LEVEL 6 - UNIT 16 – PRACTICE OF COMPANY & PARTNERSHIP LAW
SUGGESTED ANSWERS – JUNE 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 June 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)

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 are 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 LTF 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 £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).

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 did conclude, or ought to have concluded, there was no reasonable prospect of the company avoiding

going into insolvent liquidation, he took all the steps that he ought to have taken 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 Peter Myddelton's liability will be greater than the other directors, given his knowledge that invoices have been left unpaid.

(b)

Should Peter 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 Law Training for Tomorrow Limited (LTT).

As LTT has adopted the Model Articles, Peter 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 Peter 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.

Question 2(a)

LTT may purchase Peter Myddelton's shares by undertaking a buyback of shares, even though the basic principle is that a company limited by shares cannot acquire its own shares, s658 CA 2006. The reason for the general prohibition is that it is part of the body of legislation designed to preserve the share capital of companies.

However, there are exceptions to the basic principle; namely that a company limited by shares may purchase its own shares (subject to any prohibition or restriction in the articles) (s690 CA 2006) provided:

- the shares are purchased using distributable profits or the proceeds of a fresh issue of shares issued for that purpose or, if the company is private, out of capital (s692(1) and (2) CA 2006);
- that where the buyback is to be 'off market', which would be the case as the company is a private company, the terms of the contract by which the company is to purchase its shares are approved by ordinary resolution of the company before the contract is made (s696 CA 2006).

Given the reluctance of the other shareholders to purchase Peter's shares, it is unlikely that they will wish to subscribe for new shares or see the sale of new

shares to an outsider. Consequently the consideration for all the shares, £300,000 will have to be funded by the company. However, as the company has only £210,000 of distributable reserves (profits), this is insufficient for the purchase and the balance of the purchase price (i.e. £90,000) will have to be funded by the use of capital. Provided LTT follows the necessary procedure it is therefore possible for LTT to buy-back Peter's shares.

(b)

The procedures that need to be followed in order for LTT to purchase Peter's shares are:

As LTT has adopted the Model Articles, Article 36 Model Articles permits the purchase by a company of its own shares and the use of capital for that purpose.

An OR is required to approve the contract for the purchase of the shares. Additionally, a private company limited by shares (i.e. LTT) may buy its own shares using capital (s709 CA 2006) provided:

- capital is only used to the extent distributable profits are insufficient to satisfy the consideration to be paid by the company (s710 CA 2006);
- the directors and auditors make a statement that the company can carry on as a going concern (s714 CA 2006);
- the payment out of capital is first approved by special resolution of the company (s716 CA 2006);
- members who did not vote for the resolution, or creditors, have five weeks from the passing of the resolution to object to the court (s721 CA 2006) and the payment must not be made during that period (s723 CA 2006); and
- as LTT will be required to use capital to facilitate this purchase, a notice must be placed in the London Gazette and either the creditors must be informed or the notice must also be placed in a national newspaper (s719 CA 2006);
- the right to use capital is subject to any prohibition or restriction in the company's articles.

To use capital:

- Directors' statement in prescribed form with auditor's report annexed (s714 CA 2006).
- Special resolution to be passed within a week following the making by the directors of their declaration.
- The directors' declaration and the auditor's report must be available for inspection at the general meeting at which the special resolution is passed.
- The special resolution to use capital is void if it would not have been passed if the vendor had not voted.
- Note the publicity requirements and the time limit within which the purchase must be made.
- Create a capital redemption reserve.

Other procedural requirements: To buy back shares:

- Inspection of the contract or a memorandum of its terms (s696 CA 2006) (note time-scales) and board approval of terms;
- The ordinary resolution to buy back is void if it would not have been passed if the vendor had not voted (s695 CA 2006).
- Return to registrar of companies within 28 days of purchase (s707 CA 2006) and amend the register of members.

- Preservation of contract and inspection facilities for 10 years at registered office s702 CA 2006.

Question 3(a)

The potential consequence of acquiring from Whiskin & Co Limited (Whiskin) the freehold office for £250,000 is that it could be held to be a transaction at undervalue.

Where, at the 'relevant time', a company has entered into a transaction in which the company (i.e. Whiskin) receives, as in this instance, significantly less consideration than that provided by the company itself (i.e. the value of the property), the transaction may be held to be one at an undervalue and the court must make an order to restore the position to what it would have been if the company had not made the transaction (s238 Insolvency Act 1986).

The time at which a company enters into a transaction at an undervalue is a 'relevant time' if the transaction is entered into within two years of the onset of insolvency, provided that the company is unable to pay its debts at that time (s240 Insolvency Act 1986). It appears here that Whiskin is indeed unable to pay its debts.

Applying the facts, the sale may well be deemed would be at a transaction at an undervalue and it is difficult to see how it would benefit the company, as the company, Whiskin, is seeking to sell a property valued at £345,000 for £250,000. However, there is a defence of good faith with reasonable grounds for believing that the transaction would benefit the company, although nothing there is to suggest this at the moment.

Consequently, the transaction would be set aside if Whiskin were to go into liquidation within the relevant time, and the company were at the date of the transaction unable to pay its debts within the meaning of s123 Insolvency Act 1986. Whiskin may be close to the 'onset of insolvency', which is the date of the presentation of the petition for the administration order or the date of the commencement of the winding up (s240 Insolvency Act 1986).

As such, should Whiskin go into liquidation either an administrator or a liquidator can apply to the court to set aside the transaction (s238(1) Insolvency Act 1986). This could see the property transferred as part of the transaction to be re-vested in the Whiskin, meaning that CFT would lose the building acquired and it is unlikely that they will be able claim they entered into the transaction in good faith as the value proposed is less than market value.

Accordingly, he directors of Clayton Financial Training Limited (CFT) should be aware of their general duties to promote the success of the company (s172) and exercise reasonable care, skill and diligence (s174 CA 2006); which they may breach if they proceed where they know or ought to know that the transaction is subject to challenge as a transaction at an undervalue.

(b)

The proposed loan to Sean Bush would be a loan to a director. The relevant law is s197 CA 2006, which prohibits a company from entering into any loan, or guarantee in connection with a loan made by any person, to one of its directors, unless approved by a shareholders' ordinary resolution.

Section 197 CA 2006 requires that, in addition to obtaining member consent, a written memorandum setting out the nature of the transaction or arrangement, the amount and purpose of the loan and the extent of the company's liability connected with it must be made available to members before they give their approval by way of ordinary resolution.

Shareholder approval may not be required if an exception applies. The one most likely to be applicable here is the s204 CA 2006 exception for expenditure on company business where the proposed loan is less than £50,000. Given the reasons for making the loan, and the fact that it is £13,500, the exception will therefore apply and an ordinary resolution of the shareholders will not be required.

In any event the decision to grant the loan is a directors' decision. Sean must also disclose his interest (s177 CA 2006) and cannot count in the quorum, and not vote on the matter (Article 14 Model Articles).

Question 4 (a)

Directors have general authority to grant services contracts (Article 3), however as Sean's proposed director's service contract for three years, i.e. exceeding two years, the term must be approved by an OR (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) prior to the GM or attached to any Written Resolution (if used, s288-300 CA 2006). 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).

Sean 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. Sean may not however vote or be counted in the quorum at the board meeting called to approve her service contract (Article 14 Model Articles).

Administration: BM minutes and resolutions (to hold the required GM/WR to approve the term and any subsequent Board Meeting to authorised and grant the service contract), Notice of GM or WRs and minutes, the necessary OR, 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.

(b)

Tax implications for Sean 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. Sean'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 Sean 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).

(c)

In order to accept the loan from CFT, LTT's articles of association should be reviewed to confirm that there are no restrictions on the company's power to borrow money and to give security, and that its directors have the power to approve the loan and to issue a debenture. By virtue of s31 Companies Act 2006 (CA 2006), any company has unlimited capacity, save insofar as the company's articles of association expressly limit its capacity. LTT has the Model Articles of Association for a private company limited by shares. The Model Articles do not contain any such express limitation of the company's capacity. At common law a trading company has an implied power to borrow money. Therefore, LTT will have the power to borrow money and to give security. Moreover, the Model Articles also give the directors a general authority to exercise all the powers of the company which would include the power to borrow without limit and to give security (Model Articles, Article 3).

However, it may be prudent to incorporate into the constitution an express power authorising the directors to exercise the company's power to borrow. It is highly likely that CFT's advisers (if he has any) will request such an amendment. 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).

On the assumption that the loan will be secured by way of a first fixed and floating charge over the assets of the company, searches should still be undertaken of the company's register of charges, at Companies House and at the Land Registry/Land Charges Registry to make sure there are no prior charges registered. Note that the company search already shows a previously registered charged. As such this subsequent charge will rank below in order of priority.

Once the charge has been created, the charge may be registered by delivering a s859D statement of particulars to Companies House (s859A(2) CA 2006), and a certified copy of the instrument creating the charge (s859A(3) CA 2006). It is very likely that CFT's advisers will want to register the charges using Form MR01 which they should submit to Companies House within 21 days beginning with the day after the day on which the charge was created (s859A(2) and (4) CA 2006), together with the fee.

Registration of the charge is voluntary but failure to register it within the time limit renders the charge void against a liquidator or an administrator of the company, and also against the company's other creditors (s859H(3) CA 2006). For that reason the lender will want to make sure the charges are registered.

The Registrar issues a certificate of registration (s859A(2) and s859I(3) CA 2006), which (under s859I(6) CA 2006) is conclusive evidence that the charge is properly registered. If the charge is going to be over freehold property then it should be registered with the Land Registry if it is registered land.

In the event that the charge was not registered, LTT can make an application to the court for registration out of time under s859M CA 2006; this procedure allows the court, if satisfied the omission to register was accidental, to extend the time for registration. Alternatively, CFT's advisers may request LTT to grant a new charge and attempt to ensure that this is registered before any third party registers a charge that would take precedence. A further risk in granting a new charge is that if LTT goes into insolvent liquidation or administration shortly after its creation, the new charge may be open to challenge either as a preference under s238 Insolvency Act 1986 or the floating charge may be invalid under s245 IA 1986 unless it was granted for new consideration.