LEVEL 6 - UNIT 16 – THE PRACTICE OF COMPANY & PARTNERSHIP LAW
SUGGESTED ANSWERS – JANUARY 2018

Note to Candidates and Tutors:

The purpose of the suggested answers is to provide candidates and tutors with guidance as to the key points candidates should have included in their answers to the January 2018 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 tutors should review the suggested answers in conjunction with the question papers and the Chief Examiners' reports which provide feedback on candidate's performance in the examination.

Question (1a)

The business that James Spackman has entered into with Angela and Katherine Fairborn is a partnership, i.e. a relationship which subsists between persons carrying on a business in common with a view of profit (s1(1) Partnership Act 1890). On the basis of the information provided, a business has been set up after an investment has been made and the purpose behind the business is clearly to make a profit. As such the business carried on by James, Angela and Katherine satisfies s1(1) Partnership Act 1890 and can be viewed as a partnership.

In relation to any liability that James may have in relation to this partnership, and others' authority to bind the partnership (and thereby James), 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 is authorised (actual or implied through course of dealings)
- 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.

1(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 James 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, James, Angela and Katherine 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.

James 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, and whilst he is held out to be a partner (s14 Partnership Act 1890). In addition, privity of contract may also be an issue for any debt in which he is involved in negotiating.

Question 2(a)

James Spackman may be appointed a director of Greenstead Publishing House Limited ('Greenstead') 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, Greenstead could use the written resolution procedure under s288-300 CA 2006.

However, James 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. James 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. James 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.

2(b)

James 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). Whilst James may be removed by means of an ordinary resolution, that resolution may not be obtained by the written resolution procedure. The proposed service contract will not therefore prevent James' 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 James 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.

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

James 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
- a claim under LTSC may provide a financial disincentive, although it may not stop a move to remove James as a director.

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)

The directors of Greenstead have no explicit authority to allot shares under the articles of association, nor does the company have any shares.

To allot the new shares to the existing shareholders, Children Fun Factory Productions Limited ('CFFP') and James Spackman, Greenstead will first need to create the preference shares and then authorise the directors to allot all the shares, in accordance with s551 CA 2006.

The directors of Greenstead must be authorised (s549-551 CA 2006). S550 CA 2006 provides that where a private company, such as Greenstead, 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, Greenstead 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 300,000 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 Greenstead 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.

3(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 300,000 ordinary shares of £1 each and 300,000 preference shares of £1 each. The members' general meeting may be called on 14 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.

On the assumption that no special resolution is required disapplying pre-emption rights, the meeting will close. 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 directors (excluding James Spackman, who may not be a director at this stage) at the agreed price.

Alternatively, Greenstead 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 amended or suspended 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. The members will formally notify the Company of their interest in the shares (s113 CA 2006). 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 non-cash consideration.

The sum representing the unpaid amounts on existing share capital (£25,000), nominal value of the preference shares, £300,000, and the ordinary shares, £300,000 will be credited to the Called up share account. £150,000 representing the market premium on the sale of the preference shares will be credited to the share premium account.

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 are 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 Greenstead 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 (or ought to have 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 insolvency practitioner, order the delinquent directors to make such contribution to the assets of the company as it thinks proper. Given the circumstances, it may well be that directors who know of the problem will have greater liability than the other directors, given their knowledge that invoices have been left unpaid.

4(b)

Tax implications for James 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 (Earnings and Pensions) Act 2003 (ITEPA). Under the PAYE scheme, tax is deducted at source by the employer, i.e. the company. James'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 45 percent.

- Any dividends paid to James 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 incomes, 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 James if he gifts his shares:

- Tax implications for James if he gifts his shares to Alice 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 James and the incidental expenses of acquisition plus the cost of disposal from the market value.

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

- The reliefs that James could claim, in the following order, are: Entrepreneurs' Relief on the basis that the shares were a business asset of James. James will have held more than 5 per cent of the shares and have been an officer and employee of the company, accordingly the gain will be taxed at a rate of 10 per cent.

- Alternatively, provided both James and Alice elect, hold-over relief may be claimed (s165 TCGA 1992). James' shares would have to qualify as business assets. If hold-over is claimed Jane will be deemed to have acquired the assets at James's original purchase price and James'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 James 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.

- James can also claim his annual exemption for Capital Gains and Inheritance Tax.