LEVEL 6 - UNIT 1 – COMPANY AND 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 performance in the examination.

SECTION A

Question 1

It is necessary to examine the different elements 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'.

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 – does not of itself create a partnership, even where the co-owners share profits arising from such property.

It would also appear, perhaps logically, that the business must be carried on as an ongoing activity. A one-off venture may well not amount to a partnership (<u>Mann v D'Arcy</u> (1968)). Further, in <u>Keith Spicer v Mansell</u> (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: <u>Khan v Miah</u> (2001), while a mere agreement to form a partnership would be insufficient (<u>Ilott v Williams</u> (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 will 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 person is a partner. Conversely, if a person does not receive a share of profits, that can be strong evidence that she is not a partner (Geary v Rankine (2012)). However this can again be rebutted by other circumstances. This is illustrated by so-called 'salaried partners' who generally do not receive profits. Their true status has been rather problematic. The fact that a salaried partner continues to receive only a fixed salary, and not a share of profits, was held in Stekel v Ellice (1973) not to be fatal to the person being considered to be a partner, provided that the relationship exhibited enough of the other features of partnership. In this case Stekel's name appeared on the firm's notepaper and the partnership agreement gave him the right of dissolution in certain 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. The case illustrates where the court nevertheless found that the requirements for a partnership (a business in common carried on by persons with a view of profit) were fulfilled.

Question 2

A floating charge, which can only be created by a company (or an LLP), 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).

This aspect of a floating charge could be regarded as providing little protection to the creditor/charge, who effectively has little control over the charge or assets secured by it. However, several features of a floating charge do provide considerable protection for the creditor holding the charge.

First, if the charge is a 'qualifying floating charge' (ie one created on or after 15 September 2003), it gives the charge holder 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. (A floating charge created before 15 September 2003 gives the charge holder the right to appoint an administrative receiver: s29(2) Insolvency Act 1986 ('IA 1986').)

Second, the creditor will enjoy a degree of priority over other, in particular unsecured, creditors regarding the proceeds of sale of the assets subject to the charge. 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.

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, 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.

Third, some unsecured creditors can take priority over a floating charge. One such group are 'preferential creditors', including employees owed for example unpaid wages and accrued holiday remuneration (175 IA 1986). In respect of the expenses of the winding up, if the assets of a company not subject to any charge are insufficient to meet those expenses, then under s176ZA IA 1986, those expenses will be paid out of the proceeds of sale of assets covered by a floating charge. Similarly, to increase the chance of 'ordinary' unsecured creditors receiving something from the company, the Enterprise Act 2002 requires that a proportion of assets secured by a floating charge must (subject to various exceptions) be set aside to pay off unsecured creditors. The proportion of the assets which must be used in this way varies according to the amount of the company's 'net property': see Insolvency Act 1986 (Prescribed Part) Order 2003.

Finally, any floating charge could be set aside under s245 IA 1986 when it is given to secure a 'pre-existing debt' owed by the company, when that company goes into insolvency. The crucial date is when the charge is actually created, not when it is agreed to create the charge. The new money, in other words, must be given on or after the date the charge is *actually* created: see Re Shoe Lace Ltd (1992). The charge must also have been 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. If created in favour of an unconnected person, the charge can be set aside only if created within 12 months of the onset of insolvency and, moreover, only if the company was unable to pay its debts at that time (or became unable as a result of creating the charge). If, on the other hand, the charge was created in favour of a connected person, then it can be set aside if created within two years of the onset of insolvency. In addition, there is then no requirement to show the company was then unable to pay its debts, or became so as a result of creating the charge.

To conclude, a floating charge can provide valuable protection for the charge holder, but the holder needs to take steps to increase the chances of the charge taking priority over other securities given over the same assets, and the charge can, in some situations, be vulnerable to the claims of preferential and even unsecured creditors.

Question 3

S994 Companies Act 2006 (CA 2006) and Part 11 offer protection of shareholder rights, particularly where the company is unwilling to take action following directors' wrong-doing because it is itself under the control of the wrong-doers.

Under s994, a member may complain to the court where 'the company's affairs have been conducted in a manner that is unfairly prejudicial' to the interests of the members generally or some part of them including his own. The courts have interpreted the 'interests of the members' broadly: such interests could be based on the formal rights of the shareholder – under provisions of the CA 2006, or the company's own constitution – but also on understandings which were never recorded in the articles. These have been referred to both as 'legitimate expectations' (Re Saul D Harrison & Sons plc (1995)) and as 'equitable considerations'. One of the earliest cases to establish this judicial approach is Ebrahimi v Westbourne Galleries (1973). In O'Neill v Phillips (1999), Lord Hoffmann stressed that the task of the court is to give effect to the parties' own understanding, and not to override what the parties had themselves agreed. Indeed the court will take into account what may be very informal agreements. Further, the courts have generally accepted that interests enjoyed in a capacity other than as a member could also be enforced under s994: see eg Gamlestaden Fastigheter AB v Baltic Partners Ltd (2007).

Another level of protection under s994 lies in the range and effectiveness of the remedies available to the court. Under s996, the court can make any order it sees fit to remedy the unfair prejudice including the purchase of the petitioner's shares. This is by far the most common remedy sought by minorities, and awarded by the courts, which have also generally insisted that a fair price be paid for the shares (i.e. not discounted for being a minority holding): (Re Bird Precision Bellows (1986); O'Neill v Phillips (1991)).

By contrast, derivative claims, under Part 11, are brought by members on behalf of the company for any breach of duty (s260), rather than, as was previously the case, only for 'fraud on the minority'. The ground for bringing a claim must involve an act or omission involving negligence, default, breach of duty or breach of trust by a director. This contrasts with a claim under s994 that may be brought in respect of any conduct of the company's affairs that is 'unfairly prejudicial' to the interests of members. Any member bringing a derivative claim must also obtain the court's permission to continue it. S263 identifies the factors to be considered in the granting of such permission. The court must refuse permission when the company has given authority before the act (before or has ratified after the act. This reasserts the rule giving the majority the power to deny the minority the right to continue their claim (although in the case of ratification, that majority must not include the wrongdoer or those connected with her: s239).

Additionally, permission must not be given where a 'hypothetical director' acting to promote the success of the company (under s172 CA 2006) would not continue the claim: relevant considerations here include the costs of the action, the prospects of its success, the ability of the director to satisfy any order made against her, and the harm that might be caused to the company's business by continuing the claim against the director – all of which are commercial considerations, upon which a court may be ill-equipped to judge (Iesini v Westrip Holdings Ltd (2009). Consequently the courts have in fact been reluctant to rely on this bar to permission to continue. They have said that only if 'no reasonable director' would continue the claim should the courts refuse permission on this ground (Iesini). This may seem helpful to the minority, but this 'hypothetical director' test reappears as one of the discretionary factors the court must take into account where no mandatory bar requires the court to refuse its permission for continuation. When applying this discretionary factor, the courts have accepted arguments (and even from the directors of the company who are the alleged wrongdoers) that continuing the action would not be in the company's best interests: see eg Kleanthous v Paphitis (2011).

Finally the court must also ask if the member bringing the claim would instead have a personal cause of action in respect of the wrong complained of. In several cases, the courts have used this discretionary factor to rule that the member would be better off bringing a claim for unfair prejudice under s994: see eg Franbar Holdings v Patel [2008]; Mission Capital v Sinclair (2008). It would therefore appear that the courts consider the unfair prejudice remedy as a better solution for the minority.

Occasionally, however, it may be that the member does not actually wish to leave the company as they believe the company has good prospects and they and their investment are better protected by remaining shareholders (Wishart v Castlecroft Securities Ltd (2010))

To conclude, a s994 claim is a personal claim, while a derivative claim is one brought on behalf of the company. The grounds on which a derivative action can be brought are arguably narrower than under s994. The procedure for bringing a derivative claim is more complex, involving a two stage process, and there are more potential bars to bringing a claim than under s994. Finally, the sanctions available to the Court under s994 are extremely wide including ordering a purchase of the complainant's shares at fair value.

Question 4(a)

Company decision making is regulated partly by a company's articles and partly by statute.

Articles, which comprise the internal regulations for the management of a company, normally delegate the day to day management of the company to the directors, for which purpose they may exercise all the powers of the company. See for example Regulation 3 of the Model Articles for Private Companies.

The effect of this is to grant wide powers of management and decision making to the directors which, if unrestrained, would enable them to commit the company to a course of action that might be potentially damaging to the interests of shareholders. Directors usually make decisions by simple majority in board meetings.

However, some of the more important matters are reserved for shareholders to decide, generally by ordinary or special resolution. One of the more important of these is a decision to alter or adopt new articles of association which requires a special resolution (s21 CA 2006) (a 75% or more majority). Similarly, shareholders have the power to remove a director by ordinary resolution under section 168 CA 2006, and a decision to exclude the statutory pre-emption rights that apply on the allotment of shares, if not included in the articles, can only be taken by special resolution of the shareholders (ss569-571 CA 2006). Further there are strict rules in the CA 2006 relating to the shareholder decision-making, for example to ensure shareholders receive adequate notice of proposed meetings (see for example ss307 and 310 CA 2006).

In addition, the articles themselves may contain restrictions on the directors' powers of management. Regulation 4 of the Model Articles for Private Companies for example, is a general members' reserve power that enables the shareholders to direct the directors by special resolution from taking or refraining from taking any particular course of action. Such resolutions form part of the company's constitution.

The articles can be further tailored to impose restrictions on the exercise of directors' powers, such as requiring shareholder approval for borrowing over a certain limit. The breach of such a restriction can be enforced within the company, but it is worth noting that they do not affect a third party's rights to contract with the company as long as they, the third party, are acting in good faith (s40 CA2006).

(b)

Directors are agents of a company and their authority to act can be very wide. They have however for a long time been subject to a number of duties which they owe to the company, originally developed through case law, that seek to protect shareholders and ensure directors act with competence.

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

Under s171 CA 2006, a director must act in accordance with the company's constitution and only exercise powers for the purposes for which they were conferred. Generally the courts will interpret the purpose for which a particular power is conferred and then decide whether the directors have acted outside that purpose (Howard Smith Ltd v Ampol Petroleum (1974) and Hogg v Cramphorn (1966)). For example, although directors are given power to allot shares by statute, the general purpose of which is to raise finance for the company, the exercise of that power could be invalid if it were used for an improper purpose. Directors would not also be exercising their powers properly if they acted against the express wishes of all the members (Lee Panavision v Lee Lighting (1991).

Section 172 CA 2006 embodies the duty to act to promote the success of the company. This is perhaps the most fundamental duty. A director must act in good faith to promote the success of the company for the benefit of its members as a whole. 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 interests of the members generally are paramount in the exercise of this duty, but it should be noted that the section provides a long list of matters that directors are to 'have regard to', including the interests of the company's employees and the impact of the company's operations on the community and environment. Further if a company becomes insolvent the interests of the creditors will become paramount (GHLM Trading Ltd v Maroo (2012)) in preference to those of the members. So at first reading this section appears to offer protection primarily for shareholders, but through the additional matters and the position of creditors on insolvency, this shareholder protection may be diluted.

Section 174 CA 2006 contains the duty to exercise reasonable care skill and diligence. This contains both a subjective and objective test: 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)).

SECTION B

Question 1(a)

TTL could potentially take action against Jake but it would be necessary to establish if he is in fact a director of the company despite not being formally appointed.

Jake may be regarded as a 'de facto' director. This refers to someone who purports to act as a director, although he has not been formally appointed (Re Hydrodam (Corby) Ltd (1994)). Further, s250 CA 2006 extends the definition of director to the de facto director, providing that "director" includes any person occupying the position of director, by whatever name called. The definition of a de facto director was also considered in Secretary of State for Trade and Industry v Hollier (2007). Etherton J ruled that the essential question was whether the defendant was part of 'the corporate governing structure'. This would be the case where the person participated fully in board meetings and, crucially, did so as a decision maker (on a par with other directors) rather than merely as an advisor to the real directors, or as someone whose task it was to implement the decisions of the real directors. This would appear to be the case here as we are told that Jake participates regularly in board meetings and has given valuable advice to the company. It would however be prudent to investigate further the extent to which Jake has been held out by the company, or has held himself out, to be a director of TTL. Such factors along with for example access to relevant company information are to be considered when deciding if a person is a de facto director (Hollier).

It would therefore appear that he could be regarded as a de facto director. Consequently, Jake could be found to owe duties to the company, which would be relevant in establishing what action the board could take against him (see further below) in relation to his setting up in competition.

In terms of the action the company could consequently take against Jake, if we are to assume he is a de facto director, the starting point is under older case law: as long as a director has not (mis)used company property, there is no breach of duty (London & Mashonaland Exploration Co v New Mashonaland Exploration Co (1891) and Bell v Lever Bros Ltd (1932). However, more recently courts have been less tolerant of this, while still wishing to preserve a director's freedom to trade.

Once a director has formed the intention to compete, he must either resign as a director or disclose to the board his intention to set up in competition before he takes *any* preparatory steps to setting up in business in competition with his company (Hart J in British Midland Tool Ltd v Midland International Tooling Ltd (2003)).

In Shepherds Investments Ltd v Walters (2007), it was suggested that this outlawing of any steps to prepare for establishing the competing business (without either disclosing or resigning) might be too restrictive; directors might be able to take some initial preparatory steps without being forced to disclose or resign (but the court declined to say what these could be). In Foster Bryant Surveying Ltd v Bryant (2007), the court said the dividing line between acceptable and unacceptable steps towards establishing a competitive business were to be settled 'pragmatically', based on 'common sense'. We are not told in the facts here, just how far Jake has gone towards establishing his competing business. Once that is ascertained, the question must then be asked whether he has crossed the line requiring disclosure to TTL or resignation.

In addition, even if Jake did resign from TTL, there would be continuing restrictions upon what he could do in pursuit of his new business venture. So, he would not be free to exploit, on behalf of that new venture, any corporate opportunities of which he learned as directors of TTL: s170(2) CA 2006. He could not use private or confidential information which belonged to TTL, but he would be permitted to make use of the 'general fund of information and knowledge' acquired whilst director of TTL: Thermascan Ltd v Norman (2011).

(b)

Chloe can be appointed either by the directors in board meeting or by the ordinary resolution of the shareholders in general meeting or by written resolution (article 17 of the Model Articles for Private Limited Companies). Whichever procedure is followed, Companies House must be notified of the appointment within 14 days of Chloe's appointment. The company must also keep an internal register of directors (s162 CA 2006).

The granting of the service contract is more complicated. The board of TTL can approve the contract as a whole, but because it is to be for a fixed term of three years, this term must be first approved by the shareholders passing an ordinary resolution in general meeting or by written resolution (s188 CA 2006). A memorandum of the term must be available for 15 days prior to the meeting at which the resolution is to be proposed or attached to the written resolution when it is circulated. If shareholder approval were not obtained, the fixed term would be void. The service contract would still be valid, but would be terminable on reasonable notice.

Once approved by the shareholders the service contract can then be executed.

Question 2

It should first be noted that a company has a legal personality separate from that of its members (Salomon v Salomon (1897)) and, accordingly, liabilities incurred by the company belong to the company itself, not its members. Here therefore following this principle FMT's liability to its employees should be enforceable only against FMT. Further, if FMT were to go into insolvent liquidation, its shareholder, ie SOF, would have no obligation to contribute towards its assets in the winding up of the company (save to the extent of any amount unpaid on its shares). This is because FMT is a private company limited by shares.

There are, however, a number of qualifications to these principles.

First, the courts will very occasionally 'pierce the corporate veil', disregarding the separate legal personality of a company. This could result in a shareholder, here SOF, becoming liable to contribute to its company's (FMT's) liability. However, UK courts have generally been very reluctant to lift the veil. This reluctance is evident from the leading cases, such as Adams v Cape Industries Plc (1990) and Prest v Petrodel Resources Ltd (2013).

In Prest, for example, the court held that the only 'true' ground for veil piercing was where a company, here FMT, is a mere façade or sham, or being used to perpetrate a fraud; see eg Gilford Motor Co Ltd v Horne (1933) and Jones v Lipman (1962). Although it is not entirely clear what constitutes a mere façade, Adams and Prest suggest that the façade arises where a company is being used to allow the controller of that company *to evade an existing obligation*. In our scenario, however, it seems that SOF, the controller of FMT, has not used FMT to evade any obligation which SOF was already under. Rather, SOF has only ever used FMT to ensure that future liabilities, that might arise from the pursuit of the new (tool-making) business venture, would, as they arose, fall on FMT rather than on itself.

There are other situations which, although they do not technically amount to veil piercing, could nevertheless result in a shareholder finding itself liable as a result of the actions of its subsidiary. Four such situations might be mentioned here.

The first is where the separate legal identities of companies in a group are disregarded, and those companies viewed as a 'single economic entity'. However, the court in Adams held that this would be appropriate only where the proper interpretation of a statutory provision, or of a contractual document, required the court to disregard the separate identity of members of a group. There appears to be no issue here around such interpretation and therefore this ground is not applicable.

The second situation is where there is an agency relationship between company and shareholder. Such an agency relationship has been found in cases such as Re F G (Films) Ltd (1953), but the court in Adams suggested there should be an express agency agreement for this relationship to exist. This certainly does not appear to be the case in our facts.

The third situation is where a shareholder is sued directly in tort. So it may be that SOF could find itself subject to a tortious liability following the decision in Chandler v Cape Plc (2012), if it is found to be a joint tortfeasor with regard to the injured employees. In Chandler, the Court of Appeal laid down a number of preconditions for imposing on a parent company a duty of care towards the employees of its subsidiary, breach of which duty might give rise to liability as a joint tortfeasor. Amongst these was that the parent and the subsidiary companies must be 'in the same line of business' and that the parent company had a superior knowledge of issues of health and safety than did the subsidiary. This latter condition certainly seems to be satisfied, given that it is an employee of the parent company (Caitlin) who has responsibility for matters of health and safety in the subsidiary company.

In addition, there is a clear connection between the businesses of FMT and SOF – they are involved in the same industries. If SOF were a 'pure holding company', leaving all trading activities to its subsidiaries, the first condition would not be satisfied (see Thompson v Renwick Group (2014) and Okpabi v Royal Dutch Shell Plc (2017)).

Fourth, and finally, there may be an issue for SOF if FMT were to become insolvent. An action might be brought against FMT's directors for wrongful trading, under s214 Insolvency Act 1986. It would need to be shown that the directors knew, or ought to have known, that insolvency of FMT was inevitable. If that could be established, the directors would be liable unless they could show that, from the moment they knew or ought to have known that insolvency was inevitable, they took all steps to minimise the loss to the company's creditors as they ought to have taken. The determination to continue trading, in the face of the company's poor financial performance, might be evidence of a failure to take all such steps to protect creditors. Since only directors can be sued, this would not seem to provide any means of holding SOF liable. However, by s214(7), 'directors' includes 'shadow directors'. A shadow is a person in accordance with whose instructions the (legal) directors of FMT are accustomed to act. If, then, Hiba were 'accustomed to act' in accordance with SOF's instructions, then SOF might qualify as a shadow director.

Therefore our advice to SOF would be that it may find itself liable as a joint tortfeasor for injuries sustained by the FMT employees, following Chandler, and also possibly liable to contribute to FMT's assets on the basis of wrongful trading, if FMT were to become insolvent.

Question 3

A company voluntary arrangement ('CVA') is defined by s1 IA 1986 as a proposal to the company and its creditors for a composition in satisfaction of its debts or a scheme of arrangement of its affairs. It may be initiated by the directors of the company – as here. A CVA may therefore involve a proposal to re-pay creditors over a longer period than originally provided for by any credit or loan agreement or to re-pay only a proportion of the debt. Creditors may well be prepared to agree to this if, as here, the only alternative is liquidation, where for unsecured creditors certainly, the prospect is of receiving nothing or far less than they are owed.

The directors must appoint a 'nominee' who must be a qualified insolvency practitioner and who will supervise the CVA. The directors must submit to the nominee details of the proposed CVA and a statement of the company's affairs.

The nominee reports to the Court within 28 days of being given notice of the proposal on whether in his opinion the proposed CVA has a reasonable prospect of being approved and implemented and whether meetings of the company's shareholders and creditors should be summoned to approve the proposal.

If the meetings are recommended, the nominee will propose a date and time for them in his report, unless the court directs otherwise. The meetings will then decide to approve the proposals with or without modifications or to reject them. The proposal is approved at the shareholders' meeting if agreed to by more than 50% of those present and voting; approval at the creditors meeting must be by a majority representing more than 75% in value of creditors present and voting.

The CVA takes effect if it is approved at the meetings by the requisite majorities. Also if it is approved by the creditors meeting only it would take effect, but this is subject to the right of any shareholder to apply to the Court for an order that the decision of the shareholders' meeting takes effect instead (s4 IA 1986). In this case, assuming all creditors attend and vote at their meeting, the Bank could not block the CVA as it holds less than 25% of the total value of company debt. Of course, if a smaller number of creditors attended the meeting, the Bank could find it can block the proposals as it holds over 25% of the value of those at the meeting.

Once approved the CVA binds every creditor and member of the company as if they were parties to it (s5 IA 1986).

The meetings cannot approve a proposal however which would affect the rights of secured creditors to enforce their security without the consent of the creditor concerned (s4 (3) IA 1986). Here therefore the Bank would still have the right to enforce the charges under the term loan.

A difficulty in respect of the board's proposals concerns the release of the directors' personal guarantees in favour of the Bank. The Bank might be able to challenge any attempt to use the CVA to secure this release, and in two ways. First, the CVA cannot operate so as to affect the liability of third parties (here the directors) to creditors (see s4 (3) IA 1986 and Prudential Assurance Co Ltd v PRG Powerhouse Ltd (2007) and Mourant & Co Trustees Ltd v Sixty UK Ltd (in administration) (2010)). However, Prudential also confirmed that whilst the CVA could not directly affect the position as between the third party and the creditor, it could nevertheless create an obligation on the creditor, owed to the company, not to enforce its rights against the third party. If that were applied here, it would mean the Bank would have an obligation to Grafford not to pursue Grafford's directors.

The second challenge the Bank might make would be to argue that the proposed release of the personal guarantees is 'unfairly prejudicial' to the interests of the Bank. The court accepted this argument in Prudential because a number of landlords of a company entering into a CVA were losing the benefit of personal guarantees. The concern was that different landlords were treated differentially in that those landlords with personal guarantees were losing more than those without. It appears from our facts that there is only one bank set to lose the benefit of the guarantees.

Further, the Bank may still seek to enforce its security or petition for the company to be wound up before it can obtain approval for the CVA. The Bank is already pressing for repayment of its overdraft and will have powers to appoint a receiver and/or administrator under the terms of its security.

The Bank could be prevented from taking this action if the directors apply to the court for a moratorium under the IA 1986 pending approval of the CVA. The effect is to 'freeze' actions that can be taken by creditors for the duration of the moratorium: for example, no petition can be presented for winding up the company and no step may be taken to enforce any security over the company's property without leave of the Court.

A moratorium is only available to 'eligible' companies; that is, companies meeting at least two of the requirements of a small company under s382 of the Companies Act 2006 during the year ending with the date on which the application is made to the Court or the company's previous financial year. Grafford appears to meet these requirements in that its turnover does not exceed £6.5 million and it employ only 41 persons.

To obtain a moratorium the directors must file various documents with the Court including a document setting out the terms of the proposed CVA, statements of the company's affairs that the company is eligible for a moratorium and from the nominee that he is willing to act. The nominee's statement also includes for example his opinion that the CVA has a reasonable prospect of success, and that meetings of the company and its creditors should be called.

The moratorium lasts from when the documents are filed with the court and ends on the day the meetings are held, although the meetings may approve an extension to the moratorium up to two months after the last of the meetings.

The Bank will therefore be prevented from taking any action to enforce its security.

Question 4(a)

As this business is run as a partnership, the liability of the firm to the vehicle dealership depends primarily on the law of agency as applied by s5 PA 1890. Also, if the partnership is found to be liable, all the partners (Dinh, Rachel and Zachary) would be jointly and severally liable under s9 PA1890 and the Civil Liability (Contribution) Act 1978.

S5 provides that every partner is an agent of the firm for the purpose of the business of the partnership; further, a partner acting in the usual way for the purpose of carrying out business of the kind carried on by the firm will bind the firm unless the partner concerned has no authority to act and the third party either knows he has no authority or does not know or believe him to be a partner.

Each element of s5 should be considered in turn in relation to Zachary's purchase of the vehicle. First, was he acting in the usual way for the purpose of carrying out business of the kind normally carried out by the firm? It is apparent from the cases that this test is not restricted to the actual business of the firm but may extend to other activities which are incidental to it. However, Zachary's statement that he could use it for off-roading would appear to take its purpose outside that of the partnership business.

Further, in terms of his authority to act as he did, the authority of a partner to bind the firm may be actual authority, created by express or implied agreement between the principal (the firm) and the individual partner; alternatively it may be apparent authority, where the principal has through his actions represented to the third party that the agent has authority to act on its behalf e.g. by some prior course of dealing between the principal and the agent.

It seems clear in this case that Zachary had no actual authority (express or implied) as the purchase was made without the other partners' knowledge and the purchase of such a high cost vehicle does not seem to be incidental to the carrying on of their business. In addition, we are told that there were no prior dealings with the dealership so there is no implied authority either.

The firm will further escape liability if it can be shown that the dealership either did not know or believe Zachary to have been a partner. This may be a more difficult ground for the partnership to rely on depending on exactly what Zachary told the dealership about her role in the firm.

Under s7 PA 1890 where partner uses the firm's credit for purposes not connected with the firm's ordinary course of business the firm is not bound unless the partner is specifically authorised. In this case it seems likely that Zachary's motive in purchasing the car may have been partly connected with the business but also for his own private use.

In summary therefore it seems unlikely that the dealership will be able to recover the price of the car from the firm but this does not affect Zachary's personal liability for the debt if the dealership can establish he was contracting in his own right.

4(b)

A majority of partners has no power to expel another partner unless that power has been expressly included in a partnership agreement between the partners: s25 PA 1890. We are told there is no written partnership agreement between the partners, but that does not necessarily mean there was no agreement at all. If the parties had expressly (albeit orally) agreed that a majority of partners would have the power to exclude a partner, then expulsion might then be possible. However, clearly there would be considerable problems of proving the existence, or terms, of a merely oral agreement. Even if there were such an agreement permitting expulsion, the power to expel would still have to be exercised in good faith for the benefit of the partnership as a whole: Blisset v Daniel [1853].

(c)

To incorporate the partnership business, Dinh and Rachel would need to apply to Companies House for registration of the company, using the relevant form, and include for example a statement of directors and secretary (although a private limited company does not have to appoint a secretary) and of initial share capital.

They will indicate on the form the desired company name which must end in Limited or Ltd. They would not be able to register with a name of a company that already exists.

A fee is payable and they must also file the company’s constitutional documents which will consist of the memorandum and articles of association. There are standard documents they can use for these. The former indicates their intention to form a company and the latter set out the internal regulations for the company.

They could if they wished adapt the Model Articles for Private Limited Companies to for example give themselves some protection as shareholders or directors. They might also wish to enter into a shareholders’ agreement which could give them further protection for example from removal as directors.

After application for registration of the company, receipt of a certificate of incorporation from Companies House will mean the company can trade.

It should be noted that they may execute an agreement for the transfer of the assets of the partnership from them, as partners, to the new company.