilst s2 Partnership Act 1890 list a number of instances whereby a receipt of a share of profits does not, by itself, make a person a partner, there is no suggestion to the support such a contrary proposition. As such, on the basis of the information provided, a business has been set up, the purpose behind which is clearly to make a profit. Therefore the business carried on by Paul and Gemma satisfies s1(1) Partnership Act 1890 and can be viewed as a partnership.

In relation to any liability that Paul may be associated with in relation to this partnership, and others' authority to bind the partnership (and thereby Paul), liability arises under the Civil Liability (Contribution) Act 1978 and s9 Partnership Act 1890.

Authority to bind the firm arises by virtue of:

- s6 Partnership Act 1890 a partner will bind the firm if he/she is authorised, such authority being vested in a partner by express agreement or implied by the conduct of the members of the firm
- s5 Partnership Act 1890 covers apparent authority for the partner to bind the firm and need to use the four stage test:
  1. Is it the type of business carried on by the firm?
  2. Would a partner usually have authority to bind the firm?
  3. Does the third party know or reasonably suspect that the partner did not have authority?
  4. Does the third party know or believe that the individual is not a partner?

- s7 Partnership Act 1890 where an individual pledges the credit of the firm for a purpose not connected with the firm's business, the firm is not bound unless the pledge was specifically authorised by the other partners
- s8 Partnership Act 1890 provides that a restriction on a partner's authority will not bind a third party unless they have notice of it.

Paul needs to note that liability may arise after he has ceased to be a partner under s9 Partnership Act 1890 and the Civil Liability (Contribution) Act 1978. In addition, privity of contract may also be an issue for any debt in which he is involved in negotiating. Likewise, PV will be liable for debts whilst a partner under s17 Partnership Act 1890.

(b)

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

As there appears to be no formal partnership deed, or any evidence of any other contrary agreement between the partners, reliance needs to be placed on s32 of the Partnership Act 1890 apply. Accordingly, should Paul serve such notice, as the partnership is for a single adventure or undertaking (s26 PA 1890), is dissolved simply by the termination of that undertaking.

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;
- 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, Paul and Gemma, 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 dissolution.

Question 2(a)

Paul Vastone may be appointed a director of The Stop Over Limited ('TSO') either by the directors in accordance with Article 17(1) Model Articles 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 or short notice (s307 CA 2006 and Article 48 Model Articles). Alternatively, TSO could use the written resolution procedure under s288-300 CA 2006.

However, Paul is also to be awarded a director's service contract of three 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. Paul 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.

(b)

Paul may be removed from office by an ordinary resolution of the shareholders notwithstanding any contrary provision in any agreement between him and the company (s168 CA 2006). The proposed service contract will not therefore prevent Paul's removal as a director before the term of that contract has come to end. However, the right of the company to remove him as a director will be without prejudice to any claim for compensation that Paul might have if his removal constitutes a breach of his service contract (s168(5)).

Special Notice (s312 CA2006) of any such proposed resolution must be given to the company at least 28 days before the general meeting.

Paul is entitled to protest his removal by speaking at the meeting called to consider the resolution to remove her and to make written representations to the meeting (s169 CA 2006).

Paul can be protected in the following ways:

- include a Bushell v Faith clause in the Articles to give her enhanced voting rights in the event of a resolution to remove her or to amend or remove the Bushell v Faith clause from the Articles (the Bushell v Faith clause might also be prevented from amendment or removal by a 'provision for entrenchment', under s22 CA 2006)
- amend Article 18 Model Articles to reduce the circumstances in which a director would be disqualified from holding office
- by a clause in a separate shareholders' agreement which requires parties to that agreement to vote against any resolution to remove her as a director. This would not prevent his removal under s168 but might provide a remedy in damages for breach of contract if the provision were to be breached.

The articles of association may be amended by special resolution (s21 CA 2006), with a copy filed at Companies House (s30 CA 2006), together with a reprinted copy of the amended articles of association (s34 CA 2006).

Question 3(a)

This will be a substantial property transaction. Paul has been appointed a director of TSO prior to the transfer of the vehicles and equipment owned by his to the company.

Under s190 CA 2006 a company may not acquire from a director and a director may not acquire from the company, a substantial non-cash asset unless the arrangement is either first approved or made conditional upon being approved by a members' ordinary resolution.

In this instance, TSO is to acquire from one of its directors, Paul Vastone, various non-cash assets. A 'non-cash' asset is any property or interest in property other than cash (s1163 CA 2006).Under s191 CA 2006 a non-cash asset is "substantial" in relation to the company if its value exceeds 10% of the company's net asset value and is more than £5000 or its value exceeds £100,000. TSO's most recent set of audited accounts show it has net assets of £85,000. The equipment and vehicles to be transferred will therefore be substantial in value.

Accordingly, the acquisition requires the approval of members by ordinary resolution. If members' approval is not obtained the transaction will be voidable at the instance of the company. Directors who authorise the transaction without members' approval will be liable to indemnify the company for any loss or damage which results from the transaction.

In addition, as Paul will be interested in the transaction this will require a disclosure of interest under s177 Companies Act 2006 unless all the other directors are already aware of his interest (s177 (6) (b) CA 2006). Paul will not be permitted to vote at the directors' meeting at which this matter is considered nor will he count in the quorum (Article 14 Model Articles).

However, TSO currently has four other directors and therefore quorum will be achieved. Quorum for a directors' meeting is two under Article 11 of the Model Articles. Without a quorum business cannot be validly conducted at board meetings. Note, although s177 Companies Act 2006 and Article 14 Model Articles applies in relation to a directors' meeting each shareholder is free to vote at the general meeting according to their own personal interest.

(b)

Tax implications for Paul 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 (Trading and other Income) Act 2005 (ITTOIA 2005). 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 highest rate of 50 percent.

- Any dividends paid to Paul will amount to taxable income, taxable under Part 4 IT(TOI)A 2005 and are paid gross, and have the benefit of annual tax-free allowance. The allowance exempts the first £5,000 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 Paul if he gifts his shares:

- Tax implications for Paul if he gifts his shares to George 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 sale price.

- The gain arising is then subject to capital gains tax at Paul's basic rate of capital gains tax of 18%, rising to 28% should he be deemed a higher or additional rate taxpayer.

- The reliefs that Paul could claim, in the following order, are: Entrepreneurs' Relief on the basis that the shares were a business asset of Paul. Paul will have held more than 5 per cent of the shares and have been an officer and employee of the company, accordingly the gain would be reduced by 4/9ths to give a tax rate of 10 per cent and a rate of 18 per cent for gains over £10 million.

- Paul can also claim his annual exemption.

- Alternatively, provided both Paul and George elect, hold-over relief may be claimed (s165 TCGA 1992). Paul's shares would have to qualify as business assets. If hold-over is claimed George will be deemed to have acquired the assets at Paul's original purchase price and Paul'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 Paul 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 of shares would be established at the time of transfer. However, Entrepreneurs' Relief would be available.

Question 4(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).

Creditors will be able to petition the Court for the compulsory winding up of TSO on the ground that it is unable to pay its debts (s122(1)(f) Insolvency Act 1986). A company is deemed to be unable to pay its debts, *inter alia,* if a creditor for more than £5,000 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).

If the directors continue to trade and in the process increase the liabilities of the company they may be guilty of wrongful trading under s214 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 Tony Towns' liability will be greater than the other directors, given his knowledge that invoices have been left unpaid.

(b)

Should Tony be served with a bankruptcy petition by his creditors and be unable to settle his debts, he is liable to be declared bankrupt. If that were to happen, he would no longer be able to continue in office as a director of TSO.

As TSO has adopted the Model Articles, Tony will automatically lose his office of director on the making of the bankruptcy order (Article 18 Model Articles).

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