Business Organisations and Agency

Modern Business Law: Parts 5–7

Lawrence Emeka Modeme

LAWRENCE EMEKA MODEME

BUSINESS ORGANISATIONS AND AGENCY

MODERN BUSINESS LAW PART 5–7

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PART 5: PARTNERSHIPS AND COMPANIES

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18 PARTNERSHIPS

18.1 INTRODUCTION

A business may operate as a sole proprietorship, partnership or company. The choice of business organization is determined by many things, including, the number of people involved, the amount of money they have to invest, their ambition, their need for privacy and control, the nature of business, etc. The most important of the business forms are partnerships (in its various formats) and incorporated companies and are the ones with which we shall mostly concern ourselves. Sole proprietorships are of limited importance in terms of law relating to businesses. It is the simplest and most flexible form of business medium and has minimal formality. A sole proprietorship is typically an unincorporated business owned and operated by one individual, albeit sometimes with the help of people who are not co-owners. Such a business enterprise would not be a separate legal entity under the law, but rather would be an extension of the individual who owns it. The owner has possession of the business assets and is directly responsible for the liabilities incurred by the business. The profits and losses of a sole proprietorship are combined with the other incomes of the owner for income tax purposes. There are three types of partnerships, namely, the general partnership, the limited partnership, and the limited liability partnership.

18.2 LEARNING OBJECTIVES

At the end of this chapter, the reader should clearly understand:

- The meaning and nature of partnerships
- The nature of a general partnership and its characteristics
- The relative advantages and disadvantages of doing business as a general partnership
- The nature of limited partnerships and it characteristics and limitations
- The nature and characteristics of limited liability partnerships
- The relative advantages and disadvantages of limited liability partnerships

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18.3 THE GENERAL PARTNERSHIP

The general partnership is the traditional or ordinary form of partnership with others being later modifications of, or departures from, it. Unless otherwise indicated, a partnership would be a general partnership; and unless otherwise excluded by partnership agreement, the provisions of the *Partnership Act (PA) 1890* govern general partnerships. However, as observed by Lord Millet in *Khan v Mia and others* [2000] 1 WLR 2123, the provision of the Act are not statutory presumptions but default provisions; very slight evidence would be required to exclude their application.

S.1 (1) PA 1890 defines a partnership as "the relation which subsists between persons carrying on a business in common with a view of profit." A general partnership is therefore an unincorporated business organization formed by two or more persons for a common undertaking in order to make profit. This implies that non-profit undertakings may not be formed as partnerships. Persons in a partnership are collectively called "a firm", and the name under which they do business is referred to as the "firm name" (*s. 4 PA 1890*).

18.3.1 DETERMINING WHETHER A PARTNERSHIP EXISTS

It must be noted that somebody would not be considered a partner merely because he is a joint owner of property or receives payment or remuneration (regular or irregular) from a business as a servant, agent or beneficiary of a deceased partner. In addition, although the receipt of a share of the profits of a business may be evidence of partnership, such a receipt by itself does not make a person a partner – *s. 2 PA 1890.* However, if some form of agreement is in place and business activities have commenced, a partnership may be deemed to have commenced even if actual trading had not started and even if a formal partnership agreement had not been drawn up.

Whether a partnership as contemplated by s.1(1) PA 1890 exists, in that the parties are *carrying on business in common with a view to profit*, is a question of fact depending on the circumstances of the case. The description given by the parties to their association is not conclusive.

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In *Stekel v Ellice* [1973] 1 WLR 191, the claimant joined the defendant's accountancy firm as a "salaried partner" with the agreement that he would become a full partner in seven months under a full agreement to be drawn up. This agreement was never drawn up before the parties fell out even though more than seven months had elapsed. It was held that the claimant was a full partner. According to the court, the question whether persons are in a partnership is one of substance rather than form; and the label given by the parties is not determinative. The term "salaried partner", was a convenient expression used widely to denote a person who is held out to the world as being a partner and whose name appears as a partner of the firm's notepaper.

In order for a partnership to be found to exist, there must be business activity, but actual trading does not need to have commenced.

Khan v Mia and others [2000] 1 WLR 2123 – Four people agreed to open a restaurant. The appellant contributed most of the capital in return for a 50% share while the respondents contributed management and cooking skill. Pursuant to the agreement, premises and some equipment necessary for the business were acquired, a partnership bank account opened and a loan arranged. The business was also advertised in the local press. In addition, there was a contract for the conversion and fitting out of the premises as a restaurant. However, following difficulties in raising money and a breakdown in the relationship of the parties, the restaurant did not take off as anticipated and the agreement between the parties was terminated. By this time, over £50,000 had been spent on the venture. The respondents eventually completed the preparations and opened the restaurant on their own without settling accounts with the appellant. It was held by the House of Lords that there was a partnership between the parties; that trading does not actually have to start before a partnership could exist; and that the appellant was entitled to a 50% share of the proceeds. According to Lord Millett:

> The acquisition, conversion and fitting out of the premises and the purchase of furniture and equipment were all part of the joint venture, were undertaken with a view of ultimate profit, and formed part of the business which the parties agreed to carry on in partnership together.

But, a mere agreement to start a business will not create a partnership if no business activity has been carried out.

In *Khan v Mia and others*, the House of Lords stated that, "there is no rule of law that the parties to a joint venture do not become partners until actual trading commences. The rule is that persons who agree to carry on a business activity as a joint venture do not become partners until they actually embark on the activity in question."

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The above ruling was followed by the Court of Appeal in *Ilott v Williams & Ors* [2013] EWCA Civ 645. In that case, the court held that no partnership existed because the parties had not commenced any activities in relation to the business. According to the court:

> The parties had a concept for a new business but as of April 2008 they had no means of creating any profit and had made no financial commitment apart from buying a domain name. The judge did not make a finding as to the cost involved in acquiring the domain name but there is no suggestion that it was significant. There is no evidence that any of the Four (people) sought to bind the other members of the Four. There was no agreement as to the business form which the Four would adopt for their business. There was no assurance of funding or of having the means to obtain regulatory approval. The questions of external funding, business model and regulatory approval were regarded by the parties as vital pieces of the jigsaw. In my judgment the judge was entitled to conclude that, without them, the parties were not bound together as partners.

To be a partnership, business must be carried on in common by the persons involved. Merely working with others will not suffice.

> *Spicer (Keith) Ltd v Mansell* [1970] all ER 462 – B and M had agreed to form a limited company in order to run a restaurant and began to take some steps to accomplish this. B ordered some goods from the claimant for use by the company when it was formed. The goods were delivered to the address of the proposed company. Later, B and M opened a joint account in the name of the proposed company but omitting to include "limited". B became bankrupt and the supplier of the goods sued M on the ground that he was in partnership with B. It was held that when the goods were ordered, both parties were merely working together to form a company and were not carrying on business in common with a view to profit. Accordingly, they were not partners within the meaning of s. 1(1) PA 1890, and M was not liable.

> *Saywell v Pope* (Inspector of Taxes) [1979] 53 TC 40 – Until 1972, S and P were carrying on business as partners. Later, in January 1973, they brought in two more persons (R and J) to help out in the business. In June 1975, a new agreement was drawn up in which R and J were designated as partners in the business from April1973, although they did not bring any capital into it. However, the firm's banks, creditors and customers were not notified of any change in the partnership composition and the bank mandate in favour of S and P remained unchanged. It was held that the agreement of June 1975 had not created a partnership in favour of R and J.

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For a partnership to exist, there must be business carried on by the persons concerned with a view to making profits. In *Pitreavie Golf Club v Penman [1934] SLT 247*, it was held that an unincorporated golf club set up for members to play golf was not a partnership since the motive was not profit making.

However, although, business must be carried on in common with a view to making profits, sharing or receiving profits is not necessary.

> *M Young Legal Associates Ltd v Zahid Solicitors (A Firm) [2006] EWCA Civ 613* – A retired solicitor entered into an oral agreement with a newly qualified solicitor under which he provided supervision for the practice as required by Law Society Regulations. The retired solicitor did not contribute any capital and was paid a fixed salary unconnected with the profits of the firm. In an action against the firm for damages by the claimant, it had to be decided whether the retired solicitor was indeed a partner for the purpose of joint liability.
>
> It was held (by the Court of Appeal) that the retired solicitor was a partner since the requirements of s.1(1) PA 1890 had been satisfied. It was possible for a person to be a partner and liable with the others for the firm's debts even if he received only a specific amount as remuneration irrespective of profit.

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Hodson v Hodson [2009] EWCA Civ 1042; [2010] PNLR 8 – Due to ill health, R, a solicitor, sold her practice to C, a junior solicitor. However, in order to satisfy the requirements of the Law Society, both parties entered a three-year partnership agreement under which R would supervise C's practice. Under the agreement, R would get 1% of the profits while C would keep the rest. For most of the agreement period R provided the agreed supervision (usually from home) until the need for it was dispensed with by the Law Society. She was described as a partner in the firm's notepaper and she had access to the firm's client account and other facilities. However, R did not collect her share of the profits for the two years preceding the court case. On being joined in action against C for liability in negligence, R denied being a partner on the ground that: (a) the arrangement was merely a matter of convenience to enable C satisfy Law Society regulations; (b) she took no share of the firm's profits; and (c) she did not work in the firm's offices and had no influence in its business.

It was held that the requirements of a partnership had been satisfied, namely the carrying on of business by two or more people with a view to making profit, and that the actual receipt of a share of the profits was not necessary for the status of a partner to exist.

18.3.2 FORMATION OF PARTNERSHIPS

Any number of individuals could form a partnership. A partnership is relatively easy to form, there being no formal legal requirements for registration. It may be formed by deed, in writing, orally or by conduct. Partnerships are normally formed by the contractual agreement (articles of partnership) entered into by the partners as such, but which would be supplemented by implied terms under the *PA 1890*, unless excluded by the agreement. The contract (articles) of partnership will normally make provisions for things like:

- The name of the firm and the names of the partners
- The location of the business
- The contributions of each partner to the business
- How the profits of the business would be shared
- How decisions would be reached
- The power of the partners to bind or not bind the firm
- Management of the firm, and the right of the partners with respect thereto
- The firm's account and the signatories thereto
- The admission and expulsion of partners
- The settlement of disputes
- The value of the firm's good will
- The obligation of the partners not to compete with the firm
- The death and retirement of partners
- The dissolution of the partnership

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18.3.3 RIGHTS OF PARTNERS

Under *s. 24 PA 1890,* unless the partnership agreement expressly or impliedly provides otherwise, partners have the:

- Right to share equally in the capital, profits and losses of the business. However, there is no right to remuneration for acting in the partnership business.
- Right to participate in management.
- Right to indemnity in respect of payments made or liabilities incurred in the normal conduct of the firm's business or for the preservation of the business or its property
- Right to interest on any money advanced to the firm beyond the agreed contribution from the firm's profits.
- The right to consent before the introduction of another partner.
- Right not to have any changes made in the nature of the partnership without the consent of all partners.
- Right to settle differences by a majority decision.
- Right of access to and a copy of the books of the firm.

In addition, s. 25 provides that no partner may be expelled from the firm by others unless the power to do so is included in the partnership agreement.

Under s. 20(1) all partnership property – i.e. properties brought in or acquired on account or for the purposes of the partnership and in the course of the business – are to be held and applied exclusively for the partnership business and in accordance with the partnership agreement. What is partnership property may be the subject of disputation where the agreement did not make express provisions. In that kind of situation, the court will determine what partnership property included by reference to what is necessary to give the partnership agreement business efficacy.

> In *Don King Productions Inc. v Warren [1999]* 2 All ER 216, it was held that partnership property included unassignable personal boxing management contracts held by one of the partners. In *Miles v Clarke [1953] 1 All ER 779*, it was held that stock used by partners in a photography business was partnership property, while the lease of the premises held by one of the partners was not.

Partnership property also includes its goodwill and general business connections.

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18.3.4 LIABILITY OF PARTNERS

Partners are generally liable jointly and severally for everything for which the firm would be liable while they were partners – s.12. The liability extends to:

- The debts of the firm incurred while they were partners – s. 9.
- Any wrongdoing committed, or any loss caused, to a third party by any partner in the course of business – s.10. The phrase "course of business" is given a wide interpretation to include acts closely connected to the firm's business.

In *Blyth v Fladgate* [1891] 1 Ch 337 – A partner in a firm of solicitors was negligent in preparing a mortgage on behalf of a client. This made the client to lose money. It was held that the partners were jointly and severally liable for the partner's negligence.

Similarly, in *Dubai Aluminium Co Ltd v Salaam* [2003] 2 AC 366, a solicitor in firm of solicitors was involved in a scheme to defraud Dubai Aluminium of millions of pounds. He drafted the relevant documents to facilitate the fraud of which the other partners were unaware and which was not part of the firm's business. It had to be decided whether the firm and the other partners are vicariously liable for the fraud.

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It was held by the House of Lords that the acts of the fraudulent solicitor were so close to the activities that a solicitor would normally undertake, that in favour of third parties, it must be assumed that he acted in the ordinary course of his business. The other partners were therefore vicariously liable for them. According to the court:

> Perhaps the best general answer is that the wrongful conduct must be so closely connected with acts the partner or employee was authorised to do that, for the purpose of the liability of the firm or the employer to third parties, the wrongful conduct may fairly and properly be regarded as done by the partner while acting in the ordinary course of the firm's business or the employee's employment.

Conversely, in *Arbuckle v Taylor* [1815] *3 Dow 160*, it was held that the malicious prosecution and false imprisonment of somebody on allegations of theft by a partner without the involvement of the other partners were not the acts of the firm or the other partners merely because the property belonged to the firm.

- Any misapplication of a third party's money or property by the firm or a partner acting within its apparent authority – s. 11.
- Retired partners and the estate of dead partners will still be liable for the firm's outstanding debts if these were incurred while they were still partners. Retired partners may also be liable for debts incurred after their retirement unless notice of the retirement had been given to the creditors or unless there is an agreement discharging him therefrom – s. 17(2)(3).

However, a new partner will not be liable for any liabilities of the firm incurred before he became a partner – s. 17(1). The estate of a dead, bankrupt or retired partner will also not be liable for liabilities incurred after the death, bankruptcy or retirement, provided this was notified to the public or persons concerned – s. 36(3).

18.3.5 LIABILITY FOR HOLDING OUT AS A PARTNER

If a person, in writing, orally or by conduct, holds himself out, or allows himself to be held out as a partner and because of that a third party gives credit to the firm, that person would be liable to the third party for the money. However, the continued use of a firm's name after the death or retirement of a partner shall not make the dead partner's estate liable for the firm's new debts – s. 14.

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Tower Cabinet Co Ltd v Ingram [1949] 1 All ER 1033 – Ingram was in a partnership with C but subsequently retired, with C promising to inform the firm's customers of Ingram's retirement. C later ordered goods from the claimant (which had not previously dealt with the firm) with old notepaper which had the name of Ingram as a partner. He failed to pay for the goods. The claimant sued Ingram for the money on the ground that he held himself out as a partner in the firm. It was held that Ingram was not liable and did not hold himself out as a partner.

A similar decision was reached in *UCB Home Loans Corp Ltd v Soni and Soni* & Co [2013] EWCA Civ 62. S and K were partners in a firm of solicitors, but S also had a sole practice. S borrowed £2.5 million from the claimant bank in exchange for the bogus mortgage of his five houses. Although the transactions were in his personal capacity, he falsely claimed to be acting on behalf of the partnership and forged the signature of K on the relevant documents. S defaulted on the loans. It was held by the Court of Appeal that K was not liable since he was not party to S's representations to the Bank and did not hold S out as representing him or their firm.

18.3.6 PARTNERS AS AGENTS

Every general partner is an agent of the firm and can bind it and the other partners in respect of:

- Any act done in the normal cause of the firm's usual business, unless the particular partner had no such right under the agreement and the third party knows it or does not believe or know him to be a partner (*s. 5 PA 1890*)
- Any act or instrument relating to the business of the firm executed by a partner in the name or on behalf of the firm (*s. 6 PA 1890*)

Thus, the authority of a general partner to bind others and the firm is both actual and apparent. Actual authority arises from the partnership contract, while apparent authority arises from the fact of the partnership and the powers incidental thereto. The apparent authority is irrespective of contract and therefore subsists even if the partnership contract forbids the partners from doing the thing complained about unless this fact has been brought to the notice of the third party.

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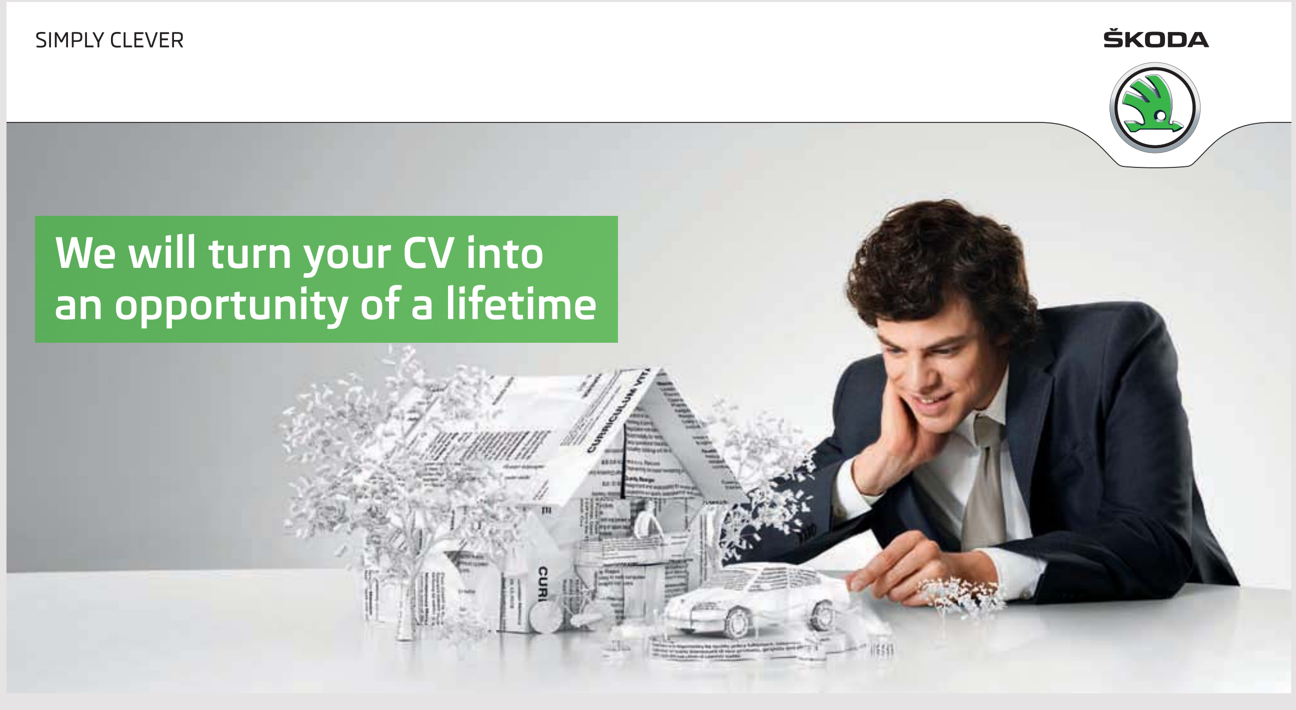
> In *Mercantile Credit Co v Garrod* [1962] 3 All ER 1103, a partnership involved car repairs and letting of lock-up garages. The partnership agreement forbade the partners from buying and selling cars. In breach of this agreement, the managing partner sold a car to the claimant. The claimant sued the sleeping partner to recover the money. The sleeping partner denied liability on the ground that the sale was done outside the scope of the partnership and in breach of the partnership agreement. It was held that the transaction was within the scope of the partnership business since it appeared to outsiders as such; and that it did not matter that the sale was in breach of the partnership agreement.

A person dealing with a partnership after its membership has changed is entitled to regard all apparent members of the firm as still members unless he has notice of the change in membership or the change has been properly advertised – s. 36(1).

However, a partner cannot bind the firm or the other partners:

- If he goes outside the scope of the partnership business or undertakes a personal transaction.
- If the partners have agreed that a particular partner would not be able to bind the firm, provided the third party had notice of this agreement – s. 8.



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- A credit arrangement was undertaken by a partner in a private capacity or in relation to something unconnected to the ordinary business of the firm – s. 7.

In *JJ Coughlan Ltd v Ruparelia and others* [2003] All ER 344, one of the partners in a firm of solicitors, acting in concert with some conmen, defrauded the claimant of $500,000 under a false promise to give it a return of $2.5million on a short term investment. It was held that the firm was not liable under sections 5 and 10 of the PA 1890 since the extra-ordinary scheme by the partner was not in the normal scope of solicitors' business.

18.3.7 DUTIES OF PARTNERS

Partners are in a fiduciary position to one another. They are supposed to act in good faith and in the interest of the firm and to deal with each other fairly. Every general partner owes the other partners the duties discussed below:

18.3.7.1 Duty of account and information

Partners are under a duty to render due and true account and provide full information in respect of partnership matters with which they are concerned – s. 28.

In *Law v Law* [1905] 1 Ch 140, it was held that in a transaction between co-partners for the sale by one to the other of a share in the partnership business, if the purchasing partner knew more about the partnership account and possessed all material facts about the partnership assets, he was under a duty to make a full disclosure of these to the vendor. If he failed to do this, the transaction would be voidable and might be set aside unless the vendor knowingly chooses not to insist on his right to full disclosure.

18.3.7.2 Duty to account for profits

Partners must account to other partners for all profits made without the knowledge or consent of the other partners from any transaction concerning the partnership, its property or business connection – s. 29.

In *Bentley v Craven* [1853] 18 Beav 75, a partner in a firm was responsible for purchasing sugar. He bought the sugar at a discount but sold it to the firm at the market price. It was held that the other partners were entitled to an account of the profits.

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In *Pathirana v Pathirana* [1967] 1 AC 233, a firm had an exclusive contract with a company. One of the partners in the firm terminated the partnership and entered into another deal with the same company in his own personal capacity. The other partner sued for an account of the profits. It was held that that the new contract was the property of the partnership since it arose from its goodwill and connections, and that the claimant was entitled to an account.

See also *John Taylors v Masons & Wilsons* [2001] EWCA Civ 2106.

18.3.7.3 Duty not to compete with the firm

Partners have a duty not to compete with their firm without the consent of the other partners and to account to the firm for any profits made from any unauthorised competition – s. 30.

18.3.8 DISSOLUTION OF PARTNERSHIPS

A partnership may come to an end in different ways, namely retirement, expiration of time, death, bankruptcy or charge. Others are illegality and court order.

18.3.8.1 Retirement

Where the partnership is not for a fixed duration, any partner may terminate it at any time by giving notice orally, in writing or by deed (depending on how the partnership was formed) to the others of his intention to retire.

18.3.8.2 Expiration of time

Unless the partners agree otherwise, a general partnership dissolves at the end of the time stipulated in the agreement; by the end of the venture or undertaking for which sole purpose it was set up; or by notice of intention to dissolve by any partner if the partnership was for an indefinite duration – s. 32.

18.3.8.3 Bankruptcy, charge or death

Unless the partners agree otherwise, a general partnership would dissolve by the death or bankruptcy of any partner. Moreover, other partners may choose to dissolve the partnership if any partner uses his share of the business as security for a personal debt – s. 33.

18.3.8.4 Illegality

A partnership will dissolve if it has become illegal for the partnership or business to continue or if it has become illegal for the partners or any of them to continue in the partnership – s. 34.

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18.3.8.5 Court order

A court may, on application by or on behalf of any partner, order the dissolution of the firm. The order of dissolution could be given because:

- A partner has become insane or of unsound mind
- A partner has become permanently incapable of performing his responsibilities
- A partner has conducted himself in a manner prejudicial to the business
- A partner has persistently breached the partnership agreement or acted in a manner making it impracticable for others to remain in partnership with him
- The business can only be operated at a loss
- It is just and equitable in the circumstances to dissolve the partnership – s. 35.

If a partner had joined for a fix term and has paid a premium but the firm is dissolved before the expiration of that term, that partner would be entitled to a refund of part of his premium as appropriate. However, there will be no refund if the dissolution was due to the fault of the partner or if there is no right to a return of premium in the partnership agreement – s. 40.

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If a partner had died or ceased to be a partner but the surviving partners continue the business with assets of that partner, that partner or his estate will be entitled to a share of the profits in proportion to his asset unless the other partners had bought out his interest – s. 42. If the share of profits is not paid, it will remain a debt owed to the partner – s. 43.

18.3.9 WINDING UP OF PARTNERSHIPS

After a partnership has been dissolved, its affairs will have to be wound up. The authority of a partner (except one who has become bankrupt) to bind the firm continues after its dissolution for the purpose of winding up the affairs of the firm and outstanding transactions – s. 38. Following dissolution, any losses or debts would be paid first from the profits, then from assets, and then from the personal assets of the partners in accordance with their profit-sharing formula. Thereafter, any money and assets of the partnership should be used to settle the liabilities of the firm; to pay back to the partners any advances they had given to the firm; and to return the partners' capital contributions. Then any left-over would be shared by the partners according to the firms' profit-sharing formula (s 44), provided that any money they owe to the firm has been deducted – s. 39).

18.3.10 ADVANTAGES PARTNERSHIPS

There are many advantages arising from doing business as a partnership. One advantage is the ease of formation. Since setting up of a partnership does not require any particular formality, it is very easy to start it. In addition, there is minimal statutory regulation in the manner in which a partnership runs its business and in the publication of its activities and accounts. These afford partnerships relative privacy.

Another advantage of partnerships is equality on which the relationship of the partners is based. Unless the partnership agreement stipulates otherwise, every partner is entitled to participate equally in the contribution of capital, in the share of profits, and in the management of the business. To this end, no partner can be expelled by the majority of partners unless the power to do so had been included in the partnership agreement – s. 25. This gives every partner equal stake and control in the business. It also means that the partners are likely to be more committed to the success of their business than they would be otherwise.

Partnerships afford flexibility to the partners and the firm. Although the provisions of the *Partnership Act 1890* are applicable to partnerships, they are essentially based on contract willingly agreed to by the partners. The partners in any firm are free to configure their business as it would suit them best. The *Partnership Act 1890* and the terms implied in it apply only where there are no partnership contracts or provisions relating to particular matters.

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Moreover, because partnerships can involve any number of persons, partners could finance their business from different quarters. This gives them more scope to grow than a sole proprietorship. Moreover, since partners may come with different abilities, skills and connections, the human resources available to a partnership could be considerable.

18.3.11 DISADVANTAGES OF PARTNERSHIPS

A partnership has a number of disadvantages, including the absence of separate legal personality and perpetual succession, and the unlimited liability of partners. For all legal purposes, a firm is not different from the partners. For this reason, debts owed by the firm are deemed to be owed by the partners, and wrongdoings of the partners in the course of business are deemed to be those of the firm. Moreover, every partner is deemed to be an agent of the firm and can bind them to contract even in breach of the partnership agreement.

Partners are fully liable for their firm's debts. Any debt owed by the firm could be satisfied from the personal finances or assets of the partners. In this respect, a partnership is similar to a sole proprietorship. This is one of the main drawbacks of traditional partnerships. Since a partnership has no separate legal personality, there is no automatic perpetual succession of membership; and a beneficiary cannot automatically inherit the interest of a partner. This means that unless otherwise stipulated in the partnership agreement, a general partnership will dissolve on the departure, bankruptcy or death of any of the partners or if a partner has used his share of the business as security for a personal debt (s. 33 Partnership Act 1890).

18.4 LIMITED PARTNERSHIPS

This type of partnership confers limited liability for the firm's debts on one or some of the partners while others remain fully liable as general partners. Being a limited partner may appeal to people who wish to invest in a business in which they do not have much expertise, of which they do not wish to manage, or the financial risks of which they do not intend fully to bear. Limited partnerships are used mainly in the private equity, venture capital or investment industry. A limited partner may be a human being or an incorporated company; however, a person may not be a limited partner and a general partner at the same time.

Limited partnerships are governed by the *Limited Partnerships Act (LPA) 1907* (as amended by the *Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013*). The Act introduced some modification on general partnerships, but unless expressly excluded, the Pa*rtnership Act 1890* and the rules of common law and equity on partnerships remain applicable to limited partnerships – s. 7. The name of a limited partnership must end with "LP", as in "Jonson and Smith LP".

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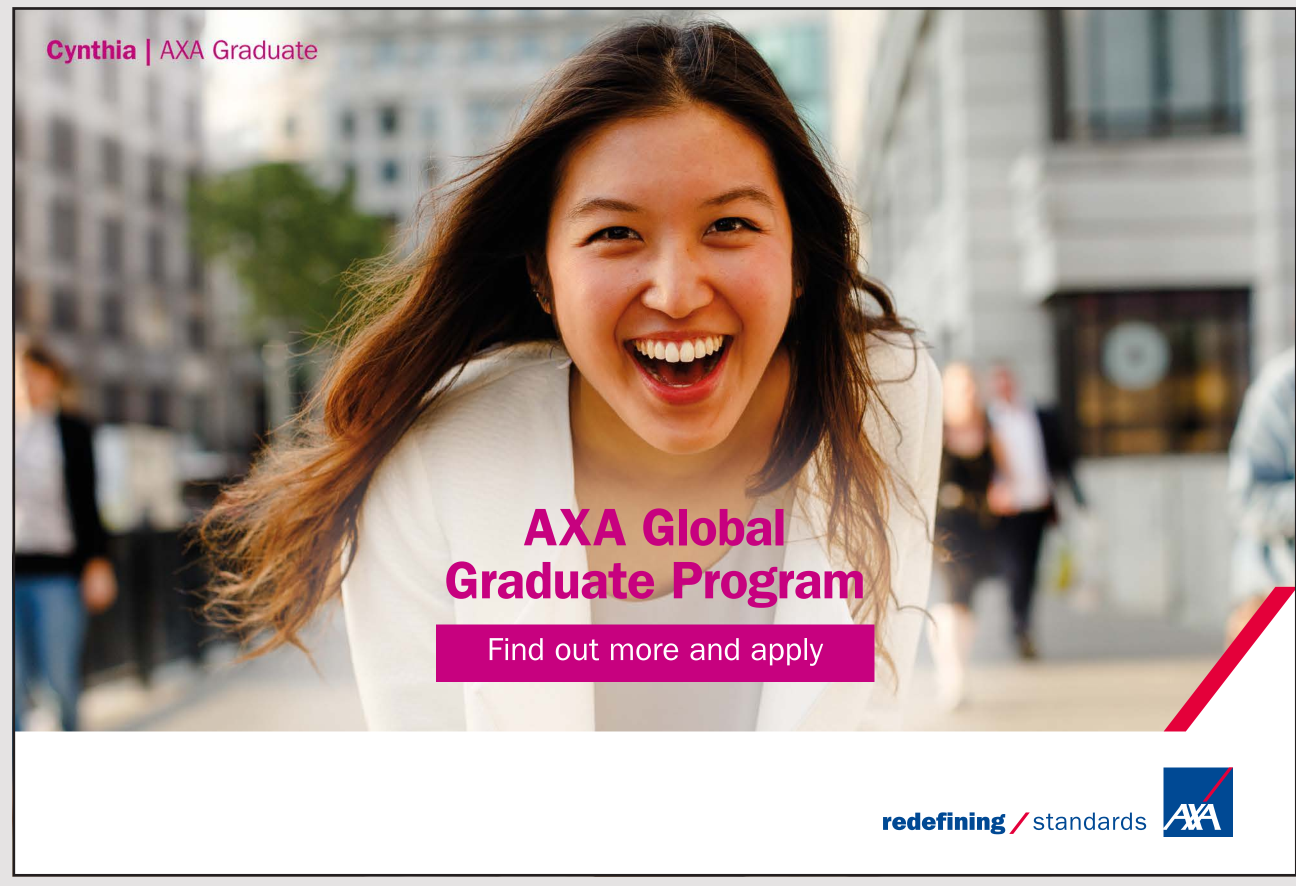
18.4.1 REQUIREMENTS FOR LIMITED LIABILITY

According to *s. 4 of the LPA 1907*:

2) A limited partnership must consist of one or more persons called general partners who shall be liable for all debts and obligations of the firm, and one or more persons to be called limited partners, who shall at the time of entering into such partnership contribute thereto a sum or sums as capital or property valued at a stated amount, and who shall not be liable for the debts or obligations of the firm beyond the amount so contributed.
3) A limited partner shall not during the continuance of the partnership, either directly or indirectly, draw out or receive back any part of his contribution, and if he does so draw out or receive back any such part, shall be liable for the debts and obligations of the firm up to the amount so drawn out or received back.



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Thus, in order to enjoy limited liability:

- A partner must make a specific contribution to the business and must not draw from or receive back this capital during the life of the partnership. Contribution may be drawn or received only where the limited partnership is authorised by the Financial Conduct Authority (FCA) to operate an Authorised Contractual Scheme (ACS). In this case, it becomes an "authorised limited partnership".
- The partner must not take part in the management of the firm although he may inspect its books and advise the general partners. s. 6(1).
- There must be at least one general or managing partner who remains fully liable for debts of firm
- The firm must be registered as a limited partnership; otherwise, it reverts to general partnership – s. 5.

If a limited partner takes part in management, he will lose his limited status and become liable with the others to the extent of the liability incurred while he was taking part in management – s. 6(1).

Similarly, if a limited partner draws from or receives his contribution or part thereof, he will be liable for liabilities incurred by the firm to the extent of the amount drawn out or received – s. 4(3).

18.4.2 MODIFICATIONS OF PARTNERSHIP LAW IN RELATION TO LIMITED PARTNERSHIPS

- A limited partner will not be an agent of the firm or other partners and will therefore not be able to bind them to any contract.
- A limited partner will not be liable to the wrongdoings of the other partners and will only be liable to their debts to the extent of his contribution.
- The death, retirement, bankruptcy or incapacity of a limited partner shall not dissolve the partnership – s. 6(2).
- General partners shall not be entitled to dissolve the partnership because a limited partner had used his share in the business as security for a loan; and a limited partner cannot dissolve the partnership by giving notice to the other partners; and – s. 6(5)(c)(e).
- Decision in the business will be made by a majority of the general partners who may admit partners into the business without reference to the limited partner – s. 6(5)(a)(d).

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18.4.3 REGISTRATION OF LIMITED PARTNERSHIPS

A limited partnership must be formally registered and receive a certificate of registration. Until a partnership is registered as limited, it will be regarded as a general partnership and all the partners will be regarded as general partners. In order to register a limited partnership, an application form (LP5) must be completed, signed by all the partners, and delivered to the registrar of companies. The following particulars must be given in the application form:

- The firm name;
- The general nature of the business;
- The principal place of business;
- The full name of each of the partners;
- The term, if any, for which the partnership is entered into, and the date of its commencement;
- A statement that the partnership is limited, and the description of every limited partner as such;
- The sum contributed by each limited partner, and whether it was paid in cash or otherwise – s. 8.

The limited partnership comes into existence upon the acceptance and registration of the LP5 by the registrar who will issue a certificate of registration.

Any change in any of the above particulars during the continuance of the partnership must be communicated to the registrar (using form LP 6) – s. 9.

For more information about limited partnerships, visit: https://www.gov.uk/set-up-and-run-limited-partnership.

18.5 LIMITED LIABILITY PARTNERSHIPS

The complexities and size of some partnership businesses, the need to offer more protection to certain professional people, and the need to encourage growth and longevity, make the general partnership unsuitable for some. The *Limited Liability Partnerships Act 2000* created limited liability partnerships to address these types of situation. S. 1 of the Act describes this type of partnership as an incorporated business with a separate legal personality and unlimited liability. The general law relating to partnerships do not apply to LLP, except as otherwise provided for in the Act or any other enactment. The extent of the liability of partners to contribute to the firm's assets is as provided under the Act.

The limited liability partnership is a hybrid business format combining a corporate structure with the internal workings and relationships of a general partnership. The name of the firm must end with "Limited Liability Partnership" or "LLP", as in "Jonson and Smith LLP".

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18.5.1 FORMATION OF LIMITED LIABILITY PARTNERSHIPS

Limited liability partnerships are formed only when they are incorporated by the Registrar of Companies. In order for incorporation to take place, two or more persons must associate for the purpose of carrying on a lawful business with a view to making profit and must subscribe to an application for registration, which must be delivered to the Registrar of Companies – s. 2(1). The application for incorporation must contain the following information:

- The name of the limited liability partnership;
- Whether the registered office of the partnership is to be situated in England and Wales, in Wales or in Scotland;
- The address of that registered office;
- The designated members or partners; and
- The name and address of the members or partners.

The LLP, as earlier noted, comes into existence when the registrar of companies registers the partnership and issues a certificate of incorporation to that effect – s. 3.

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18.5.2 MEMBERS OF THE PARTNERSHIP

The members of a LLP are those who subscribed to the incorporation document and other persons who may subsequently be admitted into the business by them. A person may cease to be a member of the partnership by death or by giving reasonable notice to the other members of his intention to leave – s. 4(3). However, the death or resignation of a partner will not dissolve the firm.

18.5.3 SIMILARITIES OF LLP TO A GENERAL PARTNERSHIP

- The members of a limited liability partnership may stipulate the nature of their relationship in their partnership agreement or in an agreement between the partners and the LLP – s. 5(1). In the absence of an agreement, the rules relating to general partners apply as appropriate – s.15(c).
- Like general partnerships, there is no requirement for LLPs to be managed in a particular way. The members may determine this by agreement. In the absence of any contrary agreement, all members have equal right to participate in management.
- The rules in general partnership relating to agency are also applicable to LLP – s.6. Thus, the members are agents of one another and the firm and have authority to bind them, except to the extent that authority is limited by agreement.
- The properties of a LLP are treated as normal partnership property – s. 10.
- The tax and National Insurance contributions of the members are calculated in the same way as those of general partners – s.10 and 13.

18.5.4 SIMILARITIES OF LLP TO A LIMITED LIABILITY COMPANY

- Like a company, the firm is incorporated by the Registrar of Companies and has a certificate of incorporation.
- The firm has a separate legal personality; accordingly, third parties contract with the firm rather than the partners.
- The firm is liable for its debts and obligations. However, in some circumstances, partners can be made to contribute to the assets of the firm on insolvency or winding up (in the event of fraudulent or wrongful trading), and that obligation may remain for up to five years – s. 10.
- The firm has unlimited contractual capacity like a limited liability company.
- Like a company, the LLP has perpetual succession, in that the death, departure, etc. of a partner does not dissolve the firm.
- The firm can secure loans with fixed and floating charges just like a company.

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- The firm is (with modifications) regulated as limited liability companies. For example, the firm is required to file membership records, audited accounts, annual returns, charges etc., with the Companies Registrar – see the *Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009.*
- The firm is wound up in a similar way as companies.

For more information about the LLP, visit: https://www.gov.uk/set-up-and-run-limited-liability-partnership

18.6 CHAPTER SUMMARY

- Partnerships are businesses set up by two or more persons for a common purpose and with a view to making profits.
- Any number of persons from two could form partnerships; and these include natural persons and incorporated bodies.
- There are three types of partnerships – the traditional or general partnership, the limited partnership, and the limited liability partnership.
- The traditional partnership is the normal or default form of partnership. Every partnership will be assumed to be traditional except it is registered as a limited partnership or a limited liability partnership.
- General partnerships are governed by the Partnership Act 1890 unless the partners draw up their own agreement and exclude its provisions.
- The general partnership is based on the equality of the partners on matters like contribution of capital, share of profit and liability for losses. If a different state of affairs is desired, the partners must state this in their partnership agreement.
- General partners have no separate legal personality. Accordingly, the partners are responsible for all the liabilities of the firm and for the wrongdoings of each other in the course of or in connection with the firm's business. For the same reason the departure or incapacity of one partner could dissolve the partnership.
- Partners have rights and duties which each of them is expected to benefit from and fulfil.
- The structure, simplicity, flexibility and privacy of a partnership confer on it some advantages over a company. There are however disadvantages, especially those relating and incidental to lack of legal personality.
- The limited partnership is a modified partnership by which one or more partners have limited liability as long as there is at least one general partner with unlimited liability; and as long as the rules relating to limited partnerships are maintained.

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- The limited liability partnership is a hybrid organisation which combines the attributes of a normal partnership with those of an incorporated company. It must be formally incorporated and wound up and is regulated largely as companies are. However, the inner workings of an LLP and the relationship of its members are similar to those of normal partnerships.
- The LLP is a useful medium for businesses where there are many partners or partners with different skills, or where the business is a complex one, yet the members do not wish to, or cannot, form a fully-fledged limited liability company.

18.7 PRACTICE QUESTIONS

1. State and explain the main advantages and disadvantages of a general partnership
2. State and explain the main duties of partners
3. Distinguish actual and ostensible authority of partners
4. State and explain the main advantages and disadvantages of limited partnerships
5. State and explain the main advantages and disadvantages of Limited Liability partnerships

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6. Three friends, Peter, James and John, wish to run a business buying and selling computers, computer software and accessories. They wish to set up a partnership but are not sure of the implications. They are also not sure about the type of partnership they should adopt. James and John are computer science graduates and are expected to provide the technical knowhow of the business. Peter is a businessman and will contribute most of the start-up capital for the business. However, Peter is busy with other things, does not wish to be involved in the daily activities of the new business, but wishes to have some say on in the business.

   Advise Peter, James and John on these issues and the best partnership option for them.

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19 COMPANIES

19.1 INTRODUCTION

Companies are the most advanced structure for the running of business. Companies come into existence by a process known as incorporation – a process that came into use in 1844 – although the concept of limited liability did not materialise until 1885. Companies are regulated by a huge body of rules contained primarily in the *Companies' Act (CA) 2006* (which) replaced the one of 1985. Some aspects of the Act came into force on December 31 2006, some in January 2007, and the rest in October 2008. The Act was designed to ease the formation of companies, reduce the regulatory burden on small companies, promote shareholder engagement and long-term investment outlook, and make the UK more competitive in the business world. Other key enactments relevant to companies are the *Insolvency Act 1986* and the *Company Directors' Disqualification Act 1986.*

19.2 LEARNING OBJECTIVES

At the end of this chapter, the reader should fully understand:

- The meaning of companies
- How companies are formed
- The different types of companies and their relative advantages

19.3 DEFINITION OF "COMPANY"

A company is defined in *s. 1 CA 2006* as any company formed, registered or existing under the new or old England or Northern Ireland Companies' Act or legislations. Thus, a business or association can only be a company if it is registered under or recognised by the Companies' Act as such.

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19.4 FORMATION OF COMPANIES

The process of forming companies is generally referred to as incorporation. A company may be incorporated in different ways, namely by *Royal Charter*, *Act of Parliament*, or *registration*. Companies incorporated by means of a royal charter (i.e., via the assent of the monarch) are referred to as chartered companies. These types of companies are usually set up for charitable, educational, professional, or non-profit purposes. Companies established by means of a law passed by the parliament are referred to as statutory companies. Public utility companies, such as electricity, water, and railway corporations, were incorporated in this manner. Certain offices are also given the status of a corporation independent of the persons who occupy them. Classic examples of this are bishops of the Church of England. However, the vast majority of companies are registered companies. These are companies formed in accordance with the registration procedure stipulated by the *Companies Act 2006*.

19.5 REGISTRATION OF COMPANIES

The procedure for the registration of companies are contained in *Part 2, ss. 7 – 16, CA 2006*. Those intending to register the company are required to submit to the Registrar of Companies in England, Scotland or Wales, the necessary documents containing the information relevant to the registration of the company. These documents are the memorandum of association, an application for registration, and a statement of compliance.

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19.5.1 THE MEMORANDUM OF ASSOCIATION

The Memorandum of Association is a formal document stating the names of the subscribers to the memorandum and the number of shares they have taken, or the extent of their interest, in the company. In effect, it the document is a statement by the original members or shareholders of company confirming their agreement to form the company.

19.5.2 AN APPLICATION FOR REGISTRATION

This is the formal application to the Registrar of Companies requesting that an organisation or business be registered as a company. The application must contain the following particulars:

- *Statement of the particulars of the first directors and secretary (or secretaries)* of the company and their residential and service addresses signed by or on behalf of the subscribers to the memorandum. The statement must contain the consent by each of the persons named on it as director or secretary to act in the relevant capacity, although a private company need not have a secretary (see chapter 25).
- *The company's proposed name.* This name must not be the same as that of any other incorporated company or registered trademark or so similar to it as to be likely to mislead. It must not also be such as to suggest a connection with the government, local authority, or the crown; neither must it be offensive nor contain sensitive or forbidden symbols.
- *Statement of intended location of the company's registered office* – i.e. whether it would be in England, Scotland, Wales or Northern Ireland.
- *The type of company* – whether limited, unlimited, limited by shares or by guarantee, and whether it is a public or private company.
- *Statement of capital and initial shareholding.* This is a statement as to the amount of share capital the company proposes to start business with. Only companies limited by shares are required to provide this statement. The statement should include the total amount of the share capital, its division into smaller units, the classes of shares and number of shares in each class and the rights attached to each class of shares, the number of shares taken by each subscriber, and the amount paid and owed on each share.
- *A copy of the company's Articles of Association*. If no Articles are provided, the relevant model Articles in the Companies Act would automatically apply to the company.
- *Statement of guarantee*. This is a statement as to the amount of guarantee provided by the subscribers. This is the amount each member agrees to pay if the company is wound up while he is a member or within one year after he ceased to be a member. Only companies limited by guarantee are required to provide this.

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19.5.3 A STATEMENT OF COMPLIANCE

This is a statement under oath made by the solicitor engaged in the formation of the company or by a person named as the first director or secretary in the Articles to the effect that the requirements of the Companies Act 2006 for the formation of the company have been complied with.

19.5.4 THE CERTIFICATE OF INCORPORATION

Once the necessary documents have been lodged and the registrar is satisfied with them, he will register the company and issue it a certificate of incorporation. Although the Registrar of Companies determines if a company should be registered, if the incorporation documents are in order and the requirements for incorporation are satisfied, he is not entitled to refuse registration. However, he may refuse registration, even though all formalities have been met, if the purpose of the proposed company is unlawful. This is because a company must not be formed for an unlawful purpose – s. 7(2) CA 2006.

The certificate of incorporation will have a unique number and contain the name of the company, the date of its registration, the type of company it is, and the situation of its registered office. The certificate of incorporation would be conclusive evidence that the requirements of the Companies Act have been complied with and that the association is a company authorised to be registered and has been duly registered. Private companies are entitled to commence business on the date of the issue of the certificate of incorporation. For public companies, they also have to obtain a *trading certificate* before they could start business. This certificate confirms that the company has the requisite minimum capital.

19.6 THE COMPANY PROMOTER

A company cannot conceive or register itself; there would usually be somebody who gets the idea to start a company, undertakes its registration, and submits the necessary application and documents to the Registrar of companies. Such a person would be the promoter of the company. According to Cockburn J. in *Twycross v. Grant* [1877] 2 CPD 469 at 541, a promoter as someone who "undertakes to form a company with reference to a given project and to set it going, and who takes the necessary steps to accomplish that purpose." A promoter may (and often does) become a shareholder or director of the company.

Promoters, like directors of a company are fiduciaries. This means that they must act in good faith and in the best interest of the company. They must not make secret profits from their position and must account for any such profits made. Any contract between a promoter and the company are pre-incorporation contracts and could be made void by the company unless a full disclosure is made and an independent board of directors or all the original members approve the contract. A company may sue its promoter for restitution and damages in respect of monies received or wrongs done against the company.

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19.7 CLASSIFICATION OF COMPANIES

An incorporated company may be classified in various ways even though all of them share the attributes of incorporation. The main classifications are as follows.

19.7.1 LIMITED AND UNLIMITED COMPANIES

Under s 3 CA 2006, a company may be registered as limited or unlimited, although only a few choose the unlimited option. An unlimited company is a legal entity but the liability of its members is not limited, meaning that they could be personally liable for the debts of the company if it is unable to pay it from its assets. However, the members would not be liable directly to the company's creditors. If the company were to be wound up, the liability of its members would be to contribute money to the company for the payment of its debts. The main reason for establishing an unlimited company is that such a company is not required to deliver annual accounts and reports to the Registrar of Companies. A limited company, on the other hand is a company the liability of whose members to contribute to its debts on liquidation is not absolute but restricted to the unpaid value of their shares or guarantee.

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19.7.2 LIMITED BY SHARES OR GUARANTEE

Under s. 3(2) CA 2006, a company is limited by guarantee if by its constitution the liability of the members "is limited to the amount, if any, unpaid on the shares held by them." Each share usually has a nominal value which the shareholders must pay to the company. If a shareholder has paid the full value of his shares, he would be free from further liabilities to the company, no matter how much it owes. However, if shareholders do not pay the entire value of the shares they hold, their liability would be limited to any amount yet to be paid on those shares.

Under s. 3(3) CA 2006, a company is limited by guarantee if by its constitution the liability of its members "is limited to such amount as the members undertake to contribute to the assets of the company in the event of its being wound up." A company limited by guarantee does not and cannot have a share capital. Instead, each member undertakes to contribute a specified sum towards the payment of the company's debts in the vent of liquidation. Since a company limited by guarantee does not have any contributed capital while the company is a going concern, it is usually formed for non-commercial and non-profit purposes.

19.7.3 PUBLIC AND PRIVATE COMPANIES

Under s. 4 CA 2006, a public company is one limited by shares or by guarantee which is registered as a public company and whose certificate of incorporation states that it is a public company. The name of a public limited company must end with the words "public limited company" or the abbreviation "plc". According to s. 763 CA 2006, a public limited company must have issued share capital of at least £50,000, (or its equivalent in Euro) though the Secretary of State can specify a different amount. A public company must receive at least one quarter (25%) of the nominal value of its authorised capital, i.e., at least £12,500, before it could start business. As earlier noted, a public company cannot start business without receiving a *trading certificate* – s. 761 CA 2006. Under s 767, it is an offence punishable by fine for a plc to carry on business without the certificate. A public company must have at least two members or shareholders, and at least one secretary. The principal reason for forming a public limited company is the ease of obtaining capital from the public through the sale of its shares, and therefore the unlimited potential for growth. A company must be formed as or become a plc if it aims to obtain contributed capital from anyone other than its founders and persons introduced individually without a public offer.

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A private company is any company that is not a public company. The vast majority of companies in the UK are private companies limited by shares. Private companies have the word "limited" or the abbreviation "Ltd.", at the end of their names. A private company may have only one member and one director (who may be same person) and does not need to have a secretary. A private company may not publish an advertisement offering its shares to the public. Private companies are less regulated than public companies.

19.7.4 COMMUNITY INTEREST COMPANIES

Under s. 6 CA 2006, a company limited by shares or by guarantee with or without a share capital may become a community interest company. Community Interest Companies (CIC) were first introduced in 2005 by the *Companies (Audit, Investigations and Community Enterprise) Act 2004* for the use of people who want to conduct business or other activities for community benefit and not purely for private advantage.

In order to be registered as a CIC, an association must pass a "community interest test". This means a demonstration that the company's profits will be used for the benefit of the community in whose interest it is being set up. For this reason, there would be a statutory "lock" on the assets and profits of the company, meaning that transfer of its assets would be restricted. The company's assets must be retained within the company for the benefit of the company; and if any transfer of asset is to be undertaken, such a transfer must comply with the rules laid down in the statute. In addition, the company must file an annual report to the Registrar of Companies explaining how their activities have benefited the community as well as the involvement of their stakeholders. A CIC regulator is responsible for ensuring that CICs comply with their legal requirements for registration and operation. More information on CIC and how to establish one could be found at

https://www.gov.uk/government/publications/community-interest-companies-how-to-form-a-cic.

19.8 CHAPTER SUMMARY

- To be a company, an association or business must be registered under, or recognised by, the Companies Act 2006 as such.
- A company may come into existence by royal charter, statute or registration, but most companies are registered.
- To be registered as a company, the promoters must submit to the Registrar of Companies a memorandum of association, an application for registration, and a statement affirming compliance with the provisions of the Companies Act 2006.
- A company may be public, private or community interest; limited or unlimited; or limited by shares or by guarantee.

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- A promoter is the person who undertakes the formation of a company and does the necessary things to bring this about. A promoter is a fiduciary and must act in the interest of the company being formed.
- When a company has been registered, it will receive from the Registrar of Companies a certificate of incorporation. The certificate enables the company to start business except for public companies which will also need to obtain a trading certificate.

19.9 PRACTICE QUESTIONS

1. Explain the key differences between a private and a public company; which would you recommend to a business and why?
2. Explain the difference between a company limited by shares and a company limited by guarantee.
3. What is a community interest company? Explain the additional requirements for the registration of such a company.

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20 CORPORATE PERSONALITY

20.1 INTRODUCTION

This chapter discusses the nature of incorporated companies and the origins, implications and consequences of corporate personality – the doctrine that a company is a separate legal person – for the company, owners and third parties.

20.2 LEARNING OBJECTIVES

At the end of the chapter, readers should clearly appreciate:

- The legal nature of companies
- The meaning and implications of corporate personality
- The effects of incorporation on companies, creditors and the public
- The circumstances in which the courts might disregard the separate personality of a company

20.3 CORPORATE PERSONALITY

Upon incorporation, a company becomes a body corporate and assumes a separate identity in law distinct from that of its members. Even though the company is owned by its members, it is regarded as different from those members. In a sense, the law raises an imaginary veil or barrier between the company and its members. A company is capable of acquiring its own rights, and is subject to its own duties and obligations. It is able to do most things a natural person could do. The House of Lords explained and consolidated the principle of corporate personality in the case of *Salomon v Salomon & Co Ltd* (1897) AC 22.

> Mr. Salomon ran a successful shoe making and repair business as a sole proprietor. Later he formed a company called Salomon and Co. Ltd. and transferred the business to it. He sold his interest in the business, which he valued at £39,000, to the company partly in cash and partly in debentures which were secured by a charge on the company's business. The other members of the company were Mr. Salomon's wife and his five children to whom he allotted one share each. Mr. Salomon was fully in control of the company and its management just as he was when the business was a sole proprietorship. Soon after incorporation, the company ran into financial difficulties and Salomon obtained unsecured loans from other people. However, the company had to be liquidated despite the efforts to keep it going. The argument was whether Mr. Salomon was entitled to recover the value of his debentures and whether he was liable personally for the company's indebtedness to its unsecured creditors. The High Court and the Court of Appeal found against Mr. Salomon, holding that the company should be treated as his agent, alias, or trustee.

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On Mr. Salomon's appeal to the House of Lords, it was held that upon registration, the company became separate from Mr. Salomon who could not be regarded as its agent or trustee. Mr. Salomon was therefore entitled to recover the value of his debenture in the same manner as any secured creditor would. He was also not liable personally to the other creditors. According to Lord Halsbury:

> Once the company is legally incorporated, it must be treated like any other independent person with rights and liabilities appropriate to itself, and that the motives of those who took part in the promotion of the company are absolutely irrelevant in discussing what those rights and liabilities are.

In *Trebanog Working Men's Club and Institute*, and *Monkwearmouth Conservative Club, Limited v Smith* [1940] 1 KB 576, it was held that the incorporated societies were legal entities distinct from their members.

Even though this principle may in some instances lead to hash results, it is firmly entrenched and fundamental in company law. The effects and advantages of the corporate personality of companies are many and are discussed below.

20.3.1 PERPETUAL SUCCESSION

A company enjoys perpetual succession in that members enter and leave it without affecting its existence. Moreover, the death or bankruptcy of a member would not normally affect the life of the company. This contrasts with the position in partnerships (except LLP) which are liable to dissolve on the retirement, death, bankruptcy or incapacity of a partner.

20.3.2 THE COMPANY OWNS ITS BUSINESS AND ASSETS

An incorporated company's business belongs to it and not to its members. Thus, the company enters into contracts and acquires assets in its own name. Only the company can convey title to buyers of its goods, assets or services. Unless they are acting as representatives of the company, members have no right to dispose of the company's properties. Moreover, subject to exceptions in cases involving directors' breach of duty, for which see chapter 24, if the company suffers wrongdoing in the hands of third parties, only the company is entitled to sue for remedy. The case of *Foss v Harbottle* [1843] 2 Hare 461 clearly demonstrates this position.

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Two shareholders brought an action against their company's directors to recover losses suffered by the company as a result of the directors' fraud. It was held that the company could sue if it wished to do so, but that it was not open for individual members to do so in cases like this. According to the court:

> It was not, nor could it successfully be argued, that it was a matter of course for any individual members of a corporation thus to assume to themselves the right of suing in the name of the corporation. In law, the corporation and the aggregate members of the corporation are not the same thing for purposes like this.

In *Macaura v Northern Assurance Co* [1925] AC 619, M did business as a timber merchant and insured the properties of the business against fire. He later incorporated a company in which he had a majority shareholding and transferred the business to it. He did not, however, transfer the insurance policy to the new company. The properties of the company were destroyed by fire and M sought to recover the losses from the insurance company. It was held that M could not recover the losses since the property covered by the insurance policy did not belong to him. It now belonged to the company which was not the policy holder.

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20.3.3 THE COMPANY WOULD BE LIABLE FOR ITS DEBTS AND WRONGDOINGS

A company does its own business and is liable for all liabilities arising therefrom and in the course of it, whether in contract, tort, or otherwise. Unless a company has been incorporated with unlimited liability, its members (unless they have personally guaranteed its debts) would enjoy freedom from the liabilities incurred by the company except to the extent of any monies outstanding on the nominal value of their shares or guarantee. Even so, these monies are debts to the company rather than the company's creditors. If a company commits a crime or civil wrong, the proper person to sue would be the company itself, rather than its members or directors.

> *Williams v Natural Life Health Foods* [1998] 1 WLR 830 – The second defendant had founded the first defendant company relying on the experience he gained from working in the health foods department of Sainsbury's Supermarket. The plaintiff entered into a franchise with the first defendant company to market its health foods. In doing this, it relied on the experience of the second defendant as contained in the company's brochure. However all negotiations and discussions were held with the company's representative at the company's office. At no time was there any communication between the plaintiff and the second defendant.
>
> The plaintiff sued the first defendant for negligent misstatement when the franchise failed to make profits but made losses instead. Upon the winding-up of the first defendant company, the plaintiffs joined the second defendant in the action and subsequently proceeded against only him when the company was dissolved. The question was whether the second defendant could be held personally liable for the tort committed by the company.
>
> The House of Lords held that the second defendant was not liable for the negligent advice given by the first defendant as there was no special relationship between him and the plaintiffs.

However, a director who commits fraud against a third party, along with the company, may be personally liable for losses caused (*Standard Chartered Bank v Pakistan National Shipping Corp* [2002] BCC 846 (see chapter 29.3).

20.3.4 THE COMPANY MAY EMPLOY ITS OWNERS

Since a company is legally separate from its owners the latter may become its employee and entitled to the attendant benefits.

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Lee v Lees Air Farming Ltd [1961] AC 12, the majority shareholder (2999 out of 3000) of a fertiliser spraying company was its sole director. He was also employed as the company's chief pilot on a specified salary. He was killed in a plane crash while working for the company. The widow sued for compensation for his death. It was held that Lee was an employee of the company for the purposes of compensation under the company's insurance policy.

Secretary of State v Bottrill [1999] BCC 177. In this case, it was held that a sole shareholder/director of a company was to be regarded as an employee of the company for the purposes of recovering a redundancy payment under an employment contract.

Secretary of State for Business, Enterprise and Regulatory Reform v Neufeld [2009] EWCA Civ 280 – The claimant was the majority shareholder and director of a company which had become insolvent while owing him arrears of wages. He claimed the arrears of wages as well as redundancy and holiday pay from the company. It was held that as long as the contract of employment was genuine and not a sham, the claims were proper.

20.3.5 THE COMPANY IS NOT AN AGENT OF ITS SHAREHOLDERS

An incorporated company is not an agent of its shareholders (including corporate shareholders) and have no actual or apparent authority to bind them.

In *Gramophone and Typewriter Co Ltd* v Stanley [1908] 2 KB 89, an English company doing business in England owned all the shares in a German company. The question was whether the English company was liable to pay tax on all the profits of the German company. It was held that the fact that all the shares in the German company were owned by the English company did not make the business of the German company the business of the English company so as to render it liable to income tax under English law. The English company was only liable to pay income tax on such profits of the German company as had been received in England.

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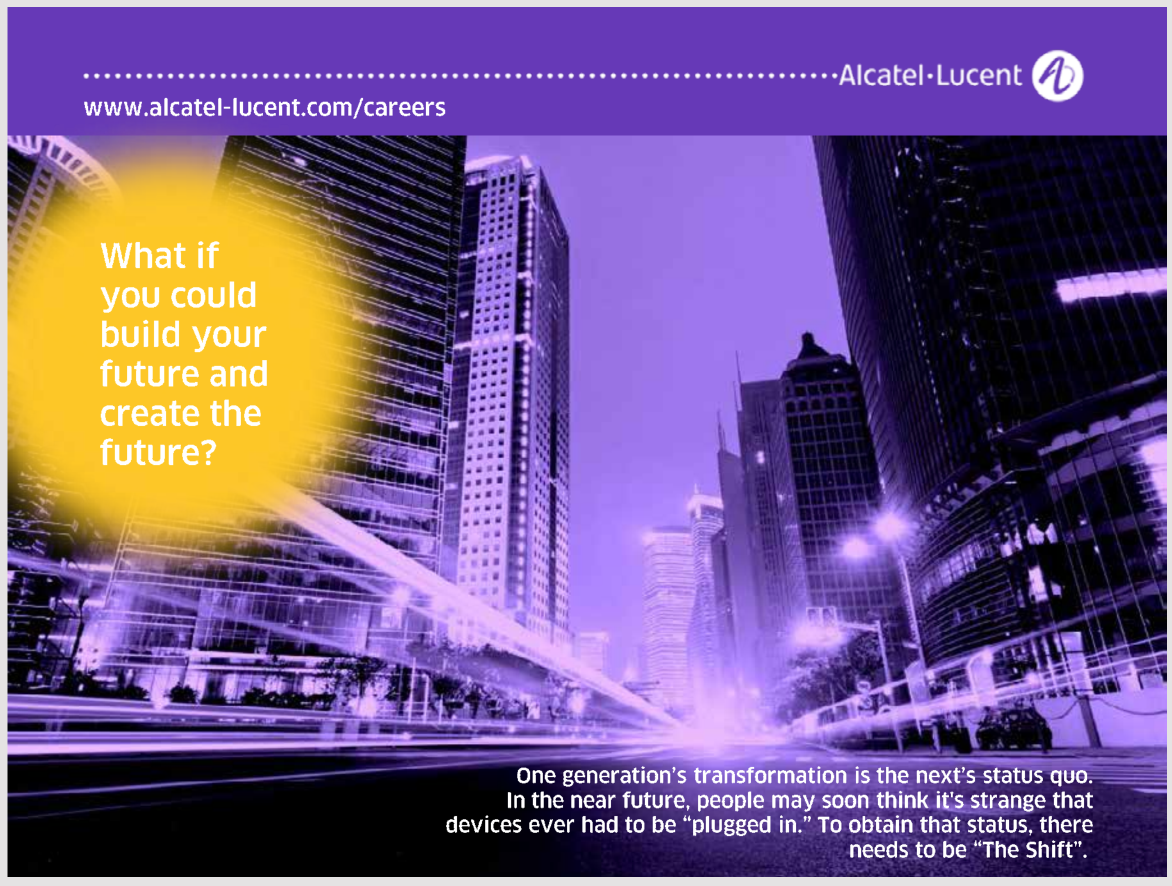
Carlton Communications, Granada Media plc v Football League [2002] EWHC 1650 (Comm) – Carlton and Granada owned 50% each of the shares in ITV Digital Holdings, which was the parent company of ONdigital plc. Under a TV broadcasting contract between ONdigital and the Football League, ONdigital was to pay the Football League £89m in 2001 and 2002. However, the company had gone into administration and was unable to pay this money. The Football League claimed the money from Calton and Granada on the ground that ONdigital had made a unilateral offer to guarantee the payment as their agent. However, the alleged guarantee was in the initial bid document, and the contract itself contained no such guarantee. Carlton and Granada claimed that it did not make any guarantee; that any guarantee was made by ONdigital on its own account; that even if there was a guarantee, it was unenforceable since it was not in writing; and that the alleged guarantee would not entitle the Football League to damages for anticipatory breach. It was held that there was no guarantee as the alleged guarantee was not in writing and was made prior to the execution of the contract. Moreover, ONdigital was not an agent of Carlton and Granada merely because they were its shareholders. According to the court:



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> It is trite law that a company has its own legal personality distinct from its shareholders: *Salomon v Salomon & Co* [1897] AC 22. The fact that a company can in common parlance be said to carry on business on behalf of its shareholders does not make the company the agent of the shareholders.

See also *Yukong Lines Ltd of Korea v Rendsburg Investment Corp. of Liberia* [1998] 1 WLR 294.

20.3.6 GREATER CAPACITY TO RAISE CAPITAL

Due to separate legal personality and the ability to acquire properties in its own name, a company could borrow money on the security of its own assets. In particular, a company can borrow money using floating charges on its recurrent assets – a facility not available to most partnerships. In addition, a public company could raise money from members of the public by the issue of its shares. This facility enables the company to generate huge resources for its business, leading potentially to great expansion. Although a private company may not issue shares to the public, it may also raise more money be issuing more shares to its existing shareholders, or privately to other persons.

20.3.7 SEPARATION OF OWNERSHIP AND MANAGEMENT

The owners of a company are not necessarily is managers and need not be. In fact, unless otherwise agreed, owners of companies are not automatically entitled to be its directors. This separation of ownership and control enables persons – natural and corporate – to acquire interests in, and benefit from, companies without having to shoulder the responsibility of management. This separation also enables a member of a company to be employed as its director.

20.4 DISADVANTAGES OF INCORPORATION

The disadvantages associated with companies are relatively minor and should not be of serious concern to persons wishing to set up business in that medium. These include state regulation, incorporation and winding-up formalities and potential loss of control.

20.4.1 STATE REGULATION

Incorporated companies do not have as much privacy as partnerships or sole proprietorships. Companies, especially public ones, have to file notices of its decisions and annual returns of its activities with the Registrar of Companies. The Companies Act 2006 provides a compulsory legal framework, with which all companies must comply. However, the rules contained in it, many of which have been relaxed for private companies, are designed to promote accountability and transparency. They should not be a hindrance to enterprise.

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20.4.2 FORMATION AND WINDING UP FORMALITIES

Formation of companies involve more formalities and some expense in comparison to sole proprietorship or partnerships. However, the expenses and formalities involved in incorporation are now minimal while the process of incorporation is quick. Applications could be made online; the fee payable is as low as £15, and registration can be completed in 24 hours. An already registered company could also be bought "off-the-shelf" at a reasonable price. For a company to cease to exist it must be formally wound up and then dissolved. However, an official liquidator would undertake this process and the cost of the exercise would be born from the assets of the company.

20.4.3 POTENTIAL LOSS OF CONTROL

Owners of companies may lose control of the business to outsiders who invest money in them. This possibility is more likely in public companies because shareholders of private companies are often able to restrict the transfer of the company's shares by certain provisions in the articles and by the agreement of shareholders. However, in no company could control be lost if members with majority shareholding are unwilling to dispose of their shares. In effect, therefore, only minority shareholders could complain of loss of control. Companies may also be vulnerable to being taken over by other companies against the wishes of minority shareholders. Again, this is more likely in public companies and cannot occur if the majority shareholders reject the takeover bid.

20.5 LIFTING OR PIERCING THE CORPORATE VEIL

Sometimes people may abuse the principle of incorporation and separate legal personality. They may form companies not for the purpose of engaging in genuine business but in order to defraud creditors or members of the public, or in order to accomplish other unlawful or ulterior purposes. An absolute adherence to the principle of corporate legal personality would enable such people to successfully argue that the company they used, and not themselves, was responsible for any wrongdoing. Moreover, people may register a company in order to undertake transactions, which they were otherwise forbidden from undertaking; to avoid legitimate obligations; to defraud the Inland Revenue, etc.

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An overarching policy of the law is that legal principles would not be allowed to be deployed as instruments for fraud or wrongdoing. In certain situations, therefore, the court will ignore the separate identity or corporate personality of a company and hold accountable the natural persons behind it. This is called lifting or piercing the veil of incorporation. This is necessary because companies are artificial persons and are therefore not able to do anything by themselves. People behind the veil of incorporation must not therefore be allowed to misuse the corporate principle. Having said that, the corporate personality principle is a fundamental one, and the courts will not lift the corporate veil lightly. Statutory provisions would be interpreted, as much as possible, to give effect to the corporate personality principle as upheld in Salomon v Salomon. In fact, the ability of the courts to lift or pierce the corporate veil is limited even if the instances where this could be done are not closed. The veil would usually be lifted where the company is fraudulent or a sham, where it is in the interest of the public to do so, or where a statute so requires. In *Prest v Petrodel Resources Ltd* [2013] 2 AC 415, 416, the Supreme Court rationalised the principle of piercing the corporate veil and explained its limits as follows:

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> The recognition of a limited power to pierce the corporate veil and to disregard the separate personality of a company in carefully defined circumstances was necessary if the law were not to be disarmed in the face of abuse and, provided that the limits were recognised and respected, it was consistent with the general approach of English law to the problems raised by the use of legal concepts to defeat mandatory rules of law; that, therefore, if a person were under an existing legal obligation or liability or subject to an existing legal restriction which he deliberately evaded or the enforcement of which he deliberately frustrated by interposing a company under his control, the court could pierce the corporate veil for the purpose, and only for the purpose, of depriving that company or its controller of the advantage which they would otherwise have obtained by the company's separate legal personality.

In *Ben Hashem v Ali Shayif* [2008] EWHC 2380, Mumby J made a similar observation:

> The common theme running through all the cases in which the court has been willing to pierce the veil is that the company was being used by its controller in an attempt to company. It is therefore necessary to identify the relevant wrongdoing.

The following are examples of circumstances where the corporate veil would be, and have been, lifted or pierced.

20.5.1 WHERE THE COMPANY IS A SHAM, FRAUDULENT OR ILLEGAL

The veil or incorporation would be lifted where a company is a sham or set up for an illegal or fraudulent purpose. The following cases provide illustrations.

> *Gilford Motor Co v Horne* [1933] Ch. 935 – The claimant company employed H, who undertook in his contract not to canvass or solicit for the customers of the employer if he left their employment (restrictive covenant). Upon leaving the claimant's employment, however, H formed a company with his wife and the company went about soliciting the customers of the claimants. It was held that the claimants were entitled to enforce the agreement against H and his company and that the company was a sham or alias of the H.

> *Jones v Lipman [*1962] 1 All ER 442 – The defendant (L) entered into a contract to sell land to the claimant (J). L however sold the land to another person. To avoid specific performance of the contract with J, L formed a new company and transferred the land to it. It was held that L and his company were bound to perform the contract with J. The company to which he purportedly transferred the land was a sham or cover to escape his contractual obligation.

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Gencor ACP Ltd v Dalby [2000] BCLC 734 – Mr Dalby, the director of the claimant company made secret profits which he caused to be paid into the account of another company he set up and controlled. It was held that the director must render an account to the claimant. According to the court, the director's new company was "in substance little other than Mr Dalby's offshore bank account held in a nominee's name', and simply … the alter ego through which Mr Dalby enjoyed the profit which he earned in breach of his fiduciary duty to ACP."

Trustor AB v Smallbone (No. 2) [2001] 1 WLR 1177 – S as the managing director of the claimant company transferred the equivalent of £39 Million from the claimant's account into the account of Introcom Ltd., a company owned by him. It was held that S was personally, along with Introcom, liable to refund the money to the claimant.

See also *Re Darby, Ex Parte Brougham* [1911] 1 KB 95.

20.5.2 WHERE THE COMPANY IS USED TO EVADE LEGAL OBLIGATIONS

The court will not allow the corporate structure to be used as a means to avoid an existing and binding legal or contractual responsibility. See *Gilford Motor Co v Horne* [1933] Ch. 935; *Jones v Lipman* [1962] 1 All ER 442 (above).

20.5.3 WHERE THERE HAS BEEN AN ABUSE OF LEGAL PROCESS

The corporate structure should not be used to undermine the provisions of the law. If an attempt is made to use it for such a purpose, the veil could be lifted.

Re Bugle Press [1961] Ch. 270 – The majority shareholders in BP (90%) tried to use their power to force the holder of the remaining 10% of the company's shares to sell their shares. Under the Companies Act, where there is a take-over bid for a company and holders of 90% of the shares agree to it, the bidding company can compulsorily purchase the shares of the unwilling members. The two major shareholders in BP formed a company and used it to launch a bid for the take-over and compulsory purchase of the minority shares. It was held that the bidding company was the same as the major shareholders of BP. The bid was therefore a fraudulent attempt forcefully to take the shares of the minority shareholder of the company.

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20.5.4 WHERE A PLC HAS ONE MEMBER OR NO TRADING CERTIFICATE

Where a public company operates with less than the statutory minimum of two members for more than six months, the person responsible for carrying on the business with that deficiency may be personally liable for losses or debts incurred in that period. Similarly, where a plc commences business without a trading certificate, the members responsible for such trading may be held personally liable for any debts incurred or losses suffered by the company.

20.5.5 WHERE DIRECTORS ARE INVOLVED IN FRAUDULENT OR WRONGFUL TRANSACTIONS

Under *sections 213 and 214 Insolvency Act 1986*, company directors could be held personally responsible for fraudulent or wrongful acts they commit during their company's insolvency.

> In *Edgington v Fitzmaurice* [1885] 29 Ch D 459 (CA), directors of a company made fraudulent misrepresentations in the company's prospectus, thereby inducing investors to buy its shares. Shortly after the share allotments, the company became insolvent. The directors were held liable for deceit.

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Similarly, in *Standard Chartered Bank v Pakistan National Shipping Corp* [2002] BCC 846 (HL), a director who signed and issued a fraudulent bill of lading in order to rely upon letters of credit from a bank was held personally, liable along with the company, for the fraud.

20.5.6 WHERE DIRECTORS ACT WHILE DISQUALIFIED

Where a director continues to act after being disqualified, that director would be jointly and severally liable with the company for any liabilities incurred during that time.

20.5.7 WHERE IT IS IN THE PUBLIC INTEREST

The veil could be lifted where the paramount interest of the public or state requires it.

Daimler Co. Ltd v Continental Tyre & Rubber Co. Ltd (Great Britain) [1916] 2 AC 307 – A company was incorporated in England in order to sell in the country tyres made in Germany by a German Company. The German company held most of the shares in the English company while all remaining shareholders (except one) and all the directors were Germans living in Germany. The only non-German was in fact a German who had become a British citizen by naturalisation and lived in England.

After the outbreak of war between England and Germany, a case was brought in England by the English company for the recovery of debts owed to it by the German company. The defendant challenged the action on the ground that it was an alien enemy company and that payment of the debt would be a trading with the enemy, and that the action was commenced without the authority of the company. The English company obtained judgment at the High Court and Court of Appeal.

On further appeal by the German company, the House of Lords held among other things that the company "was in substance a hostile partnership and was therefore incapable of suing, and that any payment to it would be illegal as a trading with the enemy" (at p. 307).

However the mere fact that a British company did business in an enemy country through an agent will not make it an enemy company.

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In *Re Hilckes* [*1917*] *1 KB 48 (CA),* an English company in 1910 acquired the estate of a debtor (a German national) in German East Africa and appointed the debtor its commercial agent in that country. When the debtor/agent failed to make the expected returns from the estate, the company dismissed him. He sued the company in Germany and lost and was ordered to pay the litigation cost. In the meantime, war had broken out between England and Germany and the debtor was detained in England. In a claim by the company from the debtor's estate of the court cost, it was argued that since the judgment was by a German court, and since the claimant company was owned by Germans, the money was not recoverable. It was held that the company was not an alien enemy and was therefore entitled to recover the cost.

20.5.8 IN CASES OF JUST AND EQUITABLE WINDING UP

The court may wind up a company on the petition of a member on the ground that it is just and equitable to do so. In such situations, the court would treat the company as a *quasi*-partnership. For more on this, see chapter 28.6.2.

20.6 CORPORATE PERSONALITY AND GROUPS OF COMPANIES

Many companies carry out their business activities (whether domestic or multinational) through a group structure. This is because a company can own shares in other companies known as subsidiaries. In a group of companies, a parent company owns controlling shares in the subsidiaries and determines the composition of their board of directors. Normally, the companies in a group have their own separate legal personalities.

In *Adams v. Cape Plc* (1990) Ch. 433, where the English parent of an American subsidiary company was sued for asbestos contamination in America, the court held:

> Save in cases which turn on the wording of particular statutes or contracts, the court is not free to disregard the principle of Salomon v. Salomon merely because it considers that justice so requires. Our law, for better or worse, recognises the creation of subsidiary companies, which though in one sense the creatures of their parent companies, will nevertheless under the general law fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities.

In *Ord v Belhaven Pubs* [1998] BCC 607, the Court of Appeal held that the court will not allow a plaintiff with a claim against one company in a group to substitute the holding company or other group subsidiaries as defendants to that claim merely because the group may be a single economic entity. A company is in law entitled to organise the group's affairs in the manner that it does, and to expect the court to apply the principle of Salomon in the ordinary way.

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20.6.1 LIFTING THE VEIL IN CORPORATE GROUPS

In some circumstances, companies in a group may be treated as a single business, effectively lifting the corporate veil. This would happen where the group structure was a sham or mere façade, or used to commit fraud, or where the subsidiary was an agent of the parent.

20.6.1.1 Sham, façade or fraud

Where the group structure is a sham or façade designed to conceal the true state of affairs, the veil of incorporation may be lifted so that the companies in the group may be treated as one.

> In *Woolfson v Strathclyde Council* (1979) 38 P & CR 521, it was held that the corporate veil should not be lifted except in cases where the relationship between a group of enterprises was that of a façade.

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20.6.1.2 Agency

Where a company acts as the agent or trustee of another, the corporate veil may be lifted for the benefit or advantage of the principal company. Thus, where a subsidiary company does the business of the parents as its agent, the companies may be treated as one. The following cases illustrate this principle.

> *Re FG (Films) Ltd* [1953] 1 All ER 615, the question before the court was whether a film made by a company registered in England was a British film for the purposes of Cinematograph Films Act 1938. 90% of the shares in the English company that made the film were owned by nominees of an American company, which financed and controlled the film production. It was held that the participation of the British company in the film production was so minor that it could not be classified as British; and that since the British company had acted as a mere agent of the American company, it was in the public interest to regard the film as foreign.
>
> *Smith, Stone and Knight v Birmingham Waterworks Ltd* [1939] 4 All ER 116 – The claimant had a wholly owned subsidiary company known as Birmingham Waste, which was a yearly tenant in a land it owned. However, Birmingham Waste carried on business as an agent and department of the claimant. Upon the land being compulsorily acquired, the claimant claimed compensation for losses suffered due to the disturbance of the business of Birmingham Waste. It was held that the claimant, as the parent company, was entitled to compensation in respect of the business carried on by its subsidiary since the subsidiary was actually doing that business on its behalf. The subsidiary was in effect the agent, employee or tool of the parent. According to the Atkinson J, a subsidiary would be an agent or nominee of the parent company where:
>
> - The profits were treated as those of the parent,
> - The persons conducting the business were appointed by the parent,
> - The parent was the head and brain of the trading venture,
> - The parent governed the venture, decided what should be done and what capital should be embarked on the venture,
> - The parent made the profits by its skill and direction, and
> - The parent was in effectual and constant control

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Firestone Tyre and Rubber Co Ltd v Lewellin [1957] 1 WLR 464 (HL) – A British based wholly owned subsidiary of a USA tyre manufacturer manufactured and sold tyres to distributors in Europe. The tyres were sold under a special contractual arrangement involving the USA parent, the UK subsidiary and the distributors. The question was whether the transactions were subject to UK tax. It was held that they were since the transactions were carried out in the UK by a UK subsidiary agent of a USA parent.

Unit Construction Co Ltd v Bullock (Inspector of Taxes) [1960] 3 WLR 1022 – A parent company wholly owned three subsidiary companies that were registered and based in Kenya. However, the boards of directors of these companies neither met nor took important decisions for the company. Instead, those decisions and the power of management were exercised by their parent company in London. Unit construction Ltd, another wholly owned subsidiary of the same parent, but which is based in the UK, paid some money to the Kenya subsidiaries and sought to deduct that payment from its profits for the purpose of tax assessment. It could do this only if the subsidiaries were resident in the UK. The question was whether the Kenya subsidiaries were resident in the UK. It was held that the residence of a company is where its management and the control of its business is." Accordingly, the Kenya subsidiaries were resident in the UK.

Chandler v Cape plc [2012] EWCA Civ 525 – The claimant worked for Cape Building Products Ltd, a subsidiary of the defendant and was exposed to asbestos dust. 50 years later, the claimant developed asbestosis (a form of cancer) from the exposure to asbestos. However, CBP had since gone out of business. The claimant sued the defendant for damages in negligence on the ground that as the parent of the subsidiary, it directly owed it a duty of care, which it breached. It was held that the defendant had a duty to prevent asbestos damage to the employees of its subsidiaries because, although a subsidiary and its parent company were two separate legal entities, the businesses of the two companies were essentially the same. The defendant therefore was, or ought to be, aware of the risks in the subsidiary's system of work and should have intervened with its superior knowledge and facilities to protect the employees from them. According to the court, a parent company would be deemed to have assumed responsibility for the safety of the employees of its subsidiary so as to be under a duty of care if it:

(i) had, or ought to have had, superior knowledge on some relevant aspect of health and safety in the particular industry, (ii) knew, or ought to have known, that the subsidiary's system of work was unsafe, and (iii) knew, or ought to have foreseen, that the subsidiary or its employees would rely on its using that superior knowledge for the employees' protection.

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> In *Thompson v The Renwick Group plc* [2014] EWCA Civ 635 (CA), where the facts were largely similar to those of Chandler v Cape plc, it was held that the parent company was not under a duty of care to the workers of its subsidiaries because it carried on no business of its own and had no superior knowledge or facility to deploy.

Apart from the above circumstances, companies in a group are required to produce a group account in addition to individual accounts – *s. 399 CA 2006*.

20.7 CHAPTER SUMMARY

- A company has a legal personality separate from the personality of its owners who are not its agents. This principle became firmly established in the case of *Salomon v Salomon*.
- Because of its separate legal personality, a company owns its business and assets, can enter contracts and take and defend legal actions in its own name, has its own legal rights and duties and can incur legal liabilities. In addition, a company's members usually have limited liability, the ownership and management of companies are normally separate, and a company has great capacity to raise money and grow.

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- Although companies have to comply with certain legal formalities in both formation, management and winding up, and although there are possibilities that owners might lose control, these are relatively minor disadvantages giving the many benefits of incorporation.
- The separate legal personality of companies is the basis of company law and would not be disturbed by the court except in exceptional circumstances.
- Where the principle of corporate personality is abused or where the company itself is illegal or a sham, the courts may disregard the concept of separate legal personality and hold accountable those behind the company.
- The doctrine of lifting or piercing of the corporate veil is designed to preserve the integrity and essence of the law on corporate personality.
- The circumstances in which the veil of incorporation may be lifted are varied but limited, and usually involve some form of misuse of the facility of incorporation.
- Where companies are organised in a group, the separate personality of all the companies in the group would be respected unless the group structure is a sham or designed for, or used to commit, fraud.

20.8 PRACTICE QUESTIONS

1. Discuss four reasons why an incorporated company would be a preferable form of business organisation to a partnership.
2. Explain the concept of “veil of incorporation”. Discuss four main circumstances in which this veil might be lifted in ordinary companies.
3. Alpha Ltd and Beta Ltd are wholly owned subsidiaries of Gamma plc, which appointed their boards of directors. Gamma plc had agreed to sell a piece of land to Omega plc. There is a legally binding contract for this sale. However, Gamma plc subsequently received a better offer for the land and wishes to pull out of the agreed sale to Omega plc. Accordingly, Gamma plc transferred the land to Beta Ltd. Omega plc has now commenced legal proceedings against Gamma plc and Beta Ltd for the specific performance of the original contract of sale.

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21 COMPANY CONSTITUTION AND CONTRACTUAL CAPACITY

21.1 INTRODUCTION

Apart from the Companies' Act 2006 that provide overarching legal rules, companies also have internal documents that regulate their functions and operations. These constitute their constitution. Apart from this, constitutions may set limits to the contractual powers of companies or the authority of their directors to bind them. This chapter considers the constitutional documents of companies, their nature, and their relationship with the Companies' Act, as well as their effects and procedure for amendment. It also considers the contractual capacity of companies, the authority of directors to bind companies, and the legal effect of any limitations on these in the companies' constitution.

21.2 LEARNING OBJECTIVES

At the end of this chapter, the reader should fully understand:

- The meaning and constituents of a company's constitution
- The sources of a companies' constitution
- The importance and effects of a company's constitution
- The enforceability of a company's constitution
- How a company's constitution may be altered
- The meaning of companies' contractual capacity
- The extent of a company's contractual capacity and the implications of any limitations on it

21.3 THE COMPANY CONSTITUTION

Under *s. 17* and *s. 29 CA 2006*, the Articles of Association of a company, along with any special resolution, or unanimous resolution or agreement *constitute the constitution of the company*. The memorandum of association, which used to be part of the constitution, is no more so. The things previously required to be included in the memorandum, such as the name, registered address, type of company, and the objects of a company are no longer required to be included under the CA 2006. The articles of association is the most important internal document of a company and contains rules for the regulation and management of the company. It will normally contain provisions for the appointment, removal, conduct and remuneration of directors, secretaries, solicitors, auditors etc.; the regulation of the conduct of different meetings; voting rights and procedure; the rights attached to various classes of shares; rules on dividends; the preparation of company accounts; membership of the company, etc.

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A company must submit a copy of its articles of association before it could be registered, but may adopt the model articles in the Companies Act (*s. 18 (1) & (2) CA 2006*). If a company does not submit or adopt any articles, the relevant model articles in the Companies Act would automatically apply to it (s. 20). Articles must be contained in one document and must be divided into paragraphs numbered consecutively – *s. 18(3).* Where the provisions of the Articles contravene a provision of the Companies Act, the contravening provisions of the Articles shall be null and void. For companies existing before the coming into force of the CA 2006, any provisions in the memorandum that would be in the articles under the 2006 Act would now be deemed to be in the articles.

21.3.1 THE EFFECTS OF THE ARTICLES OF ASSOCIATION

S. 33 of the Companies Act 2006 provides that:

a) The provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions." And,
b) "Money payable by a member to the company under its constitution is a debt due from him to the company.

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Section 33 CA 2006 is usually interpreted to mean that the articles of association form a statutory contract binding on a company and its members and enforceable by both. Moreover, the court must interpret them as a commercial or business document in order to give them reasonable business efficacy. In *Wood v Odessa Waterworks* [1889] 42 Ch D 636, it was held that "the articles of association constitute a contract not merely between the shareholders and the company, but between each individual shareholder and every other."

> In *Hickman v. Kent and Romney Sheep breeders Association* [1915] 1 Ch 881, a company's articles contained provision that any disputes between it and its members should first be submitted to arbitration. The claimant sued the company for an injunction stopping his expulsion. It was held that the action was in breach of the claimant's obligation under the company's articles requiring him to submit his grievance to arbitration.

Members of a company can enforce against it only those rights arising from pure membership status. These include, for example, right to a declared dividend, right to attend members' meetings, right to vote at members' meetings, right to share certificate, right to sell shares, right to return of capital upon winding up; and right to be entered in the register of members.

> *Wood v Odesa Waterworks Co* [1889] 42 Ch. D 639 – The articles of the company provided that the directors may, with the sanction of the ordinary meeting, declare a dividend to be paid to the members in proportion to their shares. The General meeting approved a resolution to pay dividends by way of debentures or bonds. An action was brought by dissenting shareholders to stop the company from implementing the resolution. It was held that the articles constitute a contract not merely between the shareholders and the company but between each individual shareholder and every other. Accordingly, since the provisions of the articles on the distribution of the profits have not been followed, an injunction was granted against the company.

> In *Pender v. Lushington* [1870] 6 Ch D 70, where a company chairman refused to count the votes of a shareholder, it was held that the chairman had no right to disallow the votes in breach of the company's articles.

Members of a company cannot enforce against the company "outsider rights**".** These are provisions that do not correspond to the general rights of membership available to all shareholders of the same class. Thus, a member cannot normally enforce a right as a director, secretary, solicitor etc., or any other extraneous privileges not arising from membership. A non-member cannot enforce against the company any provisions in the articles.

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In *Hickman v. Kent and Romney Sheep breeders Association Ltd* [1915] 1 Ch 881, at 900, Astbury J explained the principles governing the enforceability of rights as follows:

> Firstly, that no articles can constitute a contract between the company and a third person; secondly, that no right purporting to be given by an article to a person, whether a member or not, in a capacity other than that of a member, as for instance a solicitor, promoter, director, can be enforced against the company; and thirdly, that articles regulating the rights and obligations of the members generally as such do create rights and obligations between them and the company respectively.

The above principles were applied in the following cases:

Eley v. Positive Govt. Security Life Assurance [1876] 1 Ex D 88 – The articles of association of the company provided that the claimant who was also a member of the company, should be appointed the company solicitor for life. It was held that the claimant could not enforce that provision.

Browne v. La Trinidad [1877] 37 Ch D 1 – A company's articles contained a provision that in consideration of the sale by B of his property to the company, he would become a member of the company and would be appointed a director for at least four years. B was removed as a director before the stated four years. He never became a member of the company. It was held that even if B had become a member, he could not enforce the provision since it was an outsider right.

In *Globalink Telecommunications v Wilbury Ltd* [2003] 1 BCLC 145, it was held that the articles do not constitute a contract between a company and its officers but only between the company and its members.

*A*n outsider right may only be enforceable if it is supported by an independent contract or if its enforcement arises from the enforcement of a membership right. This was demonstrated in *Quin & Axtens v Salmon* [1909] AC 442:

A company's articles provided that any of its two managing directors could veto a decision of the Board of Directors in certain circumstances. The claimant, pursuant to that provision, vetoed a decision of the Board. The veto was ignored. The claimant sued as a member of the company to compel compliance with the articles. It was held that the company, in seeking to disregard the veto, was in effect attempting to bypass its own rules on decision-making; and that this was an irregular attempt to alter the company's articles.

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A member of a company may sue a fellow member to enforce the constitution. In *Woods v Odesa Waterworks*, the court made it clear that the articles constituted a contract also between each individual shareholder and every other shareholder. This was illustrated in *Rayfield v Hands* [1960] Ch. 1:

> The articles of R's company provided that any member who wished to transfer his shares should notify the directors who would take the shares among them at a fair price. R wanted to transfer his shares and informed H and the other directors accordingly. The directors refused to take the shares and denied any obligation to do so. R sued the directors. It was held that the directors must take the shares in accordance with the contractual provision of the articles.

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21.3.2 THE NATURE OF THE S.33 CONTRACT

The "contract" under s. 33 has many features that are not the norm in an ordinary contract. First, unlike in normal contracts the courts cannot imply any terms into it.

> In *Towcester Racecourse Co Ltd v The Racecourse Association [2003] 1 BCLC* 260, it was held that no terms could be implied into the articles of a company from extrinsic sources to make the company or its directors contractually liable to the members for the manner in which the company's functions were carried out.

Secondly, the court will not rectify the statutory contract nor vary its terms; and the statutory contract is not liable to be set aside on grounds of misrepresentation, duress, undue influence, or mistake.

> In *Bratton Seymour Service Co Ltd v Oxborough [1992] BCC 471,* it was held that:
>
> > The articles of association of a company differ very considerably from a normal contract. They are a document, which has statutory force… The articles thus registered are one of the statutory documents of the company open for inspection by anyone minded to deal with the company or to take shares in the company. *The court has no jurisdiction to rectify the articles of association of a company even if those articles do not accord with what is proved to be the concurrent intention of the signatories to the memorandum at the moment of signature* (Emphasis added).

Third, if the articles are not in accordance with the intentions of the subscribers, they have to be altered only by the statutory procedure laid down in the Company's Act. This requires special resolution. Even where the articles are to be altered by the members, they are not allowed to thereby impose extra burden of financial contribution on any member who does not support the alteration.

21.3.3 ALTERATION OF THE ARTICLES OF ASSOCIATION

A company has the power to alter the contents of its articles at any time and cannot deprive itself of the power or ability to do so. The procedure for alteration depends on whether the provision to be altered is a general or entrenched provision.

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Entrenched provisions are those which the articles state may be altered by a special procedure or subject to the fulfilment of specified conditions. Entrenched provisions are usually more difficult to alter than general provisions. Entrenched provisions may also be altered or repealed by unanimous agreement of members of the company, or by the order of a court – s. 22 CA 2006. However, entrenched provisions will not be valid if they seek to make the articles impossible to alter. Whenever an entrenched provision is altered, a statement of compliance with the stipulated method must be submitted to the Registrar of Companies. Any entrenched provisions in the articles or its removal must be notified to the registrar – *s. 23 CA 2006.*

General provisions are those other than entrenched ones. These may be altered by means of a special resolution – *s. 21 CA 2006.* The articles may give more weight to certain shares held in the company, thereby giving the holders more power in the alteration of the constitution. This is usually referred to as the *Bushel v Faith* clause. Such provisions are legal provided they do not attempt to make alteration of the articles impossible.

> *Bushell v Faith* [1970] AC 1099 (HL) – A company had 300 shares of £1 each and three shareholders – F and his two sisters. Each of them owned 100 shares. One of the sisters and F were the only directors of the company. The articles of association of the company provided that upon any motion to remove a director, the director concerned would have three votes for each share. At a general meeting, the two sisters proposed to remove F from the board and voted in favour. Mr. Faith voted against it. The sisters contended that F had been removed as a director by their 200 poll votes. F claimed that the proposal to remove him had been defeated by his weighted 300 votes. The House of Lords held that the articles of a company could assign more voting weight to certain shares and that the proposal to remove F had been defeated by F's votes.

A company must send to the registrar of companies a copy of the amended articles within 15 days of the amendment. It is an offence no to do so – s. 26.

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21.3.3.1 Restrictions on the power of alteration

Although members of a company have the power to alter the company's articles at any time, there are statutory limitations on this power of alteration. These are designed to maintain the supremacy of the CA 2006 and protect the interest of the company and those of its minority members. The restrictions are as follows:

- Any alteration must not be inconsistent with the provisions of the Companies Act. Any inconsistent provision would be void.
- The articles cannot be altered so as to compel a member to take more shares in the company unless the member agrees in writing before or after the alteration – s. 25 CA 2006.
- The articles cannot be altered so as to impose more liability on a member to contribute to the company's capital unless the member agrees in writing before or after the alteration – s. 25 CA 2006.
- Members of a company must exercise their powers to alter the articles in good faith and in the interest of the company or of the members as a whole.

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In *Allen v. Gold Reefs of West Africa Ltd* [1900] 1 Ch 656, members altered a company's articles to give the company a lien on the paid-up shares of shareholders who did not pay for other called-up shares. It was held that the alteration was valid. Lindley J the explained the power of companies to alter their articles as follows:

> The power thus conferred on companies to alter the regulations contained in their articles is limited only by the provisions contained in the statute and the conditions contained in the company's memorandum of association […]. The power conferred on it must, like all other powers…be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded.

The measure of what is in the best interest of the company as a whole is generally determined by reference to what the members who made the alteration genuinely considered to be in the best interest of the company. This is a subjective test.

Sidebottom v. Kershaw, Leese & Co. Ltd [1920] 1 Ch. 154 – The defendant company altered its articles to enable its directors to buy out the shares of any member who carried on a business in competition with the company. The plaintiffs carried on such business and the directors compulsorily purchased their shares. It was held that it was primarily in the interest of the company that the alteration should be made.

It is not generally, for the court to decide what is in the best interest of the company since it does not run the business of companies. But, as was held in *Shuttleworth v. Cox Brothers & Co. Ltd.* [1927] 2 KB 9, if the alteration was oppressive or suspicious, or extravagant such that no reasonable person would consider it to be in the best interest of the company, the court may set it aside, especially where the interest of minorities is concerned.

Browne v. British Abrasive Wheel Co. Ltd. [1919] 2 Ch. 290 – Provisions of the articles of the defendant company were altered to enable holders of 98% of the shares to compulsorily buy the holders of the remaining 2%. The alteration was held to be invalid because it discriminated against the minority for the benefit of the majority. It was therefore not in the interest of the company as a whole.

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21.4 COMPANY CONTRACTUAL CAPACITY

Company capacity refers to the ability and power of a company to enter into contracts or to undertake transactions. Although the issue of company capacity was very thorny in the past, it has in recent years, undergone considerable and fundamental improvements. Far from what it was under the common law, the *Companies Act 2006* has attempted to align the contractual capacity of companies with that of natural persons.

21.4.1 COMPANY CAPACITY UNDER THE COMMON LAW

A company's contractual capacity under the common law had two aspects – the power of the company itself and the power of directors of the company to bind it. A company's contractual capacity was specified and limited by the objects clause in its memorandum of association. A contract entered into by a company, which was outside its objects, as stated in the memorandum of association, was said to be ultra vires. Such a contract was held to be null and void and unenforceable. Even the company's general meeting could not ratify an ultra vires contract.

Under the common law, a person was deemed to have constructive knowledge of everything in a company's memorandum and articles since they are public documents. Thus, it was presumed that everybody knew that a company is acting beyond its powers if the act was not sanctioned in the objects clause. The original reason for the *ultra vires* doctrine was the protection of the public who had dealings with companies. Making it clear what a company could do was intended to prevent companies veering off the stipulated businesses to the potential detriment of investors and customers. The House of Lords confirmed the *ultra vires* doctrine by deciding that companies did not have unlimited contractual capacity: their capacity was limited to the pursuit of the objects set out in the "objects clause" in their memorandum of association.

> *Ashbury Ry. Carriage v Riche (1875) LR 7 653 (HL)* – A company's objects were to make, sell, or lend on hire, railway carriages and wagons, and all kinds of railway plants, fittings, machinery and rolling stock. They were also to carry on business as mechanical engineers among other things. The directors of the company bought a concession to construct a railway and subcontracted it to R. The company later breached the contract as the members opposed it. It was held that this transaction was outside the company's objects and was therefore void and unenforceable.

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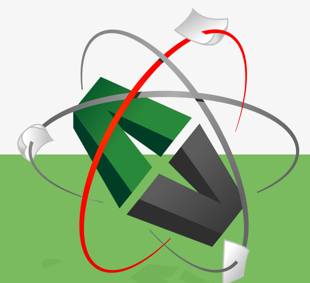
> *Re Introductions Ltd.* [*1970*] *Ch 199 (CA)* – A company's main object was providing tourist services to foreign visitors to the UK. The company had an express power to borrow money for its business. It later engaged in the business of pig breeding as its only business and borrowed money from a bank to put into it. The company subsequently went into liquidation. The bank sought to recover the loan. It was held by the Court of Appeal that the company had borrowed money for a business not covered in its objects. Such borrowing was therefore ultra vires and the bank could not recover the money.

Furthermore, under Common Law, the power of companies' directors to bind their company to a contract was limited to the power granted to them to do so by the articles of association. If the directors exceeded their powers, the contract would not be binding on the company, which would be free to repudiate it. The *ultra vires* rule proved to be a source of hardship to creditors and customers even though the original intention was to protect them. It was possible for companies to enter into contracts outside their objects clause, derive benefits from them and then refrain from performing their own side of the bargain on *ultra vires* grounds. The need to beat the ultra vires doctrine led to the drafting of very long comprehensive objects clauses, including open-ended "sweeper" clauses giving the board of companies the discretion to extend the company's activities.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21.4.2 COMPANY CAPACITY UNDER THE COMPANIES ACT 2006

Following a European Union directive, the law governing company contracts and the power of directors to bind the company was modified drastically. The European Community's *First Company Law Directive* (EEC/68/151) requires member states to ensure that parties dealing with companies enjoy "security of transaction". The danger of a contract proving void due to a company's lack of contractual capacity would threaten this "security of transaction". The CA 1985 and 1989 made several provisions to implement the EU directive. The Companies Act 2006 have reinforced and enlarged these provisions to the following effect:

21.4.2.1 Companies now have unlimited capacity

S. 31 CA 2006 provides that a company should have unlimited contractual capacity unless its capacity was specifically restricted in its own articles. Companies are therefore no longer required to have an objects clause. This means that, in the absence of express limitations in a company's articles, no lawful activity should be beyond the powers of a company. However, if the articles specifically restrict the powers of a company, its capacity would be limited accordingly. If a company does any act forbidden by its articles, that act would technically be beyond its powers.

21.4.2.2 Transactions outside the provisions of the constitution remain valid

S. 39 CA 2006 provides that, "the validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution." In other words, a contract entered into by a company will remain valid even though it goes beyond the limit of the powers of the company in the articles. Such contracts remain enforceable although members may punish the directors responsible for them. Moreover, constructive notice of the contents of a company's articles has now been abolished. S.39, however, does not apply to charitable companies, which must abide by the provisions of their constitution. Acts outside the constitution of a charitable company are not valid unless the other party to the transaction paid fully for the deal without knowledge of the company's status – s. 42.

21.4.2.3 The power of directors to bind company is now unlimited

S. 40 CA 2006 provides that:

> In favour of a person *dealing with a company in good faith*, the power of the directors of that company to bind the company or authorize others to do so shall be deemed to be free from any limitation under the company's constitution.

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This means that as far as innocent third parties are concerned, the directors of a company have unlimited power to tie the company to contracts or to authorise others to do so. A person deals with a company if he is a party to any transaction or act to which the company is also a party. This includes anybody engaged in business deals and contracts with the company. A person dealing with the company is deemed to have acted in good faith unless the contrary is proved. The burden of proof is on the company. Mere knowledge that an act is beyond the powers of the company or directors does not indicate bad faith. This provision guarantees that a contract entered into by a company with a third a party cannot be nullified on the ground of lack of capacity on the part of the company's directors.

21.4.2.4 Directors cannot benefit personally from s. 40

Under section 41, a director of a company cannot benefit from s. 40 (i.e. from a transaction entered into in excess of the power of the directors). If the directors of a company enter into any transaction beyond their powers, and the other party to the contract is a director of the company or of its holding company, or is a person connected with the director or a company with whom the director was associated, the company has a right to cancel the contract. Any director who was a party to the transaction or who authorised it would be liable to account to the company for any gains they had made. They would also be liable to indemnify the company for any losses suffered. This liability remains whether or not the company avoids or cancels the transaction although the members may, by special resolution, relieve the directors of liability. However, a company cannot cancel a transaction entered into in breach of s.40 if:

- It is no longer possible to restore the parties to their original position, or
- The company has been indemnified for any loss or damage it suffered, or
- A third party, who is not a party to the transaction and who did not know that the directors have exceeded their powers, have acquired rights in good faith and for value.
- The company's general meeting has ratified the transaction by the appropriate resolution.

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21.4.2.5 Members can prevent acts beyond directors' powers

Where a company has limited its directors' powers in its articles, the members can bring a court action to prevent the directors from doing any act beyond those powers. However no action could be brought if the act *was done in fulfilment of an existing obligation arising from a previous act of the company – s. 40 (4).* Thus, members of a company may stop their company directors from going against their articles *before* the transaction takes place. If the directors fail to abide by the members' wishes, they could be liable to the company for any losses.

21.4.2.6 Companies' capacity to make political donations remains limited

A company has no power to make political donations or expenditure to any political party, independent candidate, or political organisation of more than £5000 in any one year without a resolution by the company – *s. 366 CA 2006.* If directors make unauthorised political donations or expenditure, they are personally liable to refund the money and to pay for any loses or damages suffered by the company as a result – *s. 369.* However, donations or expenditure to trade unions or trade associations, or All Party Parliamentary Groups are not to be regarded as political donations/expenditures – *s. 37.*

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21.5 CHAPTER SUMMARY

- A company's constitution comprises its articles of association and any special and unanimous resolutions.
- Every company must have articles of association. It may make its own, or the appropriate model articles in the Companies Act would automatically apply to it.
- Articles of association contain rules for the organisation and running of the affairs of a company, the regulation of the activities and rights of its members and officials, the election and removal of officers, and other things relevant to the business and functioning of the company.
- A company's articles of association is a contractual document binding the company and its members and enforceable by them but only in respect of rights arising from membership.
- The articles are not a contract between a company and its officials and outsiders who are not entitled to enforce any provisions in them.
- The provisions of a company's articles are alterable by the members by special resolution or by such means as may be stipulated therein. The power of members to alter the articles cannot, however, be removed by any provisions in the articles.
- Any alteration of the articles must be done in good faith and in the interest of the company as a whole. Moreover, no alteration would be valid if it contravenes the Companies Act 2006; imposes more shares or liability on members; or is oppressive of minority shareholders.
- Unless articles of association impose limits on the capacity of a company or the power of its directors, a company is deemed to have unlimited capacity and directors unlimited power to bind it.
- However, any limitations on a company's capacity or directors' powers will not affect the validity of any transaction undertaken by them in contravention of the provisions with third parties acting in good faith. Such limitations are now internal matters between a company and its directors who may incur personal liability for going against the constitutional limitations.
- Nebertheless, a company's capacity to make political donations without the approval of members is limited to £5000 in any one year.

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21.6 PRACTICE QUESTIONS

1. Explain the legal effects of a company's constitution
2. Explain the procedure for making changes in company's constitution and the legal restrictions on the power of a company to make those changes.
3. Explain the terms "pure membership rights" and "outsider rights" in the context of a company's constitution.
4. The articles of association of Telcon Ltd contain the following provisions among others:

    - That any disputes between the company and its members should first be submitted to arbitration before it may be taken to court;
    - That the directors of the company may, with the approval of the general meeting, declare a dividend to be paid to the members in cash and in proportion to their shares;
    - That in consideration for the sale of his property to the company, Adam would become a member of the company and would be a director for at least four years.

    In spite of these provisions, Sandra, a shareholder in the company, without going through arbitration, sued the company for a breach of contract for failing to pay her the agreed rate of dividend. The General meeting of the company, against the vote of Malcom, passed a resolution to pay dividends by way of debentures instead of cash. Adam never became a member of the company but was made a director. He was however, removed as a director before the stated four years.

    Advise Telcon Ltd, Sandra, Malcolm and Adam on their respective rights and liabilities under the company's articles.

5. To what extent and effect can the capacity of a company or its directors now be limited in company law?

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22 COMPANY MEMBERS

22.1 INTRODUCTION

Even though a company is a separate legal entity, it is unable to act or to do anything on its own. It needs human beings to act on its behalf. The members or directors of a company take decisions for the company and carry out its activities. Members of a company are often responsible for its formation, formulation of the purposes of the company and drafting or adopting its articles of association. Members, especially the founding ones, therefore set the general tone of a company's business, while existing members at any time are responsible for effecting changes in its constitution and appointing and removing directors. Members of a company also retain the residual powers of the board and may exercise these when there is no proper board of directors or when there is a deadlock in the board. Thus, members of a company have control of the company while directors have the responsibility for management. Both powers may, however, be held by the same people, especially in private companies where the same persons are often the members and shareholders.

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22.2 LEARNING OBJECTIVES

The objectives of this chapter are to show:

- Who the members of a company are
- How a person could become a member of a company
- The rights and powers of members
- How membership of a company may be terminated
- The types and purposes of meetings members may have
- The legal requirements of members' meetings
- How members take decisions and the types of decisions they take

22.3 MEMBERSHIP OF A COMPANY

Members of companies may be natural persons or legal persons, i.e., companies. Every company must keep a register of its members. The register should contain the names and addresses of the members, the type and number of shares owned by them, the amount paid for the shares, and the dates of commencement and end of membership. A company having more than 50 members must also keep an index of all its members – s. 115 CA 2006. Every shareholder is entitled to receive a share certificate within 2 months of becoming a member as evidence of the shares held in the company, except where the shares are uncertificated – s. 768 & 769 CA 2006. The certificate, however, is not a title document. It is evidence of title. A person ceases to be a member of a company by death, bankruptcy, sale, transfer, forfeiture, or surrender of shares, or by the liquidation of the company. Membership of a company may arise in the following ways.

22.3.1 SUBSCRIPTION TO THE MEMORANDUM OF ASSOCIATION

The first method of becoming a member of a company is by subscribing to the memorandum and articles of association during the formation of the company. A subscriber to a company's memorandum is deemed to have agreed to become a member of the company and to have his name entered in the company's register of members – *s. 112 (1) CA 2006.*

22.3.2 PURCHASE OF SHARES FROM THE COMPANY

A person may become a member of a company by making a successful application for the company's shares when the company issues or allots them to potential shareholders. While a public company can allot its shares to the public through the stock market, a private company cannot do so. *S. 755 CA 2006* makes it an offence for a private company to allot its shares to the public. Shares of private companies can only be acquired by private arrangements.

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22.3.3 PURCHASE OF SHARES FROM A MEMBER

Another way of becoming a member is by buying shares from an existing shareholder. A shareholder can always sell his shares. In public companies, this is usually done through stockbrokers; in private companies, the sale has to be by private arrangement. Usually, though, members of a company are required to offer their shares to other members first before offering them to non-members. This is called *right of pre-emption* and is governed by s*s. 561–573 CA 2006.*

22.3.4 INHERITANCE

A person may become a member of a company by inheriting the shares of a dead or bankrupt shareholder. This happens by operation of the law and is referred to as transmission.

22.3.5 EMPLOYEE SHARE SCHEME

Membership of a company may also be acquired through an employee share scheme. The Companies Act allows the allotment of shares to present and former employees of a company or to their spouses, widow/widower, children or stepchildren under the age of 18 – *see ss. 682(2) and .1166 CA 2006.* The purpose of this scheme is to give greater and personal stake in a company to the employees as a way of increasing their commitment and productivity or as reward for their services.

22.4 MEMBERS' MEETINGS

A meeting of a company's members is called a general meeting. General meetings are presided over by the company chairman who is responsible for their proper conduct – ss. 319 – 320 CA 2006. The articles of association will normally make provisions for the appointment of a chairman – usually one of the members of the Board of Directors. Where the chairman is unavailable, the directors shall nominate another director to be the chairman. Where there is no chairman or director, the members at a general meeting may elect anyone among themselves to be the chairman of the meeting. There are three types of general meetings – the Annual General Meeting (AGM), the Extraordinary General Meeting (EGM), and general meeting ordered by the court.

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22.4.1 THE ANNUAL GENERAL MEETING

Annual General Meetings (AGM) are held once every year. Every Public company is required by law to hold AGM. The AGM must be held within six months of the company's last annual account. It is an offence, punishable by fine, for a plc not to hold an AGM – *s. 366 CA 2006*. Private companies are no longer required to hold AGM. They may only do so if they wish or if members request for it. It is the responsibility of the directors of a company to convene an AGM. However, members accounting for at least 10% of the shares or membership have a right to demand it. A request in the first instance would be made to the Board of directors who must convene the meeting within 21 days. If the directors fail to call the meeting, the members concerned may themselves convene it at the company's expense – *s. 303–305 CA 2006*. Matters to be discussed at the AGM include:

a) The company's annual audited account
b) The directors' and auditors' annual report
c) The election and re-election of directors
d) The appointment and re-appointment of auditors
e) The payment of directors' and auditors' fees
f) Such businesses as proposed by the directors or members.

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22.4.2 THE EXTRA-ORDINARY GENERAL MEETING

Any general meeting of a company other than the Annual General Meeting is called Extraordinary General Meeting (EGM). An EGM may be convened when:

a) The Board of Directors consider it necessary. They must, however in good faith and in the interest of the company as a whole.
b) In the case of public company, *its assets fall to half or below half of its called-up capital.*
c) Members of a company holding 10% or more of the paid-up shares or voting rights demand the meeting. If the directors fail to convene the meeting within 21 days, the members concerned may convene it themselves.

22.4.3 GENERAL MEETING ORDERED BY COURT

A court may, on the application of a director or member of a company, order the holding of a general meeting when it is *impracticable* to convene or hold the meeting in the normal way – s. 306 CA 2006. Such a meeting may be ordered, for example, where minority member(s) who are also directors refuse to sanction the convening of a general meeting in order to prevent decisions unfavourable to them from being taken, or where they refuse to attend the meeting in order to deny it of the necessary quorum. When ordering the meeting, the court will give the necessary directions as to its conduct and quorum. Such a meeting will usually be regarded as an EGM.

22.4.4 QUORUM FOR MEETINGS

Quorum refers to the number of people who must be present at a meeting to make it regular and valid. A meeting held without the required quorum would be null and void. The quorum for meetings is normally stated in the articles of association of a company. *S. 318 CA 2006* makes the following provisions:

> Where no provision is made in the articles, and the company has two or more members, the quorum shall be two members. In the case of a company with one member, the quorum shall be one person.

The court or the Secretary of State may also, in appropriate circumstances stipulate the quorum for a meeting.

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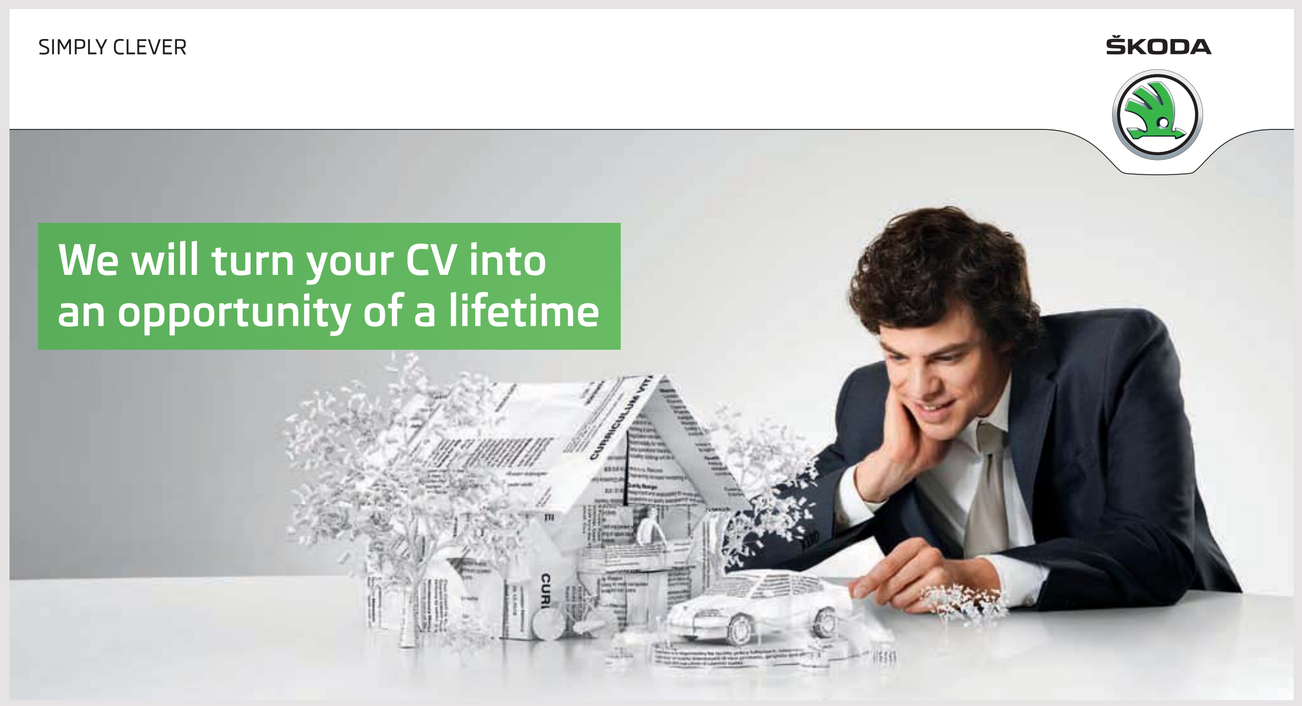
22.4.5 NOTICE OF MEETINGS

Before the decision of general meeting will be considered valid and binding, every member and every director entitled to attend the meeting must be given sufficient notice of it – *s. 310 CA 2006.* The notice of meeting shall contain the date, venue, and nature of matters to be discussed – *s. 311,* and may be in writing or electronic form (fax. Telex, email, email or website) – *s. 308.*

- The length of notice shall be 14 days for a general meeting of a private company.
- For a plc, the notice shall be 21 days (AGM), or 14 days for any other general meeting – *s. 307*. A longer period of notice may however be given if the articles so provide. Any provision in the article prescribing a shorter notice than these will be invalid.
- However, shorter notice may be given in private companies if 90% of members entitled to attend and vote agree to the shorter period. In a plc 95% of the members must agree for general meetings other than the AGM – *s. 307*. For an AGM, a shorter notice could only be given if all the members of the plc agree to it – *s. 337.*



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If a meeting is called without notice or adequate notice, it will be invalid unless all members entitled to notice do in fact attend the meeting notwithstanding the lack of notice and waive their right to notice. Where some members could not attend due to lack of notice, the meeting and any decision taken in it would be invalid unless the affected members expressly agree to waive the irregularity.

> In *Re Pearce Duff and Co. Ltd* [1960] 1 WLR 1014, a company's general meeting was called mistakenly without adequate notice. Some members could not attend the meeting because of insufficient notice. At the meeting, a decision was made to reduce the company's capital. Later all the members of the company entitled to vote at the meeting agreed in writing to approve the decision. The meeting and the reduction of capital were held to be valid.

If the failure to give notice to some members was accidental, it shall not invalidate the meeting unless it was called by or at the instance of members – *s. 313* CA 2006.

22.5 RESOLUTIONS

Decisions of company members are passed as resolutions. These are binding on the company and its managers. The resolutions recognised by the Companies Act 2006 are the ordinary resolution, special resolution and written resolution. There is also the unanimous resolution established under the Common Law. Special and unanimous resolutions and the unanimous resolution of a class of shareholders, or which is binding on all members of the class, have the effect of altering a company's constitution (s. 29 CA 2006). Resolutions may be passed at general meetings or without the need for general meetings. Ordinary and special resolutions require a general meeting. Written resolutions and unanimous resolutions do not require a general meeting. Resolutions may also be passed at class meetings of shareholders.

22.5.1 ORDINARY RESOLUTION – S.282 CA 2006

This is a decision by a simple majority (at least 51%) of members *present and voting* at a general meeting. This means that the necessary majority is counted from the shareholders who actually attend the meeting and cast their votes. For example, if a company has hundred members and only fifty attend a general meeting, the simple majority by show of hands shall be twenty-six. Provided all members entitled to vote at a meeting have been duly invited, they are bound by the decisions of those who attend the meeting. Unless the articles of association or the Company's Act stipulate a larger majority, decisions at a general meeting should be adopted by ordinary resolution.

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22.5.2 SPECIAL RESOLUTION – S. 283 CA 2006

This type of resolution requires at least 75% of the votes of members *present and voting at a general meeting.* Usually decisions on serious matters require special resolutions. If a matter is to be proposed as a special resolution, the notice of meeting must state the text of the proposed resolution and the intention to propose it as a special resolution. This is necessary to allow members to study the proposal and decide which way to vote. Matters requiring special resolutions include alteration of articles of association, voluntary winding up, and reduction of share capital. All resolutions of a plc must be passed either by ordinary or special resolution at a general meeting.

22.5.3 WRITTEN RESOLUTIONS – S. 288 CA 2006

A private company may take decisions by way of a written resolution. This is a resolution signed by the members without the need for a general meeting. A public company cannot use a written resolution. Written resolutions, which replaced the previous regime of elective resolutions, make decision-making easier for private companies. Members of a company or the Board of Directors may propose a resolution as a written resolution. A class of shareholders may also use written resolutions. The proposal of the resolution must contain a text of the resolution and the method of assenting to it and must be circulated to all eligible members along with any supporting statement. A written resolution may be passed by a simple or special majority as may be stipulated in the articles (see s. 282 (2) & s. 283 (2)).

Any decision of a private company may be passed as written resolution unless it would be vexatious, frivolous, or contrary to the Companies Act or the company's' constitution – *s. 292(2) CA 2006.* However, directors and auditors of a company cannot be removed by written resolution before the end of their tenure because of the requirement of self-defence for the officers affected.

22.5.4 UNANIMOUS RESOLUTIONS

Under the common law, where all the members of a company entitled to attend a meeting reach an agreement on a matter, that agreement is binding as if it were reached at a general meeting. The agreement, which may be oral or in writing, will not be invalidated simply because it was not reached at a formal meeting. The rationale for this principle is that since the essence of a meeting is for members to come together and take a decision, if they are able to agree on anything without holding a formal meeting, there is no reason why that agreement should not be respected. This is sometimes called the *duomatic principle* after the case in which it was adopted.

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In *Re Duomatic Ltd* (1969) 1 All ER 161 – it was held that a payment approved unanimously by all the shareholders of a company without a general meeting as required by the company's articles was valid as if it was approved by the general meeting. The court remarked as follows:

> Where it can be shown that all shareholders who have a right to attend and vote at a general meeting of a company assent to some matter which a general meeting of the company could carry into effect, that assent is binding as a resolution in general meeting would be.

See also *Rolfe v Rolfe* [2010] EWHC 244

This principle, which has been impliedly preserved by s. 281 CA 2006, will not apply to the removal of directors or auditors since, in both cases, the officers concerned are entitled to attend a general meeting and to defend themselves – ss. 168 and 169 CA 2006.

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22.5.5 REGISTRATION OF RESOLUTIONS – S. 30 CA 2006

When a company passes a resolution, the effect may be to change the contents of a document already filed at the Companies' House. The effect may also be to introduce a new element in the company, meaning that the old document may give a misleading picture about the company to potential or existing creditors, investors, and customers. There is therefore need to keep the Registrar of Companies informed of important changes in companies' affairs or documents. Accordingly, under the Companies Act a company must file with the registrar of companies, within 15 days, a copy of any special or unanimous resolution of the members, or the unanimous resolution of a class or which binds all the members of a class of shareholders. Any subsequent articles of the company must include the new resolution.

22.6 VOTING AT MEETINGS – S. 284 CA 2006

Decisions of members are reached by the voting. The vote may be by assenting to a written resolution, by show of hands or by poll.

a) *By assenting to written resolution* – For a private company using a written resolution, every member has one assent or vote. If the company has a share capital, each member has one vote per share or one vote for every £10 of stock.
b) *By show of hands* – In this case, all members present have one vote each notwithstanding the number of shares they have in the company. Every member is however entitled to demand a vote by poll.
c) *By Poll* – This means voting according to the number of shares held by members, who are entitled to one vote per share or in case of stock, to one vote per £10 stock. The articles may however make different provisions on the number of votes a share may have.
Voting by poll benefits the larger shareholders and ensures that those with majority shareholding effectively control the company. A company cannot remove the right of a member to demand a vote by poll – *s. 321 CA 2006*. However, a member is not entitled to a vote by poll in respect of any shares that have not been paid for. For example, if Y has 1000 shares in a company but has only paid for 500, his right to poll is restricted to 500 hundred votes. If a member has not paid anything on his shares, he will not be entitled to vote at all.

Quoted companies must publish on their website the results of any poll taken at a general meeting. The publication must include the text of the resolution, the date of the meeting, the number of votes in favour and the number of votes against – s. 341. They must also provide an independent report on any poll taken or to be taken if this is demanded by members accounting for 5% of the shares or membership or 100 of the members who have paid at least £100 on their shares – s. 342 CA 2006.

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22.6.1 PROXIES – S. 324 CA 2006

A proxy is someone appointed to represent a member at a company general meeting. Proxies are necessary because it is not always possible or convenient for a shareholder to attend a meeting in person. Besides, a member may not feel sufficiently knowledgeable on the matters for decision and may therefore appoint someone with a better knowledge to represent him. Every member has a right to attend the meeting in person or to appoint a proxy to attend and vote on his behalf. The proxy may be a member of the company or an outsider.

- A member can only appoint one proxy for a meeting but in a company with a share capital, a member may appoint more than one proxy to represent the different classes of shares or stock held by him – s. 324.
- A proxy is able to exercise the powers of the member who appointed him, including the right to speak at the meeting and to vote. A proxy can now also vote both by show of hands and by poll (s. 284 (2) & s. 329).
- A proxy may be elected as chairman of the meeting by a resolution – s. 328.
- Where a member attends a meeting after appointing a proxy, the vote of the member and not that of the proxy should be counted. The articles of a company may extend the rights of a member and proxy.

22.7 CHAPTER SUMMARY

- Membership of a company may comprise natural persons or companies
- Members of a company are the owners and controllers of the company. They have the power to make and amend the company's constitution and are responsible for the appointment and removal of the directors and some of other officials.
- Company membership may be acquired by subscription to the memorandum of association; by purchase of shares from a company or its members; by inheritance; and through employee share scheme.
- Members of a company usually hold two types of meetings – the Annual General Meeting (AGM) and the extra-ordinary General Meeting (EGM). However, in some circumstances they may hold a general meeting on the order or a court. Although a plc must hold general meetings, a private company may choose not to have them.
- General meetings must be called with proper notice to members. Improper notice may invalidate a meeting and its decisions unless the lack of notice was accidental or the members who were denied notice elect to waive their right.
- A quorum must be formed before a general could be validly held.

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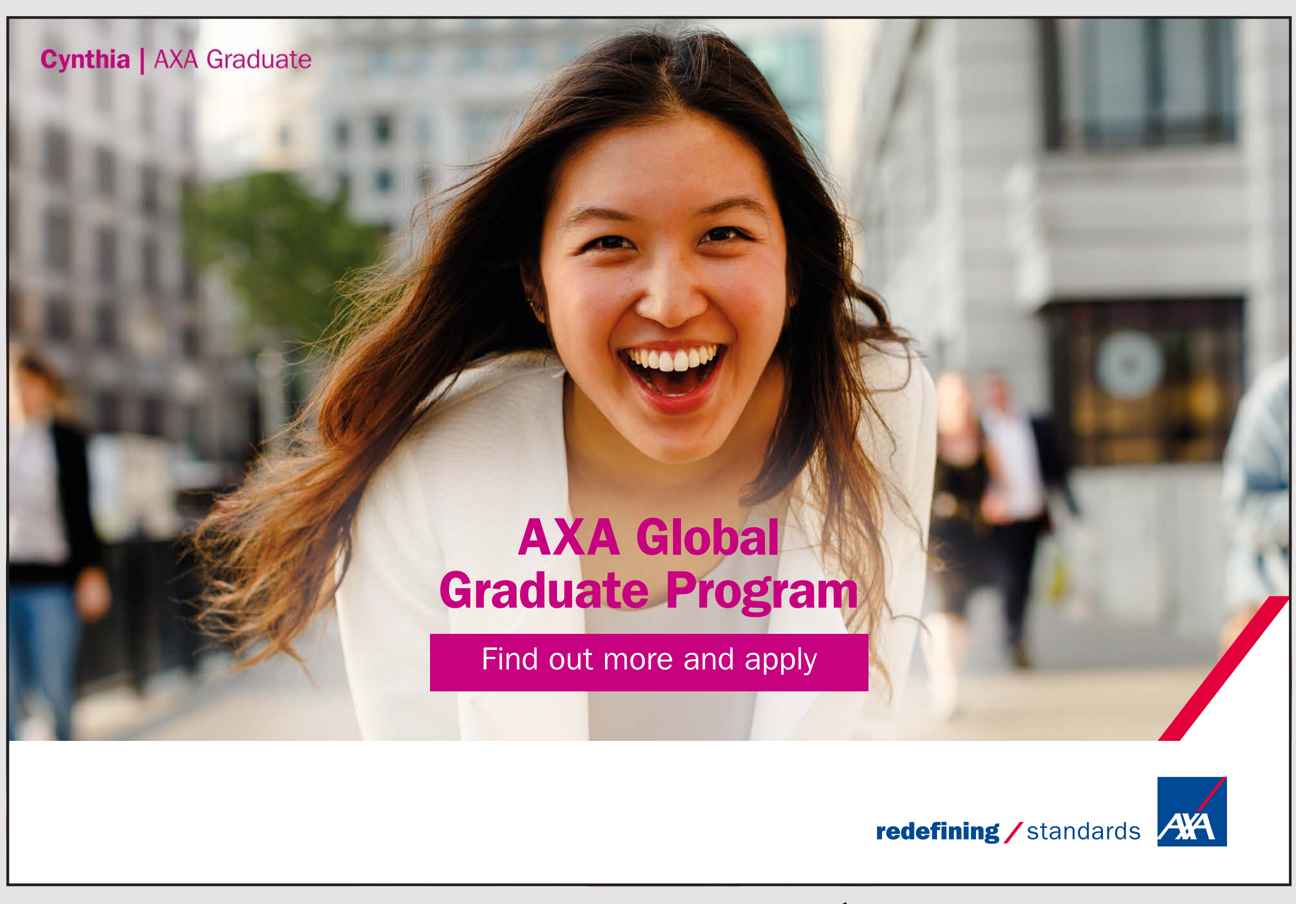
- Decisions of company members are called resolutions. These are of four types: ordinary, special, written, and unanimous resolutions. Only private companies may use written resolutions and dispense with general meetings.
- Decisions of company members may be by show of hand, poll or assent to written resolutions.
- Every member is entitled to attend a general meeting, either in person or by proxy.

22.8 PRACTICE QUESTIONS

1. State and explain how membership of a company may be obtained.
2. Explain the type and uses of company resolutions.
3. Distinguish between voting by show of hands and voting by poll, and the implications of each.
4. Explain the functions of a company's annual and extra-ordinary general meetings.



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23 MEMBERS' POWERS AND THE PROTECTION OF MINORITIES

23.1 INTRODUCTION

Normally, a company's powers comprise management and control, with the former lying with the directors and the latter with the members. In many companies, however, especially private ones, the owners and directors may be the same persons, so putting ownership and control in the same hands. The separation of ownership and control therefore finds real expression in large companies and public limited companies. The power of control by members in reality resides with those with majority shares or interest who may take decisions irrespective of the wishes of the minority. Although minorities have the right to participate in decision-making, ultimately only the majority shareholders could control the company or its directors. Sometimes however, the majority may abuse their powers or exercise them in a way detrimental to the interest of the company and its minority shareholders, especially when the majority is large and controls the board of directors. Hence, there is need, in some circumstances to protect company minorities (and the companies) from oppression or abuse of power by the majority.

23.2 LEARNING OBJECTIVES

At the end of the chapter, the reader should clearly understand:

- The balance of power between owners and directors of companies
- The powers of control which company members have and how they may be exercised
- The need to protect minority shareholders and companies from abuse of power by majorities
- The different mechanisms for the protection of minority shareholders and when and how they may be used

23.3 MEMBERS' POWERS

Members of a company are not normally involved in its management, the prerogative of which belongs to the board of directors. Members do not have the power to direct the board of directors on the details of management. They do however, have the prerogative to decide several matters concerning the company's business through the making and alteration of the articles of association, the passing of resolutions and the power to authorise certain actions of directors. Members also have the power to appoint and remove directors and other officers and the residual power to assume management responsibilities.

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23.3.1 CONTROL THROUGH THE CONSTITUTION AND RESOLUTIONS

One crucial way in which members exercise control over their company is the making and alteration of the articles of association. By this power, members are able not only to determine the rules under which the company would be governed but also to change a lot of things in the company, including the name, status, nature of the company's undertakings, the capacity of the company, and the powers of its directors – ss. 21 & 22 CA 2006. Moreover, the exercise of directors' powers is subject to the articles of association**.** Under s. 171 CA 2006, directors must act within their powers and must use them for their proper purpose. In furtherance of this objective, article 2 of the 2007 model articles provides that *"subject to the articles,* the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company."

The articles of association of a company may also give the members the power to instruct directors generally on the direction of the company. For example, article 3 of the 2007 model articles provide as follows:

1) The shareholders may, by special resolution:
    a) alter the scope of the directors' functions; or
    b) require the directors to act in a specific manner
2) No special resolution passed under paragraph (1) shall have retrospective effect

The above provisions mean that although the directors have the general power of management, members have reserve powers, by means of a special resolution, to review the scope of directors' powers and to instruct directors to act in a specified manner. However, the members cannot invalidate anything already done before a special resolution was passed or before the articles were amended. The members may increase or decrease directors' powers by altering the articles accordingly and thereby decide the general direction of a company.

23.3.2 CONTROL THROUGH APPOINTMENTS AND REMOVALS

Another crucial way members exercise control is in the appointment and removal of directors and other officers of the company. This important power ensures that directors and other officers of the company owe their job to the members – see *ss. 154, 160,* and *168 CA 2006*. It would therefore be in their interest not to disregard the wishes of company members, especially institutional shareholders.

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23.3.3 CONTROL THROUGH APPROVALS AND AUTHORISATIONS

Members have the prerogative to approve their companies' annual accounts and directors' reports. This (at least in theory) enables them to monitor and evaluate the performance of the company and that of the board of directors and to decide which directors should be retained. Members also have the prerogative to forgive directors for engaging in transactions which are outside the capacity of the company as stated in the articles, especially where the third party involved is not connected to the director – s. 239 CA 2006. If members do not forgive such conduct, directors could be held personally liable for any losses incurred by the company as a result. Members also have the prerogative to approve the remuneration and entitlements of directors and other officers of the company.

Further, members exercise control through their power to authorise directors to allot shares (an authority directors are not allowed to exceed) and the power to increase or reduce their company's share capital. The authorisation of increase or reduction of share capital enables shareholders to enlarge or reduce the size of the company as circumstances may demand. Finally, only members can authorise the voluntary winding-up of their company. Directors cannot do so (*Re Emmadart Ltd.* [*1979*] *Ch. 540*). Therefore, the long-term fate of the company is in the hands of the members.

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23.3.4 CONTROL THROUGH RESIDUAL POWER OF MANAGEMENT

Company members may exercise the powers of the board of directors if there is no competent board or if the board is not able to act. This situation may arise if existing directors are incapacitated; there is an intractable deadlock in the board of directors; or the board could not form a quorum.

> In *Barron v. Porter* [1914] 1 Ch 895, a company had two directors. Owing to enmity and deadlock between the directors, no board meetings were held. The plaintiff called a general meeting at which additional directors were appointed. One of the directors objected on the ground that the power to appoint the additional directors was vested in the board by the articles. It was held that, due to the deadlock in the board, the powers of the board reverted to the members in general meetings.

In the exercise of their residual powers, members may call general meetings where directors fail or are unable to call one – *s. 305 CA 2006.*

23.4 PROTECTION OF MINORITY SHAREHOLDERS

There are different mechanisms by which the protection of minority shareholders might be accomplished. These are the common law derivative action, derivative claims and continuing derivative claims for directors' breach of duty under the CA 2006, the unfair prejudice remedy under the CA 2006, and the just and equitable winding-up under the *Insolvency Act 1986*.

23.4.1 DERIVATIVE ACTION UNDER THE COMMON LAW

Derivative actions under the common law are an exception to the "Rule in Foss v Harbottle". This rule, as we saw earlier (see chapter 20) states that if a company suffers a wrongdoing in the hands of anybody, whether from outside or inside the company, the proper person to bring an action for redress is the company itself. Individual shareholders have no right to take action on their own behalf or on behalf of the company.

> In *Foss v. Harbottle* (1843) [1843] 2 Hare 461, Foss and another shareholder of their company brought an action against three directors, a shareholder, the solicitor and architect of the company for themselves and on behalf of other shareholders of the company, in respect of losses suffered by the company due to the defendants' misconduct and fraud. The defendants were alleged to have enriched themselves at the expense of the company. It was held that the company itself could take action against the defendants if it wished; that the plaintiffs were not entitled to be bring the action; and that since the company could confirm the actions of the defendants by a majority vote, the court could not interfere.

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However, where majority shareholders abuse their position, or where there are allegations of mal-administration against directors who are majority shareholders, difficulty arises as to how to protect the interest of the company or those of the minority. This is because those in control may not be willing to sue on behalf of the company since they are the wrongdoers. In these types of circumstances, the rule in *Foss v. Harbottle* may be displaced to allow individual shareholders to take action on behalf of other aggrieved shareholders in order to protect the minority and the company. This kind of lawsuit, which could be to prevent, stop or nullify the action of the majority, is called a '*derivative action*' because the suing shareholder derives his authority to sue from the company.

Before a derivative action could be brought under the exceptions to Foss v Harbottle, it must be shown that:

- The wrongdoers are in control of the company and would not take action on behalf of the company; and
- The complainant did not take part in the wrongful act; and
- The action would be brought on behalf of the company which would be the beneficiary of any judgment. To accomplish this, the company would normally be joined as a defendant in the case, although the court may order the company to pay the complainant's cost – *Wallersteiner v Moir* [1974] 3 All ER 217.

Derivative action may be taken on any of the following grounds:

- That the act contemplated by the company is illegal, *ultra vires*, or contrary to the Companies Act
- That an act, which could only be done by a special majority, was purportedly done by a simple majority

    In *Edward v. Halliwell* [1950] 2 All ER 1064, the constitution of a company provided that the amount of contribution by members could only be altered in a ballot in which two-third of the members voted in favour. The amount of contribution was increased without ballot and the members were compelled to pay it. Some members sued to challenge the increase. It was held that the rule in Foss v. Harbottle was not applicable because (a) the act could only be done by a special majority, (b) the rights of individual shareholders were involved, and (c) there was oppression.

- That the personal right of a shareholder was infringed. In *Pender v. Lushington* [1877] 6 Ch D 70, a shareholder who was denied his voting rights was able to bring an action for redress. Similarly, in *Edward v. Halliwell* [1950] 2 All ER 1064, the increase of contribution affected the members personally, entitling them to sue.

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- That there has been a fraud on the company or the minority. Fraud includes any act done in bad faith and against the interest of the company. Thus, any act by majority shareholders calculated to oppress the minority or defraud the company would be regarded as fraud entitling minority shareholders to bring an action. Misappropriation of corporate assets or opportunity by majority shareholders or directors may also be regarded as fraud on the company and the minority shareholders. Breach of directors' duties could also amount to fraud on the company and minority. Below are some examples of fraud on the company or minority:

  Cook v Deeks [1916] 1 AC 554 – Directors used their position to obtain a contract which the company would have obtained. They then used their majority votes in the company to pass a resolution that the company was not interested in the contract. It was held that a fraud had been done on the minority and the directors liable to account.

  Daniels v Daniels [1978] Ch 406 – Directors of a company sold the company's properties to one of themselves at a gross undervalue. That director later re-sold the property at a huge profit. It was held that a shareholder could sue to bring the directors to account since they have used their position to benefit themselves to the detriment of the company.

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Where majority shareholders forcibly buy the shares of minority shareholders in order to force them out of the company, this will be regarded as a fraud on the minority – *Browne v. British Abrasive Wheel Co. Ltd* [1919] 1 Ch 290.

23.4.2 DERIVATIVE CLAIMS FOR DIRECTORS' BREACH OF DUTY

Members of a company may bring action on behalf of the company where directors have been involved in an actual or proposed act or omission involving negligence, default, breach of duty, or breach of trust – *s. 260(3) CA 2006.* This provision covers failure to perform duties expected of the directors, breach of any duty owed by directors including fiduciary duties and duty of care and skill. The action may be brought against a director (including shadow directors) or any other person responsible for the wrongdoing. Members may sue for wrongdoing committed while they are members or before they became members – s. 260(4).

In order to bring a derivative claim, a member would need to apply to the court and show a prima facie case. This means that he must show on the face of it that a wrongdoing as described above has taken place. The court may decide either to permit the action, dismiss it, and/or give such directions as necessary – s. 261 CA 2006. In deciding whether or not to give permission, the court would consider:

- Whether the act is such as would likely be authorized or ratified by the company
- Whether the member bringing the action was acting in good faith
- Whether the company has decided not to bring any action in respect of the wrongdoing
- Whether the action should rather be pursued as a personal claim by the member concerned – S. 263(3) CA 2006
- The evidence of members who have no personal interest in the matter – s. 263(4)

The court would refuse permission where a perceived wrongdoing was authorized, approved or ratified by the company – s. 280.

23.4.3 CONTINUING AN ACTION AS A DERIVATIVE CLAIM

Where a company or any member has brought an action against a director for wrongdoing, another member of the company may apply to the court to take over and continue the case as a derivative claim – s. 262 and 264 CA 2006. The court would give permission for the take-over and continuation of the action if it is appropriate for the claimant to do so and the court is satisfied that the action was brought in abuse of the court process and that the company or those who brought it have failed to pursue the case diligently. See *Stainer v Lee* [2010] EWHC 1539. This provision is designed to prevent directors or interested shareholders from blocking court action against their wrongdoing.

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23.4.4 THE UNFAIR PREJUDICE REMEDY

Sections *994–996 Companies Act 2006* make provisions to protect minority shareholders from the wrongful act or conduct of majority shareholders. A member or shareholder of a company may petition the court for remedy on the ground:

- That the affairs of the company have been or are being conducted in a manner *unfairly prejudicial to the interest* of its members generally or part thereof (including himself), or;
- That an actual or proposed act or omission of the company is or would be prejudicial – s. 994(1)

To succeed on the ground of unfair prejudice, the act complained of must amount to a prejudice and must also be unfair. An unfairly prejudicial act means an inequitable act or act done in bad faith and which is injurious or detrimental to the minority shareholders. This would include a serious breach or abuse of the company's rules. The unfair prejudice must however be a commercial detriment or disadvantage. Emotional or social disadvantage is not enough. Thus, it will include matters connected with a shareholder's shares, the business of the company, dividends, company profits and expenditure, voting, general meetings, etc. It will also include "legitimate expectations" of membership, i.e., expectations related or connected to rights of membership.

The act, proposed act, conduct or omission must also concern the interest of members in their capacity as members and not in any other capacity. For example, any act or omission that devalues shareholders' shares or interest in the company would be a commercial detriment. It would be unfairly prejudicial for majority shareholders who are directors to dismiss minority shareholders who are also directors from the board without just cause, or for majority shareholders to divert business from the company to another company or to appropriate company property. It would also be unfairly prejudicial to prevent a shareholder from selling his shares at the best price or to compel him to sell below the market value. The following cases illustrate some of the circumstances in which unfair prejudice has been found to exist:

> *Re London School of Electronics Ltd.* [1986] Ch 211 – Shareholders who controlled 75% of a company's shares diverted the business of the company to another company in which they were also the major shareholders. This deprived holders of the remaining 25% shares of their share of the company's profits. It was held that this was an unfairly prejudicial conduct.

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Re Cumana Ltd. [1986] BCLC 430 – Two owners of a company agreed to share the profits at the ratio of 2:1. The majority shareholder devised many ways to deprive the minority of his own share. First, he diverted the company business to another company controlled by him; secondly he made large rights issue that he knows the minority shareholder could not afford; and thirdly he got the company to pay excessive contribution to his pension fund. It was held that these conducts were unfairly prejudicial to the interest of the minority shareholder.

Re Little Olympian Each Ways Ltd (No.3) [1995] 1BCLC 636 – Directors of a company transferred their shares to a new company in which they had controlling interest. They then sold the assets of the company to the new company for a nominal price of £1.00. Then the directors subsequently sold their shares in the new company for £10 million. It was held that this was unfairly prejudicial conduct.

Re Elgindata Ltd. [1991] BCLC 959 – The managing director of a company used assets of the company for the benefit of himself, his family and friends, but to the detriment of the company. This was held to be an unfairly prejudicial conduct.

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In *Re a Company (No. 008699 of 1985*) [1986] 2 BCC 99023; [1986] 1 WLR 281, there were two rival bids for the takeover of a company. The chairman of a company on behalf of the board of directors deliberately misled the shareholders into accepting the lower bid made by a company of which the directors were promoters by falsely claiming that the higher bid would not succeed. This meant the shareholders sold their shares at a much lower price. Shareholders with 29% of the shares sued for unfair prejudice. It was held that the conduct of the directors was unfairly prejudicial.

Where persons who are both directors and shareholders pay themselves excessive remuneration but do not pay dividends to other shareholders who are not directors even though there was no other use for the company's retained profits, this will be unfairly prejudicial to these shareholders.

Maidment v Attwood [2013] EWCA Civ 998 – M was a minority shareholder in a company of which the defendant (A) was the major shareholder and sole director. M alleged that A paid himself excessive remuneration at a time when the company was making substantial losses, used the company's trading name for free in a private business, and sold the company's trading name at an undervalue. It was held (by the Court of Appeal) that the defendant had acted in a manner prejudicial to the interest of the claimant and was liable to account to him for the losses he and the company had suffered.

In *Irvine v Irvine* [2006] EWHC 1875; [2006] All ER 329, it was held that the payment to himself of excessive remuneration by a majority shareholder/director amounted to unfair prejudice.

In *Rodliffe v Rodliffe & Another* [2012] EWHC 917, there were a finding of unfair prejudice by majority shareholders/directors because of violence and breakdown in working relationship.

However, mere mismanagement of the company, poor corporate judgement by the directors due to incompetence does not amount to unfairly prejudicial conduct, or trivial or technical infringement of the articles would not amount to unfairly prejudicial conduct. Moreover, outsider interests unconnected to rights of membership are not covered by the provision on unfair prejudice.

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In *O'Neil v. Phillips* [1999] UKHL 24, O was the acting MD of a company. The owner of the company gave him 25% of the shares and promised that if certain targets were met, O would be given 50% of the company's shares and 50% of the profits. These promises were not covered by any contract. When the company began to do badly, the owner took over as MD and told O that he would no longer receive 50% of the profits or 50% of the shares. O left the company and petitioned under s. 459 CA 1985 (Similar to s. 994) claiming that his legitimate expectations of membership had been unfairly prejudiced. It was held that O was not legally entitled to either the 50% share or 50% of the profits, therefore no legitimate expectation could arise from them to give rise to a conclusion of unfair prejudice under s. 459.

23.4.4.1 Orders the court could make

S. 996 (1) empowers the court, if it thinks that an action was well-founded, to make such orders as it thinks fit to give relief from the matters complained, including (but not limited to):

- An order to regulate the affairs of the company in the future
- An order requiring the company to stop doing the act complained of, or to do an act which it has omitted.
- An order authorising civil proceedings to be brought in the name or on behalf of the company by certain persons under terms specified by the court
- An order for the purchase by the company or other members of the shares of any members of the company at the market price
- An order preventing the alteration of company articles without court approval

In order to give effect to its order the court may alter or insert new provisions in the company's memorandum and articles. The company cannot, without the permission of the court, change any such alteration or insertion.

23.4.5 THE JUST AND EQUITABLE WINDING-UP

Under *s. 122(1)(g) Insolvency Act 1986*, a member of a company may petition the court to wind it up on the ground that it is just and equitable to do so. In order to be able to petition for winding up under this provision, the petitioner has to show (as in s. 994 CA 2006) that the wrongdoing affects him in his capacity as a member and not in any other capacity. See *Lock v John Blackwood Ltd* [1924] AC 783, and *Ebrahimi v Westbourne Galleries Ltd. (1973) AC 360.* This type of winding-up is discussed more fully in chapter 28.

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23.5 CHAPTER SUMMARY

- The powers of companies are shared between owners and directors of companies; while members have the power of control, directors have the power of management
- The powers of control which members have are usually exerted by persons who hold the majority shares or interest in the company
- The powers of control of company members include the power to make an alter the articles of association; the power to make resolutions; the power to appoint and remove directors; the power to authorise and approve certain actions of directors; and the power of residual management.
- The exercise of control by majority shareholders (or members) especially those who are also directors may be detrimental to the interests of minority shareholders and the company. This makes it necessary to have rules to protect them.
- There are different rules for the protection of minority shareholders. These include the common law derivative action; derivative actions under the CA 2006; and continuing an action as a derivative claim. Others are the unfair prejudice remedy and the just and equitable winding-up.

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23.6 PRACTICE QUESTIONS

1. Discuss the powers of a company's members and their effects on the management of a company.
2. Mrs Smith holds 10% of the shares in Trans Co Ltd. and has been a director of the company for three years. The other directors who own majority of the shares have now removed her from the board because she disagrees with them at board meetings. Mrs Smith claims the directors now pay themselves excessive salaries and buy for themselves luxury goods and cars while refusing to pay her any dividend. She also alleges that the directors siphon the profits of the company into foreign bank accounts and have refused to present an annual account for two consecutive years.

   Advise Mrs Smith as to whether she has a cause of action as a minority shareholder under the common law and under the Companies' Act 2006.

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24 COMPANY DIRECTORS

24.1 INTRODUCTION

Directors are responsible for managing companies and directing their day-to-affairs. These directors may be owners of the companies or only employees. In many companies, especially private ones, many directors are also their owners or shareholders. However, directors need not be members of the company they manage, a situation that is more prevalent in public companies. The position of directors is critical as a company's well-being, success or failure may depend on it. A company director could be a natural person or a company.

24.2 LEARNING OBJECTIVES

The objectives of this chapter are to enable a clear understanding of:

- The meaning and types of company directors
- How directors are appointed
- How the tenure of directors may be ended
- The powers and responsibilities of directors
- The duties that directors owe to their companies
- The consequences of directors' failure to live up to their duties

24.3 WHO IS A DIRECTOR?

Being a company director is not merely a matter of designation but of fact. A company director "includes any person occupying the position of director, by whatever name called" – s. *250 CA 2006*. Thus, whatever the official title or designation of a person might be, whether he is director of the company would depend on the roles he performs. By this definition, director includes *de jure* directors, *de facto* directors, and shadow directors – *s. 251 CA 2006.*

De jure directors are directors in law. They are persons officially and legitimately appointed by the members or stated in the articles of association of a company as directors of a company. *De facto* directors are directors in fact. They are persons not officially appointed as directors but who exercise the functions of that office. An employee who acts like and exercises the functions of a director of a company would be regarded as a *de facto* director even if directorship is not in his job description. A person invalidly appointed as a director (e.g. a person under 16 years) but who continues to act as a director would be regarded as de facto director.

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A *Shadow director* is a person who has not been appointed as a director but on whose instructions and directions the directors of a company usually act. In other words, the person indirectly runs the company from behind the scenes. Such a person will be bound by the same rules as other directors although he has not been appointed or designated as a director. However, a person giving professional advice to the board of directors of a company (such as s solicitor or accountant) is not be regarded as a shadow director. Similarly, a parent company is not to be regarded as a shadow director of its subsidiary because the subsidiary carries out its instructions.

A company director may be a natural person or a body corporate; but a body corporate cannot be the only director in a company. There must be one natural person s. 155.

24.4 TYPES OF DIRECTORS

Irrespective of how they come into position, directors may be classed as executive or non-executive.

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24.4.1 EXECUTIVE DIRECTORS

Executive directors are employed full time by a company; are involved in the day--to-day management of the company; and exercise specific functions for it. Usually they would be in charge of specified departments in the company. Examples of executive directors are the Managing director, directors of finance, marketing, procurement, personnel, etc. Normally these directors have specific contracts of employment which designate their roles and functions. The articles of association may also specify these. The managing director is the chief executive officer and the most important of the executive directors. Other directors usually delegate their authority to the managing director who can act on behalf of the board and the company. He can exercise such powers as the board of directors could exercise. The board of directors of a company may appoint somebody from among its members to the office of managing director and other executive offices. It is also the duty of the board of directors to appoint and remove a managing director; the shareholders have no power to do this. However, a managing director would lose his office if the shareholders remove him as a director.

24.4.2 NON-EXECUTIVE DIRECTORS

Non-executive directors are those other than the executives. They are directors who are not in full-time contractual employment of their companies. They do not have specific executive roles but take part in management on a part-time basis. They sit on the board of directors of and are bound by the same rules as other directors. However, unlike executive directors, they do not have to attend all board meetings. They have a duty, however, to attend whenever they reasonably can and to keep themselves informed of their company's affairs. Non-executive directors are usually selected from the rank of professionals, political or public figures, or retired former executive directors and business people. Apart from acting as a check on executive directors, non-executives also bring influence and connections to the company.

24.4.3 ALTERNATE DIRECTORS

An existing director may appoint another person to represent him at a board meeting when he could not attend. These persons are known as alternate directors and could be executive or non-executive. They could be an existing director or any other person. Before an alternate can be appointed, the articles of a company must authorize, and the board of directors must approve, the appointment. An alternate director is entitled to vote according to his own wisdom; and is not necessarily an agent of the director who appointed him. An alternate is bound by the same rules as other directors.

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24.5 APPOINTMENT OF DIRECTORS

Directors may be appointed in different ways depending on whether they are the first or subsequent directors and whether they are substantive or interim. The subscribers to a company's memorandum usually name the first directors of the company in the application for incorporation. In small private companies, these first directors are likely to be the subscribers or some of them**.** The members or shareholders of a company appoint subsequent directors at general meetings either to increase the number of board members or to fill vacancies. The articles of association will normally make provisions on the appointment of directors, although the members have an inherent power in this regard. Usually, the appointment of directors by the members require only an ordinary resolution. However, members must exercise their power to appoint directors bona fide and in the interest of the company and not for ulterior purposes. A person appointed a director must consent to act as such; otherwise, the appointment will not be valid.

Vacancies in the board of directors due to the death, retirement, resignation, dismissal, or disqualification of directors may be filled by the board on a casual or interim basis – *s. 168 CA 2006*. However, in filling the vacancy, the directors must not exceed the maximum number of directors stipulated by the members in the articles or otherwise. A director appointed to fill a casual vacancy remains in office only until the next AGM when he must quit unless re-elected by the members.

24.5.1 DIRECTORS' SERVICE CONTRACTS

Under *s. 188 CA 2006,* the shareholders of a company must approve any director's contract guaranteed for up to two years. This provision makes it less expensive for shareholders to remove erring directors from office and ensures greater shareholder influence in the management of their companies. Directors' service contract, include contracts of service, contracts for service, and letters of appointment – *s. 227 CA 2006.* A copy of directors' service contract or a memorandum of the contract (where the contract is not in writing) must be kept available for inspection at the company's registered office (or such other place as specified by the Secretary of State) – s. 228. If a director's service contract is made in contravention of this provision, the company may terminate it at any time by giving a reasonable notice – s. 189 CA 2006.

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24.5.2 NUMBER AND REGISTER OF DIRECTORS

A private company may have only one director, while a public company must have at least two – s. 154 CA 2006. Usually, however, a company's articles stipulate the number of directors the company will have (subject to the statutory minimum). Despite the number, all companies must have at least one director who is a natural person. Thus, where a private company has only one director, that director must be a human being – s. 155 CA 2006 (for the purposes of this section, a *corporation sole* is regarded as a natural person). The Secretary of State may give an order to a company to comply with the above provisions, and it is an offence for a company not to do so – s. 156 CA 2006. Where a company has less than the minimum prescribed number of directors, the rest should not act unless the articles permit them to do so. Every company must keep a register of all its directors, their particulars, and residential address at its registered office (or such place as may be designated by the Secretary of State). The register must be open for inspection to members of the company and the public – s. 163, 164 & 165 CA 2006.

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24.6 QUALIFICATION OF DIRECTORS

Under the CA 2006, there is no specific qualification set out for persons to be appointed directors, except that they should not be minors. However, under the UK Corporate Governance Code, public companies are required to appoint as directors persons who possess the necessary skills, knowledge and experience to run the particular company. A person may or may not be a shareholder in the company in which he is a director.

Under s 157 CA 2006, a natural person must be at least 16 years old before he could be appointed a director or before his appointment could take effect. Any appointment contrary to this provision would be void, unless it would take effect when the appointee attains the right age. Where an existing company has a director under the age of 16, that person ceases to be a director from the commencement of this provision. The secretary of State may, however make regulations allowing persons under 16 to be directors in certain circumstances – s. 158 CA 2006.

However, a defective appointment or disqualification of directors does not affect the validity of acts done by them on behalf of their companies – s. 161 CA 2006. If an underage person acts as or exercises the powers of a director (as a de facto or shadow director, for instance), that person would be liable for those acts – s. 157 (5) CA 2006.

24.7 TERMINATION OF DIRECTORSHIP

A director's appointment may be ended by resignation, retirement, removal or disqualification. A director may also resign his position at any time by giving notice to the company or at the expiration of his term under his contract of service.

The first directors of a company must retire at the first AGM of the company. During subsequent AGM, one-third of the directors shall retire. Retiring directors may be (and are usually) re-elected. Retirement is done in order of seniority of appointment, provided that where many directors were appointed at the same time, the retirees would be determined by lot (see the Model Articles of PLC, article 21). The process of annual retirement gives the shareholders the power to exercise control over the board of directors.

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The members of a company have the power to remove or dismiss a director from office at any time. They may do this even before the end of the directors' contracts, and notwithstanding anything in the articles. An ordinary resolution is required to carry out the removal. However, a special notice of the intention to propose the resolution is required and the director concerned must be notified of the intention to remove him – s. 168 CA 2006. A director proposed for removal is entitled to defend himself before the members at the general meeting before the resolution to remove him could be passed – s. 169 CA 2006. Because of this, a director cannot be removed by written resolution. Note that a company may not follow this procedure if its articles provide for the removal of its directors in other ways (s. 168 (5) CA 2006).

A director removed before the end of his contract may be entitled to damages for breach of contract if he has a contract.

24.8 DISQUALIFICATION OF DIRECTORS

Under the s. 280 CA 2006, a director may be disqualified from acting as such following a number of events, including when he:

- becomes bankrupt or makes arrangement or composition with his creditors,
- becomes of unsound mind,
- fails to attend board meetings for six consecutive months without permission – (See Model articles), or
- acts as a secretary at the same time in the same company (if the company is a plc).

Under the *Company Directors' Disqualification Act (CDDA) 1986*, a court could order the disqualification of a person as a director. The order of disqualification may be mandatory or discretionary. A court is under an obligation to order the disqualification of a person as director for between *2* and15 years if he has been a director of an insolvent company and his conduct in that company makes him unfit to be a director. In deciding whether the person has been unfit, the court considers, among other things:

- Whether he has been involved in any misfeasance or breach of duty as a director;
- Whether he has been involved in any misappropriation of company's money or property;
- Whether he had failed to comply with accounting and publicity requirements of companies legislations;
- The extent of the person's responsibility in the insolvency of the previous company, and,
- The extent of the person's responsibility in the other company's failure to supply any goods or services already paid for – (See s. 9 and Schedule 1 of the Act).

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The court is also under an obligation to disqualify a person as a director if he breaches the United Kingdom or European Union competition laws by *distorting* or *restricting* competition; or by *abusing a company's dominant position*, *and* his conduct makes him unfit to be involved in the management of a company – *s. 9 CDDA 1986.*

Under *sections 2, 3, 4, 10 CDDA 1986,* the court may on its discretion disqualify a person as a director for between five to fifteen years:

- if he has been convicted of an indictable offence connected with the management of a company, or
- if he has been persistently in default of the provisions of company legislation, or
- if he has been found guilty of fraudulent or wrongful trading.

It is an offence for a person who has been disqualified under the CDDA 1986, to act as a director in disobedience of the disqualification order or his own undertaking. The punishment for the offence ranges from 6 months to 2 years imprisonment with or without fine – *S. 13 CDDA 1986.* The person is also liable personally (with the company) for any debts or liabilities incurred while acting as director when disqualified – *s. 13 CDDA 1986.*

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24.9 POWERS OF DIRECTORS

The powers of directors are extensive. They have authority to manage their companies and in so doing exercise all its powers, Directors have the power to bind their companies both on their own merit and as their agents.

24.9.1 POWER TO MANAGE COMPANY AND EXERCISE ITS POWERS

Article 3 of the Model Articles of Association of public companies (which is a standard clause in companies' articles)[1] provides that:

> Subject to the articles, the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company.

Therefore, directors are free to manage a company as they see fit; however:

- Directors' power of management is subject to their companies' articles and resolutions passed by members; and
- Directors' are subject to the duties imposed by the general law and the Companies' Act 2006; and
- Directors must exercise the powers conferred on them only for the purposes for which they were given and not for any other purpose – s. 171 CA 2006.

Directors may exercise their powers personally or in delegation to fellow directors or other persons. For, example, the managing director is a delegate of the board of directors in the exercise of the powers of a chief executive (see article 5 of the Model articles).

24.9.2 DIRECTORS AS AGENTS

Directors are agents of their companies. Accordingly, the companies, being the principals would be liable for the actions of directors done in the performance of their responsibilities. In this context, directors have both actual and ostensible authority. The actual authority of a director who has been officially appointed arises from the terms of his appointment or by implication from the office. Ostensible authority arises where someone has not been (validly) appointed as a director but has been held out as one by the company. In that situation, the person has authority to bind the company as its agent.

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Under s. 40 Companies Act 2006, the power of directors to bind their companies are deemed to be unlimited in favour of anybody dealing with it in good faith. This means that as far as innocent third parties are concerned, directors of a company have unlimited power to tie the company to contracts or to authorise others to do so. No restrictions placed on the power of the directors either by the articles or the general meeting or any class of shareholders will affect the validity of such contracts.

These provision guarantees that a contract entered into by a company with a third a party cannot be nullified on the ground of lack of capacity on the part of the company's directors unless the contract involves the director or persons connected with him. Although, members of a company may pass a special resolution to give directives to directors to do or not to do any anything, they cannot overrule any actions taken by directors (see article 4 of the model articles). However, if directors go outside the provisions of the company's articles or special resolutions passed by the members, they may incur personal liability to the company.

It must be noted that, in general directors are not agents of members of the company. Even where a shareholder has nominated a director, the director is not an agent of the shareholder. A member cannot therefore be vicariously liable for the actions of a director. A director may become an agent of a shareholder only where he assumes personal responsibility for that shareholder. This would be the case, for example, where the director agrees to personally sell the shares of a shareholder.

24.10 DIRECTORS AS FIDUCIARIES

Directors occupy a fiduciary position in relation to their companies. This means that they must conduct their companies' business in good faith and in such a manner as will benefit the company as a whole. They must not act in manner that is harmful to the interests of the company. They must not abuse their office or use the company for the benefit of themselves or somebody else. In judging whether directors have acted in good faith, the test is subjective. The question would be whether the directors honestly believed they were acting in the interest of the company to the best of their knowledge and ability. If they did, they would not be in breach of duty even though they turn out to be wrong unless the action was such that no reasonable person could believe it was in the interest of the company.

In addition, sections *172 (1)(b) & 247 CA 2006* now require directors to also take account of the interest of employees or former employees of the company as well as those of the shareholders. The interest of shareholders should however outweigh those of employees. If a company is insolvent, the directors must have regard to the interest of creditors and must take reasonable care to minimize losses to them – s. 172(3) CA 2006.

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The following cases illustrate the general principle that directors must act in good faith and in the interest of the whole company:

> *Re W & M Roith Ltd.* (1967) 1 WLR 432 – One of the directors of a company was very ill. The Board of Directors of the company signed a new service contract with the sick director in which they agreed to pay his widow a generous pension in the event of his death. The director died shortly after the new contract was signed. It was held that the company was not bound by that contract because the directors have used their power to benefit a fellow director's widow and not the company.
>
> *CMS Dolphin Ltd. v Simonet (2001) EWHC Ch 415* – The defendant, a director in the claimant company, resigned from the company and formed his own company. He then transferred to this new company the main clients and businesses of his former company. His former company sued him for breach of the duty to act bona fide in the interest of the company as a whole. It was held that the defendant had breached this fiduciary duty by his appropriation of the company's maturing business and its existing clients.

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24.11 DIRECTORS' DUTIES

Given the extent of directors' power; the right of directors to use their discretion in the running of companies; the link between the destiny of companies and the performance of their directors; and the position of directors as fiduciaries, the necessity to have some checks on directors' powers has long been recognized. To this end, the law has imposed certain duties on them to ensure that they do their jobs properly and do not abuse their positions. These duties, which arose from common law, equitable and statutory principles, have now all been codified in the Companies Act 2006. It must be noted that the duties are owed by all categories of directors to the company itself and not to its members – s. 170(1) CA 2006. The main duties of directors are discussed below.

24.11.1 DUTY TO ACT WITHIN POWERS AND TO EXERCISE IT PROPERLY

S. 171 CA 2006 provides that directors must act in accordance with their companies' constitution and must exercise their powers for the purpose for which they were conferred. They cannot misuse their power to do whatever they liked, or for any collateral purpose. If directors use their powers for an improper or collateral purpose, they will be in breach of duty and the transaction or act in question could be set aside. The application of this rule is often seen in the power of directors to allot companies' shares. This power should be exercised for the purpose of raising money for the growth of a company when necessary; it is not be used for any ulterior or collateral purpose:

> In *Howard Smith v. Ampol Petroleum (1974) AC 821,* directors allotted new shares in order to destroy the majority control of two shareholders who were opposed to a proposed takeover of the company – a takeover that was sponsored by the board of directors. It was held that the allotment was void since it was made for a collateral purpose (changing the balance of power), and for an improper motive.
>
> Similarly, in *Hogg v. Cramphorn (1967) Ch. 254,* one of the directors of a company allotted shares to employees under an employee share scheme in order to fight off a take-over bid, which he believed would not be good for the company. It was held that the allotment was invalid.

Where directors have exercised their powers for an improper purpose, the shareholders, if they wish, may ratify the transaction, as in *Hogg v. Cramphorn,* where the shareholders later ratified the allotments.

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24.11.2 DUTY TO PROMOTE THE COMPANY' SUCCESS

Under s. 172 CA 2006, directors have a duty to act in good faith and in such a way as would promote the success of their company. In so doing, directors should:

- Consider the long-term consequences of their actions;
- Consider the interest of the company's employees;
- Foster good business relations with the company's suppliers, customers, and others;
- Consider the impact of the company's activities on the environment;
- Endeavour to maintain good reputation and high standard in business; and
- Treat members of the company fairly.

This duty is also referred to as enabling "enlightened shareholder value" and allows directors to adopt a wider, holistic, and longer-term approach in the assessment of what is for the benefit of the company. Thus, genuine long-term strategic decisions will not be contrary to the interest of the members even if they lead to loss of profit to the shareholders in the shorter term.

24.11.3 DUTY TO AVOID CONFLICT OF INTEREST

Another important fiduciary duty is the duty of directors to ensure that their personal interests do not conflict with their official responsibilities. This duty, which is provided in s. 175 CA 2006, states that directors should not involve the company in transactions in which they stand to benefit personally. For example, if a director of a company awards a contract to himself, his wife, father or son, etc., this might be a conflict of interest. In any of these situations, the director's interest in looking after his close family might undermine his responsibility to look after the interest of the company. According to *Bray v. Ford* (1896) AC 44, a fiduciary (including a director) is not entitled to make a profit or to put himself in a position where his duty and interests conflict. The following cases illustrate this principle:

> *Aberdeen Railway Co. v. Blaike Bros* (1854) 1 Marq 461; [1854] 17 D HL 20 – A company entered into a contract with a firm for the supply of some goods. The chairman of the company was also a partner in the firm supplying the goods. It was held that there has been a breach of duty. The court stated that no one having fiduciary duties to discharge shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict with the interest of those whom he is bound to protect.

> *Transvaal Lands Co. v New Belgium (Transvaal) Land and Development Co.* (1914) 2 Ch 488 – Company A and company B entered into a contract. One of the directors of company A held shares in company B on trust for someone else. It was held that the contract was invalid because of the conflict of interest as director and trustee.

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24.11.3.1 The corporate opportunity doctrine

A particular application of the conflict of interest rule is the "corporate opportunity doctrine". This is the requirement that all corporate opportunities, information or property must be applied for the benefit of the company. Directors must not unduly profit from these in the course of their employment – s. *175 (2*). This duty subsists whether or not the company would take advantage of the property, information, or opportunity. If a director uses corporate opportunity, etc., for their own benefit or if they make secret profits, they must render account of the transaction or profits to the company. The principle remains applicable even after a director's resignation. The following cases illustrate:

> *Cook v. Deeks* (1916) 1 AC 554 – Directors of a company became aware that a lucrative contract was about to be awarded to the company. They resigned and formed a new company which they used to get the contract for themselves. It was held that the directors were in breach of their duty and liable to account to their former company.

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Regal Hastings v. Gulliver (1942) 1 All ER 378 – The claimant company which owned one cinema formed a subsidiary to buy two more cinemas in order to sell all three together. Because the company could not raise all the money needed for the purchase, the directors of the company bought personal shares in the subsidiary. They later sold these shares at a large profit. It was held that the directors were in breach of their fiduciary duty and should account to the company for the profits.

Industrial Development Consultants Ltd. v. Cooley (1972) 1 WLR 443 – Cooley was a director of IDC involved in the negotiation of a lucrative deal with the Eastern Gas Board. The EGB later approached Cooley and offered him a lucrative consultancy contract without involving IDC. Cooley retired from IDC on the pretence of being ill and entered into a contract with EGB. It was held that Cooley must account to IDC for the profits he made because he became aware of the opportunity by virtue of his position as its director.

24.11.3.2 Exceptions to the corporate opportunity doctrine

There are a number of exceptions to the corporate opportunity doctrine. First, the doctrine would be inapplicable where the articles of a company allows transactions in conflict of interest or provide that the rule will not apply. However, the director first has to disclose his interest to the board of directors.

Second, the doctrine would not apply where the director brings the business opportunity to the attention of the company and the board of directors authorises the director to take advantage of it or decides not to pursue the business on the company's behalf – s. 175 (4) CA 2006. The decision of the board must, however, be made in good faith and the director in question must not vote in the decision. If directors rejected the business only in order to clear the way for them to do it themselves, they will be in breach of duty.

In *Peso Silver Mines v. Cropper* [1966] SCR 673, a company's geologist advised it to invest in a certain prospecting claim, which he considered promising. The board of directors rejected the advice. The geologist resigned and formed his own company, which bought the claim. One of the directors of Peso became a shareholder in the new company and made substantial profits. Peso sued him for account. It was held that the director was not in breach of duty since Peso was told about the deal and it refused to take it up.

Finally, the doctrine cannot be used as a device for restraint of trade. A former director may, in appropriate cases, make use of information and knowledge acquired in his previous employment as long as his departure from the company was not motivated by a desire to pursue a particular opportunity privately.

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In *Island Export co. Ltd v Umunna* [1986] BCLC 460, the defendant, who was the managing director of the claimant company resigned because he was no longer satisfied with the situation there. While he was still the MD, the defendant had secured a contract on behalf of the company for the supply of postal boxes to Cameroon. Subsequent to his resignation, the defendant formed his own company and was able to secure for it two contracts for the supply of postal boxes in the Cameroon. At the time of his resignation however, his former company was not actively seeking any more of such contracts. His former company sued him on the ground of conflict of interest and for account.

It was held that the defendant was not in breach of duty; that although the no-conflict rule continued after resignation, the defendant' resignation was not motivated by the desire to exploit the business opportunity; and that to prevent directors totally from making use of the knowledge gained in the service of a company would amount to a restraint of trade.

24.11.4 DUTY TO DISCLOSE CONFLICT OF INTEREST

Sometimes some conflict of interest might be unavoidable or even beneficial to a company. Under s. 177 CA 2006, if a director finds himself interested, directly or indirectly, in a proposed transaction or arrangement, which may involve a conflict of interest he is required to declare his interest to the Board of Directors before the transaction is done – s. *177 CA 2006*. This requirement will pose no problems where a director is acting in good faith and in the interest of the company. The disclosure may be done formally at a meeting or by notice, or informally by somehow making the other directors aware of the interest, as was the case in *Lee Panavision Ltd. v Lee Lighting Ltd* (1992) BCLC 22. However, disclosure would not be necessary where the other directors are already aware of the interest, or where the matter involves a director's service contract.

Runciman v. Walter Runciman Plc. (1992) BCLC 1084 – The claimant, the executive chairman of the defendant company, was unfairly dismissed from office. He sued for damages for unfair dismissal. The company sought to reduce the amount of damages payable to him on the ground that his service contract and that of other executive directors had been extended without the claimant disclosing his interest in this to the board of directors. Because of this, the company argued that the contract was voidable. It was held that since it was blatantly obvious to everybody in the management of the company that the plaintiff had an interest in his own service contract, there was no need for a formal declaration of the interest to the board.

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Similarly, if a director has an interest in an existing transaction, contract or arrangement involving his company, he must declare the nature and extent of this interest to the board of directors as soon as reasonably practicable – *s. 182 CA 2006.* Again the declaration may be at a meeting, by notice, or informally. If the director fails to disclose such an interest, he will be committing a crime punishable with a fine – *s. 183.*

Where a company has only one director, the director must declare and record his interest in a meeting of the board even though he would be the only person in attendance – *s. 231 CA 2006; Neptune (Vehicle Washing Equipment) Ltd. v. Fitzgerald* (1995) 1 BCLC 352; [1996] Ch 274.

24.11.5 DUTY TO EXERCISE INDEPENDENT JUDGEMENT

Under *s.173 CA 2006,* a director must exercise independent judgement in the best interest of the company. This means that he must not allow himself to be unduly influenced in his future decisions by third parties. A director must not fetter the future exercise of his discretion unless he is acting (a) in accordance with an agreement between him and the company, or (b) in accordance with the company's constitution. It could in fact be said that any fettering of directors' discretion for the company's benefit would not contravene this rule as illustrated in *Fulham Football Club and Others v Cabra Estates Plc* (1994) 1 BCLC 363:

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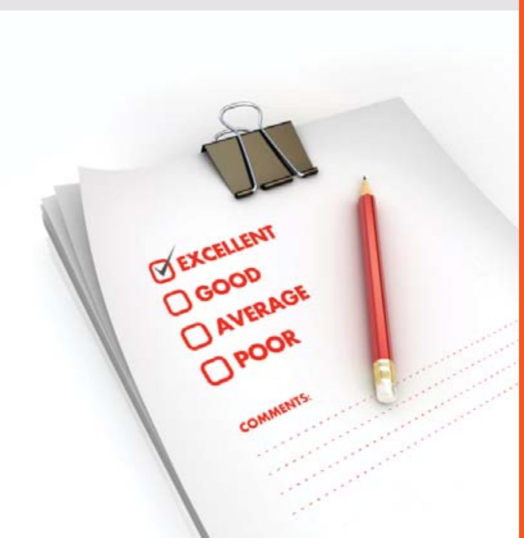

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> Fulham FC leased a piece of land from Cabra Estates. In return for a substantial payment to Fulham, the directors of the club made an undertaking to support future planning applications filed by Cabra Estates with respect to that land and to oppose contrary plans from the local council. The directors proceeded to carry out this undertaking. The question was whether the undertaking was an improper fettering of the directors' discretion and whether it infringed their fiduciary duty to Fulham FC. It was held that the directors have not improperly fettered their discretion and that they had not breached their fiduciary duty since the undertaking was done bona fide and for the benefit of the company.

24.11.6 DUTY NOT TO ACCEPT BENEFITS FROM THIRD PARTIES

Directors must not, in the course of their employment, accept benefits from third parties by virtue of their being directors, or in order to do or refrain from doing their duties as directors – *s. 176 CA 2006.* This duty, which aims to prevent corruption that might compromise the performance of a director's responsibilities, is a reaffirmation of the duties to avoid conflict of interest and to exercise independent judgment. The acceptance of a benefit from a third party might vest in a director a personal interest in the direction or outcome of corporate policy or activity, and might compromise the exercise by the director of an independent judgment. It might also compromise the director's overall duty to act bona fide in the interest of the company as a whole. However benefits conferred by the company or authorised by the shareholders are not covered by this provision – *s. 180 (4) CA 2006.*

24.11.7 DUTY TO USE CARE AND SKILL

Under the Common Law, directors were required to exercise reasonable care and skill in their conduct and management of the company's affairs. They would be liable in negligence if they fail to exercise appropriate care and skill or competence. *S. 174 CA 2006* has codified this rule. Originally, the common law did not set for directors a particularly high standard of care and skill as evident from *Re Equitable Fire Insurance Ltd.* (1925) Ch 407.

> There, it was held that, a director might only exercise such knowledge as may be expected of a person of his knowledge and experience; that he is not bound to give continuous attention to the affairs of the company; and that he may delegate his duties to other directors and officers of the company.

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Now however, the standard of care is stricter, with the test being both *objective* and *subjective*. Under s. 174 CA 2006, directors must act:

- With the care, skill, and diligence that would be exercised by a reasonably diligent person with the knowledge and skill and experience of any person in the same position (objective test); and with
- The general knowledge, skill, and experienced possessed by that particular director (subjective test).

This dual test is the same used to determine whether a director is guilty of wrongful trading under *s 214 of the Insolvency Act 1986* and applied in *Norman v. Theodore Goddard* [1992] BCLC 14. The decision in *Re City Equitable Fire Insurance* that, a director does not need to devote his full time to the affairs of the company now applies only to non-executive directors employed on a part-time basis. Executive directors who have full time service contracts are required to devote their full time to the service of their companies. Even non-executive directors have a duty to attend board meetings whenever they can because continuous absenteeism, without permission, for more than six months is a ground for dismissal.

However, even though directors may delegate their duties to co-directors where appropriate, they now have a responsibility to supervise and monitor the discharge of those duties and keep themselves informed of their companies' businesses. The right to delegate is not a permission to abdicate responsibility.

> In *Equitable Life Assurance Society v. Bowley* (2003) EWHC 2263 (Comm), it was held that a non-executive director was not entitled to delegate his responsibilities if it meant an unquestioning dependence on others to do his job. Similarly, in *Re Barings Plc, Secretary of State for Trade and Industry v Baker* (No. 5) [1999] 1 BCLC 433, it was held that the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of those functions. It was also held that directors collectively have a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties.

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A direct application of the rule on care and skill could be seen in *Dorchester Finance Co. v. Stebbing* [1989] BCLC 498:

> Two non-executive directors of a finance company were in the habit of signing blank cheques for the use of their co-director. One of these non-executive directors was a chartered accountant while the other had extensive experience in accounting. The result of the directors' actions was that the company lost a lot of money due the misuse of the cheques by their co-director to give irregular loans to friends and family members. It was held that the company was entitled to sue the two non-executive directors for negligence.

Note, however, that for listed companies, the UK Corporate Governance Code now requires that their directors and senior management must collectively have appropriate expertise and experience to manage their businesses.

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24.11.8 DUTY TO SECURE MEMBERS' APPROVAL FOR SUBSTANTIAL PROPERTY TRANSACTIONS

Under s. *190 CA 2006,* shareholders must approve (by ordinary resolution) any contract by which the company acquires from or sells to any of its directors or persons connected with them a substantial non-cash asset. A substantial property transaction is one that involves an asset of a value which is more than £5,000 and more than10% of the company's net asset or called up capital, or which in any case exceeds £100,000. Any transaction entered into in contravention of this provision is *voidable* at the instance of the company (unless restitution is no longer possible; the company has already been indemnified for its losses; or a third party has acquired rights under the contract (s. 195); or unless the company had subsequently approved the transaction (s. 196). This provision is necessary to prevent directors from selling their properties to the company at overvalue, or from buying at undervalue (asset stripping).

No approval is needed, however where the property is less than £5,000; where the transaction is with a director in his "character" as a member of the company; or where the company is undergoing administration or winding-up.

24.11.9 DUTY TO SECURE MEMBERS' APPROVAL FOR PERSONAL LOANS

Companies cannot give loans to their directors or persons connected to them (e.g. spouse, parents, children) neither can they give any guarantee or security for loans to directors without the approval of the company. The same rule applies to directors of their holding company – *s. 197 CA 2006.* Where a company gives a loan to a director in contravention of this rule, the transaction is voidable at the instance of the company and the directors are liable to indemnify the company for money received or losses suffered – *s. 213 CA 2006.* The reason for these provisions is to prevent directors misappropriating company's funds for their own benefit. However, the rule does not apply:

- Where the amount of the loan does not exceed £10,000 – s. *207 CA 200*
- Where the loan was to enable a director perform his duties or cover expenses incurred in the company's business, provided the company had approved the transaction in advance. For a plc or subsidiary of a plc, the limit of the loan is £50, 000 – *s. 204 CA 2006.*
- Where the company's business is money lending, provided special concessions have not been given to the director – s. *209 CA 2006*
- Where the loan was to enable a director defend himself in court for alleged negligence, default, breach of duty/trust, or regulatory action/investigation, provided the loan is to be repaid if the director loses the case – s. *205 CA 2006*

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24.12 REMEDIES FOR BREACH OF DUTY

Since directors owe their duties to the company as a whole and not to individual shareholders, where a director has done a transaction involving a breach of his duties, the transaction is *voidable* at the instance of the company. Any provision in the company's constitution preventing the director from being liable or providing immunity for breach of duty is void (except provisions of insurance or indemnity against third parties). Under sections 178 and 239 CA 2006, members of a company may take any of several actions against an offending director:

- They can pass a resolution to cancel the relevant contract.
- They can demand from the director an account of any profits made and an indemnity for any loss suffered.
- They may remove the offending directors from office.
- They may ratify the transaction (*Bamford v Bamford* [1970] Ch 212).

However, the court may relieve a director from liability for negligence, breach of duty, or breach of trust, if it appears to it that the director acted honestly and reasonably, and that he ought, having regard to the circumstances of the case, fairly to be excused. This enables directors to escape liability where they have made a genuine mistake. The members of a company may also decide to forgive a director's breach of duty by passing a resolution to that effect in a general meeting.

24.13 CHAPTER SUMMARY

- Company directors are the persons responsible for the management of a company at their discretion.
- Every private company must have at least one director while every public company must have at least two.
- Directors are appointed firstly by the subscribers to a company's memorandum of association and subsequently by the members, via ordinary resolution, at general meetings. Casual vacancies may be filled by the board of directors until the next AGM.
- A person may become a director by formal appointment (de jure) or by virtue of their actual activities (de facto) or by exercising control over formal directors (shadow). Thus, directorship is primarily determined by function, rather than title.
- There is no formal qualifications under the Companies Act 2006 for directors except that they must be 16 years or above.
- A director may be executive or non-executive. Any of these may be an alternate director if appointed as a representative of an existing director.

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- A person's directorship may cease due to death, bankruptcy, resignation, retirement, removal or disqualification.
- Directors are able to exercise all the powers of a company in the course of managing it and have authority as agents to bind the company to transactions.
- Directors are in a fiduciary relationship with their companies. Accordingly, they must always act in good faith and in the interest of the company as a whole.
- In performing the official functions, directors are bound by many duties. These are duties to act within their powers and to exercise these powers properly; duty to promote the success of the company; duty to avoid, or to declare conflict of interest; duty to exercise independent judgment; and duty to avoid accepting benefits from third parties.
- Other duties are to use reasonable care and skill; and to secure approval of members in respect of substantial property transaction and personal loans.
- Directors who breach their duties are accountable to the company for all profits made, and liable to it for all loses incurred, although the members may choose to ratify the transactions or to forgive the breach of duty.
- The court may also refrain from imposing liability on a director for breach of duty or trust if he had acted out of genuine and reasonable error.

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24.14 PRACTICE QUESTIONS

1. Explain the difference between a shadow director and an alternate director.
2. Explain the differences between an executive and a non-executive director.
3. State and explain the circumstances in which a director could be disqualified.
4. In their relationship with their companies, directors are said to be fiduciaries; explain.
5. In relation to directors, explain the phrase "conflict of interest".
6. What do you understand by the phrase "corporate opportunity"? Under what circumstances may a director use a corporate opportunity for his own benefit?
7. Chris, Matthew, Comfort and Mary have been directors of Sixco Ltd, a consultancy company, for four years. Three of the directors have now formed a new company of their own and have begun to transfer to it the main clients and businesses of Sixco Ltd. Following opposition from the majority shareholders of the company, the directors allotted new shares to new investors and employees in order to dilute the power of the majority shareholders and nullify their opposition. Mary was not aware of these developments because she left the management of the company to the other directors and attended board meetings only occasionally. Following the activities of the three directors, Sixco Ltd is now insolvent and facing imminent liquidation.

   Advise the shareholders of Sixco on the conduct of the directors and the potential remedies they may have against them.

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25 THE COMPANY SECRETARY AND AUDITOR

25.1 INTRODUCTION

Secretaries and auditors perform different roles in a company – one administrative and the other financial. The position of a secretary is very important and senior and must not be confused with that of a clerk or front-desk employee. Auditors are responsible for scrutinising and affirming the annual accounts of companies. This chapter looks at the legal position and roles of secretaries and auditors in a company.

25.2 LEARNING OBJECTIVES

At the end of this chapter, the reader should fully understand:

- Who the company secretary is
- Who may be appointed a company secretary
- Which companies are required to appoint secretaries
- The functions and powers of company secretaries
- Which companies are required to appoint auditors and how the appointments are made
- Who may be appointed auditors, when they must cease to act, and how auditors' appointment may be terminated
- The responsibilities and duties of auditors
- The potential liabilities of auditors for breach of duty

25.3 THE COMPANY SECRETARY

The company secretary is the chief administrative officer of the company and the legal adviser of the board of directors. A private company is not required to have a secretary, but may have one if it so wishes (s. 270 CA 2006) but a public company must have at least one secretary. It is an offence for a public company not to have a secretary (s. 271 & 272 CA 2006). Public companies must keep a register of their secretaries at their registered offices and must notify the registrar of companies of any changes to them – s. 275 & 276 CA 2006. The same person cannot perform the functions of a company director and its secretary (s. 280 CA 2006). This provision, however may only meaningfully apply to public companies.

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25.3.1 QUALIFICATION OF THE SECRETARY

Before somebody could be appointed the secretary of a public company, the directors must be satisfied that he has the knowledge and experience needed to carry out the responsibilities of the office and:

- have held the office of company secretary for at least 3 of the preceding 5 years; or
- is be qualified as a barrister or solicitor in the UK; or
- belongs to the Institute of Chartered Accounts of England, Scotland or Wales or Ireland; Association of Certified Accountants; Institute of Chartered Secretaries and Administrators; Chartered Institute of Management Accountants; and Chartered Institute of Public Finance and Accountancy; or
- has held any office in the past or belongs to a professional body that equips him to be a secretary (s. 273 CA 2006).

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25.3.2 FUNCTIONS OF THE SECRETARY

Although the Companies Act did not specify any responsibilities for a secretary, a company secretary is an officer normally responsible for performing administrative and secretarial duties in a company. In fact, the UK Corporate Governance Code regards the company secretary as an impartial civil servant in the service of the board of directors. The responsibilities of the company secretary include:

- Organizing and taking minutes of General Meetings and Board of directors' meetings
- Maintaining a company's statutory registers, e.g. register of members, debenture holders, and charges
- Filing necessary and statutory returns to the registrar of companies
- Advising the board of directors on compliance with the Companies' Act and the procedures of the board
- Ensuring that the company's accounts are prepared in accordance with statutory requirements
- Ensuring that procedures for company meetings are followed

The UK Corporate Governance Code 2012 adds that the responsibilities of the secretary include:

- Ensuring good information flow within the board and its committees and between senior management and non-executive directors, and
- Facilitating induction and assisting with professional development as necessary

25.3.3 POWERS OF THE SECRETARY

A secretary is not a member of the board of directors and is not usually involved in the management of a company. Accordingly, a secretary cannot generally act as an agent of a company to bind it to contracts. The position of the secretary was outlined by Pennycuick VC in *Re Maidstone Building Provisions Ltd* [1971] 3 All ER 363 as follows:

> So far as the position of a secretary is concerned, it is established beyond all question that a secretary while merely performing the duties appropriate to the office of secretary is not concerned in the management of the company. Equally, I think he is not concerned in carrying on the business of the company.

A company secretary has no power to institute court action for the company unless expressly authorised by the board to do so.

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However, a secretary may have apparent or ostensible authority to bind a company on matters pertaining to his official responsibilities; or if he has been allowed by the company to act in an executive capacity. According to Pennycuick VC in *Re Maidstone Building Provisions Ltd*, "it is equally well established, indeed it is obvious, that a person who holds the office of secretary may in some other capacity be concerned in the management of the company's business". The question of the authority of a company secretary was settled in *Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd* [1971] 3 All ER 16:

> The defendant company's secretary ordered cars from the claimant company on behalf of the company. The secretary entered into the contract and signed it in his capacity as the company secretary. The vehicles were however used in the secretary's private affairs. The hire company sued the defendant company for the hire charges. It was held that the defendant company was liable for the charges since the secretary had apparent authority to enter the contract on its behalf on matters related to the administration of the company. According to the Court of Appeal, per Denning MR, the company secretary is no longer a mere clerk:
>
>> He regularly makes representations on behalf of the company and enters into contracts on its behalf which come within the day-to-day running of the company's business. So much so that he may be regarded as held out as having authority to do such things on behalf of the company. He is certainly entitled to sign contracts connected with the administrative side of a company's affairs, such as employing staff, and ordering cars, and so forth. All such matters now come within the ostensible authority of a company's secretary.

25.4 THE COMPANY AUDITOR

Companies are required to prepare annual accounts of their financial activities and positions and present the same to the company's shareholders for approval. Because directors are in charge of the company's affairs and finances, it is possible that they could mismanage or misappropriate the company's finances and then produce misleading accounts to cover their tracts. There could also be genuine errors in the accounts produced by a company's accountants. If there are misleading information in the accounts, ordinary shareholders might not be in a position to spot them; a qualified accountant, unconnected to the board of directors, would be in the best position to do so. The Companies Act 2006 provides that companies should appoint independent auditors to scrutinize and endorse their accounts. The requirement for independent auditing is aimed at ensuring good financial management and protecting shareholders' investments. According to Leggart LJ in *Barings Plc v Coopers and Lybrand* (1997) 1 BCLC 427:

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> The primary responsibility for safeguarding a company's assets and preventing errors and defalcations rests with the directors. But material irregularities, and *a fortiori* fraud, will normally be brought to light by sound audit procedures, one of which is the practice of pointing out weaknesses in internal controls. An auditor's task is so to conduct the audit as to make it possible that material misstatements in financial documents will be detected.

An individual or a firm of auditors may be appointed to perform the task of auditing. The remuneration of auditors is to be determined by the directors, members of the company, or the Secretary of State depending on who appointed them – *s. 492 CA 2006.*

25.4.1 AUDITING REQUIREMENT

Under s. 475 CA 2006, every public limited company must appoint an auditor to audit its annual accounts. Every private company that does not qualify as a small company under *s. 384 CA 2006* must also appoint an auditor for the same purpose. Companies exempt from auditing requirements are small private companies, dormant companies and non-profit companies subject to public audit. These companies do not need to carry out annual audits unless their members request one. The request may be made by members who own at least 10% of the shares or who account for at least 10% of the membership. In this situation, the directors must appoint an auditor – *s. 476(1) CA 2006.*

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A small company is one that has an annual turnover of not more than £5.6 million, a balance sheet total of not more than £2.8 million, and not more than 50 employees – s. 477(1)(2). A group qualifies as a small company if its net turnover and balance sheet total corresponds to the above figures (or £6.72 Million gross and £3.36 Million gross respectively). Charitable companies, which meet the requirements of a small company, are also exempt from auditing requirements and the appointment of auditors. The small company exemption does not apply to public companies, insurance companies, investment or management Company, e-money issuing company, building societies, industrial and provident societies – *s. 478 CA 2006***.**

A company is regarded as dormant if it has not done business since its formation, or if it has not done business throughout a particular financial year – *s. 480 CA 2006*. A company is not required to appoint auditors or to prepare an audit during any financial year in which it is dormant. However, some types of companies cannot take advantage of this provision even if they are small. These are banking, investment, management, insurance companies, and e-money issuing company. These companies would still need to prepare an audited account even if they were dormant – *s. 481 CA 2006.*

Companies which are not for profit and whose accounts are subject to audit by the Comptroller or Auditor General of the country are not required to appoint auditors to audit their accounts – s. *482 CA 2006.* Before these exemptions could apply however, company directors must specifically claim them in the company's balance sheet – *s. 475(2) CA 2006*.

25.4.2 APPOINTMENT OF AUDITORS OF PRIVATE COMPANIES

Private companies must appoint auditors annually unless the directors resolve on reasonable grounds that an audit is not needed – *s. 485 CA 2006*. This would be the case where the members resolve not to have an audit. *The first auditors* of a company would be appointed by the directors of the company to hold office until the end of the current financial year. Directors may also appoint auditors immediately after a period of exemption from audit or to fill casual vacancies. If the directors do not make the appointment, the members may themselves appoint the first auditors. The members of a company by means of an ordinary resolution appoint *subsequent auditors*. Where the directors and AGM fail to appoint an auditor as required by the Act, the company must inform the Secretary of State about this. The Secretary of State would then appoint an auditor to fill the vacancy – *s. 486 CA 2006.*

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The appointment of an auditor of a private company runs from one financial year to the next. The auditor shall vacate his position if another auditor is appointed for the next financial year. However, if no new auditor is appointed for the next financial year, the existing auditor shall be deemed to have been re-appointed for another year – *s. 487(1) CA 2006*. The auditor, would however, not be deemed to have been re-appointed if:

- He was appointed by directors, or
- The company's articles require actual re-appointment, or
- 5% of the members give notice to prevent the re-appointment, or
- Members resolve not to re-appoint the auditor, or
- Directors have resolved that no auditors are needed for that financial year – *s. 487(2) & s. 488 CA 2006.*

25.4.3 APPOINTMENT OF AUDITORS BY PUBLIC COMPANIES

As in private companies, the first auditors of public companies are to be appointed by directors who may also fill casual vacancies. Subsequent auditors are to be appointed by the members in AGMs by ordinary resolution for one financial year. Where the directors or members fail to appoint an auditor the Secretary of the company must inform the Secretary of State who is entitled to appoint the auditor – *s. 490 CA 2006*. Auditors of public companies hold office until the next financial year unless they are re-appointed. There is no automatic reappointment for auditors of public companies – *s. 491 CA 2006*. In addition, the UK Corporate Governance Code provides that every listed company should have an audit committee to recommend those to be appointed as auditors. The committee will also ensure the independence of auditors and that internal financial controls are in place. All listed companies are required to comply with this provision.

25.4.4 ELIGIBILITY OF AUDITORS

Before a person could be appointed a company auditor, he must be a member of a recognised professional body and must be eligible for appointment under the rules of that body. The recognised professional bodies are the Institute of Chartered Accountants in England and Wales (ICAEW), the Institute of Chartered Accountants of Scotland (ICAS), The Institute of Chartered Accountants of Ireland (ICAI), the Association of Chartered Certified Accountants (ACCA), and the Association of Authorised Public Accountants (AAPA). The person must also hold an appropriate qualification as determined by the regulatory bodies. In the case of a firm, the people responsible for audit work must hold the appropriate qualification, and the firm must be controlled by qualified persons.

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In addition, the person must be independent. This means that he must not be an officer or employee of the company whose account he is to audit. He must also not be a partner or employee of such officer or employee of the company or be involved in a partnership with them. A person will also be ineligible for appointment if was ineligible to be appointed auditor of an associated company (i.e. a parent or subsidiary).

A person must not act as a company auditor if he is ineligible (i.e. if he is not qualified, becomes disqualified, or ceases to be independent). If a company auditor becomes ineligible, he must vacate his office immediately and give notice to the company that he is vacating due to ineligibility.

It is also an offence for an ineligible person to act as company auditor. The person could however escape punishment if he could prove that he does not know and had no reason to believe that he was or had become ineligible. Where a company's audit has been done by an ineligible person, it will have to be reviewed or re-done by an eligible auditor.

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25.4.5 RESPONSIBILITIES OF THE AUDITOR

The auditor's main responsibility is to prepare a report on a company's annual accounts for the financial year and to deliver the report to the company secretary and the Registrar of companies – s. *495 CA 2006*. The report must contain the name and signature of the auditor or those of a partner in a firm of auditors. It is an offence to submit an audit report without name and signature – *s. 503 CA 2006* (Name and signature of auditor may be excluded where there is a serious risk of violence on the auditor concerned – s. 506).

The auditor's report must:

- State whether the annual accounts of the company give a true and fair view of the balance sheet and profit and loss of the company or group of companies for the financial year.
- State whether the accounts have been prepared in accordance with the relevant reporting framework, and
- State whether the accounts have been prepared in accordance with the Companies Act – s. 495(3).
- State whether the directors' report is consistent with the annual account. – *s. 496 CA 2006.*
- Include any reservations the auditor has about the accounts or directors' report and any qualifications and emphasis which the auditor wishes to call attention to – s. *495(4*). In this regard, the auditors' report must state*,* where applicable:
    a) that adequate accounting records have not been kept;
    b) that returns adequate for the audit have not been received from branches not physically visited; or
    c) that company's individual accounts are not in agreement with the accounting records and returns – *s. 498 CA 2006.*

For quoted companies the auditor also has to include a report on the auditable part of the directors' remuneration report and whether this has been prepared in accordance with the Companies Act – *s. 497 CA 2006.*

25.4.6 DUTIES OF THE AUDITOR

Some checks, in the form of duties, have been placed on the performance of company auditors with the aim of ensuring that the audits are done properly. These duties are those of investigation and care and skill.

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25.4.6.1 Duty to investigate

An auditor needs to conduct a independent investigation in order to verify whether adequate accounting records have been kept and whether adequate returns on the accounts from all branches have been made. He must also satisfy himself that the individual accounts agree with the accounting records and returns – s. 498 CA 2006. For quoted companies, the auditor must also satisfy himself that the auditable part of the directors' remuneration report agrees with the accounting records and returns. If the auditor is not satisfied with any of the above matters, he must state this fact in his report. The auditor must also state if he had failed to obtain all the information and explanation necessary for his report – s. 498 (2)(3).

The auditor has the right to obtain all the information and documents he needs to do his work. Accordingly, he is entitled to inspect the company's books, records, accounts, vouchers etc. and to obtain information from its officers – *s. 499 CA 2006*. If an auditor is denied access to any documents he needs, he must state this fact in his report. It is an offence for any officer of the company to knowingly or recklessly give false, deceptive or misleading information to an auditor – *s. 501 & s. 507 CA 2006*. Failure of an auditor to carry out proper investigation may amount to a breach of his duty of care and skill.

25.4.6.2 Duty of care and skill

Auditors must carry out their duties with care, skill and caution. Under *s. 49(1) of the Consumer Rights Act 2015,* there is an implied term that a supplier of services (such as an auditor) will perform the service with reasonable care and skill. The duty of auditors, however, is not to guarantee the absence of fraud but to do their best to detect irregularities and/or fraud in the accounts. The nature of auditors' duty of care and skill is explained in the following cases:

Re Kingston Cotton Mill Co. (No. 2) (1896) 2 Ch 279, at 288-289 (per Lopes LJ):

> It is the duty of the auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective or, as was said, to approach his work with suspicion or with foregone conclusion that there is something wrong. He is a watchdog not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is something calculated to excite suspicion, he must probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful. An auditor does not guarantee the discovery of fraud.

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Fomento (Sterling Area) Ltd v Selsdon Fountain Pen Co Ltd [1958] 1 WLR 45 (Lord Denning):

> An auditor is not to be confined to the mechanics of checking vouchers and making arithmetical computations. He is not to be written off as a professional 'adder-upper and subtractor'. His vital task is to take care to see that errors are not made, be they errors of computation or errors of omission or commission, or downright untruths. To perform this task properly he must come to it with an enquiring mind – not suspicious of dishonesty […] but suspecting that someone may have made a mistake somewhere and that a check has to be made to ensure that there has been none.

The key words for auditors in the conduct of their investigations and the preparation of their reports are therefore *skill*, *care*, *caution*, and *diligence*. If an auditor applies these and yet fails to discover errors in the accounts, he will have acted with due care and skill. If an auditor follows laid down and accepted procedures and practices of the accountancy profession, he would be deemed to have acted with appropriate care and skill. The converse would be the case if he disregards these and performs an erroneous audit.

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The best thing for an auditor to do is to follow the recommendations of their professional bodies in the Financial Reporting Standards and other published material. Where a person exercises a particular specialist skill or calling, his conduct would be measured by the standard expected of a reasonable practitioner of that skill or calling (*Bolam v Friern Hospital Management* Committee [1957] 1 WLR 583; *Wilsher v Essex Area Health Authority* [1987] QB 730). In the case of an auditor therefore, the standard would be that of a qualified, chattered, certified accountant. If it were to be proven that he had followed the standard practice of his professional colleagues, the auditor would most likely avoid liability in negligence.

25.4.7 AUDITORS' LIABILITY

An auditor who prepares and erroneous audit may be liable to the client company for breach of contract. However, apart from liability for breach of contract, a client company can take action in tort against an auditor for losses suffered due to a negligently prepared account. Proximity in this case would be based on the contractual relationship between the auditor and the company which employed him.

Individual shareholders, however, are not entitled to take action against auditors for errors in a company's audit report. Since the document is deemed not to have been prepared for them, no proximity would exist between them and the auditor, and it would not be fair just or reasonable to hold the auditor liable in that instance. Accordingly, no duty of care arises in favour of the members. In *Caparo Industries Ltd. v. Dickman (1990) 2 AC 605*, it was held that it is the right of a company to take action against an auditor for breach of duty; and that it is not open to individual shareholders to do so.

The auditors' duty of care is also not owed to members of the public or outsiders generally. Therefore, if an investor buys shares or lends money to a company on the strength of an erroneously prepare audit report, the auditor cannot be held responsible for any losses suffered by that investor or creditor (*Caparo Industries Ltd. v. Dickman*).

In the absence of a contractual relationship, an auditor may only owe a duty of care to individuals for negligent misstatements under the *Hedley Byrne principle v Heller & Partners* (see chapter 11.4.2).

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25.4.8 AVOIDING OR LIMITING LIABILITY

An auditor may avoid or minimize liability for an erroneous audit in a number of ways, including, agreement with the company, the use of exclusion or limitation clauses, and the use of disclaimers. An auditor may limit his liability for negligence, default, breach of duty, or breach of trust by an agreement with the members of the company for one financial year provided the agreement is fair and reasonable – *s. 534 CA 2006.* An auditor may also disclaim liability by making express statements to that effect. The disclaimer will prevent a third party (in the absence of contract) from suing an auditor in negligence.

In addition, an auditor may cover his potential liability by insurance. The policy will usually cover losses caused to a client by breach of contract and to a non-client by the tort of professional negligence.

25.4.9 TERMINATION OF AUDITORS' APPOINTMENT

An auditor's appointment may come to an end by removal, resignation, and ineligibility. Whenever an auditor leaves office before the end of his term both the auditor and the company must give notice of that fact to the Secretary of State or his representative along with a statement of the reason for the auditor's departure – *ss. 522 and 523 CA 2006.*

Members of a company may, at any time, in a general meeting pass an ordinary resolution to remove an auditor from office. This may be done notwithstanding any agreement or contract with the auditor, although he may be entitled to compensation if there was a breach of contract – *s. 510 CA 2006.* The auditor is entitled to be given a special notice of the proposal to remove him; and to defend himself before shareholders – *s. 511 CA 2006.* Because of these requirements, an auditor may not be removed by unanimous consent or the written resolution of private companies. The company must within 14 days inform the registrar of the removal of an auditor – *s. 512 CA 2006.* An auditor of a public company is also required to vacate office at next AGM unless re-appointed.

An auditor may resign his appointment by giving notice to the company. The notice must be accompanied by a statement of the circumstances leading to his resignation, otherwise it would not be valid – s. *516 CA 2006.* The statement should indicate whether or not any matters surrounding the resignation should be brought to the attention of the company – *s. 519 CA 2006.* The auditor, if he so wishes, is entitled to attend the company's next general meeting or to request one in order to bring any matters connected with the company's account and his leaving office to the attention of the shareholders. Notice of an auditor's resignation must be given to the registrar of companies – *s. 517 CA 2006.*

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Finally, a person who has been appointed an auditor but is ineligible or subsequently becomes ineligible must vacate his office and a replacement must be appointed. As earlier noted, it is offence for a person to act as an auditor after he has become ineligible.

25.5 CHAPTER SUMMARY

Company Secretary

- Secretaries are persons responsible for the administration of companies, the keeping and filing of company's statutory records, and advising the board of directors on legal matters, especially compliance with company legislations.
- A person cannot be a secretary unless he has any of the stipulated qualifications.
- A public company must have at least one secretary and this person must not also be a director of the company.
- A private company does not have to appoint a secretary if it does not wish to do so.
- A secretary is not an executive officer of a company; is not normally part of the management of the company; and would not normally share liability with directors for wrongdoing.
- A secretary does not have power to bind the company to contracts except in respect of matters within his usual responsibilities or unless he had been held out by the company as a person possessing management powers.

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Company Auditor

- An auditor is an external qualified and independent accountant appointed to check and validate a company's annual accounts and directors' report.
- The responsibility of the auditor is to affirm whether or not the annual accounts and directors' report truly reflect the company's financial status, and whether they are consistent with each other and with the Companies Act 2006.
- To be appointed an auditor, a person must have the requisite professional qualification and must remain so through-out his tenure, otherwise he must vacate office. The person must also be independent of the company and its directors.
- All companies must audit their accounts annually except small and dormant companies and non-profit companies which are audited by the public sector auditor.
- Auditors are normally appointed for a period of one year at a time by the members of a company (in public companies following the recommendation of audit committees). However, directors normally appoint the first auditors while the Secretary of State may make the appointment in some circumstances.
- In carrying out his responsibilities, the auditor is under a duty to conduct independent investigation and to perform with care and skill.
- An auditor may be liable for breach of contract and negligence were the audit to be done badly. This liability could however be minimized or avoided by the use of exclusion clauses, disclaimer or insurance.
- An auditor's appointment may be terminated by resignation, removal or ineligibility.

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25.6 PRACTICE QUESTIONS

1. You have been invited for an interview for the post of a company secretary. Explain to your interviewers why you believe you might be qualified for the job and what the post entails.
2. Explain what makes a person eligible to work as a company auditor.
3. What are the consequences of a person acting as auditor when they are not eligible to do so.
4. Jack has been the auditor of Mainstream Plc for five years. The directors of the presented papers indicating high stock levels and a profit of £10 million. They also proposed a dividend payment of £2 per share. Because Jack trusted the directors of Mainstream plc, he accepted the documents as true reflections of the company's state of affairs. In truth, the company's actual stock levels were far lower than those reported in the accounts and its profit was only £1 million. The company went ahead and paid dividends to its shareholders as recommended in the accounts. Mainstream Plc is now insolvent because the dividends were in fact paid from the company's capital. Meanwhile, it has emerged that at the time of the audit, the Association of Chattered Certified Accountants (ACCA) had revoked the membership of Jack for gross professional misconduct following a complaint from a previous client.

   Advise Mainstream plc and Jack on their potential claims and liabilities in company law

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26 COMPANY SHARE CAPITAL

26.1 INTRODUCTION

A company limited by shares must have a share capital. This share capital is the nominal amount of money which the shareholders of a company invest in the business by acquiring the company's shares. In the past, companies must state in their memorandum of association the amount of their shares (or authorized) capital and this amount becomes the limit of its capital unless and until formally increased. The CA 2006 has now abolished this requirement, with the effect that companies do not need to specify what their share capital would be. However, public companies must have a minimum share capital of £50,000, while there is no prescribed minimum for a private company. A company's share capital must be sub-divided into small units of shares of a certain amount. For example, the memorandum of ABC Ltd may state that the company has a share capital of £100,000 divided into 100,000 shares of £1.00 each. While the share capital shows the total value of the company's capital outlay, each £1.00 share represents a unit of interest in the company. The extent of the interest and liability of a member of the company is measured by the amount of shares the member has in the company.

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26.2 LEARNING OBJECTIVES

At the end of this chapter, the reader should clearly understand:

- The meaning, sources and categorisations of a company's share capital
- The meaning and nature of shares
- The rights of shareholders
- The types of shares, their respective rights and relative advantages and disadvantages
- The need for a company to maintain its share capital and the rules designed for this purpose

26.3 DEFINITION AND NATURE OF SHARES

A share means a stake in a company's share capital – *s. 540 CA 2006*. As famously described by Farwell J in *Borland Trustees v. Steel Bros & Co Ltd (1901) 1 Ch 279, at 288:*

> A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place and interest in the second, but also consisting of a mutual set of covenants entered into by all the shareholders inter se.

From this definition, the characteristics of a share stand out:

- A share is an *interest* in a company. A share therefore is an intangible and invisible property. It is a chose in action. Its value arises from what they represent – a right to membership of a company with the accompanying rights and obligations.
- A share must have a *monetary value*. A share must have a determinate value, which must be calculable in monetary terms. Shares allotted without monetary value are void (see *s. 542 CA 2006*).
- Shares show the *extent of a shareholder's liability* to contribute capital to a company. The liability of a shareholder is limited to the amount unpaid on his shares. Once this amount has been paid, the shareholder is not liable to make further contributions.
- Shares also show the *extent of the interest* a person has in the company. The larger the amount of share, the greater the interest and control a person has in a company. Shares of different classes also designate special rights to the holders of the shares of that class.
- Shareholding in a company commits the holder to covenants or undertakings of company membership. Thus, shareholders are bound in contract with the company and with other shareholders (see *s. 33, CA 2006*).
- Shares are regarded as personal and moveable property and not as real property or heritage (see *s. 541 CA 2006*).

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26.3.1 CATEGORIES OF SHARE CAPITAL

There are different categories or classifications of share capital. Some of these are as follows:

26.3.1.1 Equity share capital

This means "issued share capital excluding any part of that capital that, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution" – s. 548. Equity shares give the holders all the rights of a shareholder, in particular, the right to participate in the distribution of surplus assets and the right to the return of capital upon liquidation. Ordinary shares are usually equity shares.

26.3.1.2 Authorised share capital

This was the maximum amount of shares which company can issue and was specified in the memorandum of association. The CA 2006 has abolished concept and requirement of authorised capital for new private companies. Accordingly, companies now do not have to specify or restrict the total number and nominal value of the shares the company may have unless, for some reason they wish to do so. Any such voluntary restrictions will now be stated in the company's articles.

26.3.1.3 Issued and allotted shares

Issued and allotted capital mean the value of shares that have actually been issued or allotted to shareholders; and include shares taken up by the subscribers to the company's memorandum of association at the time of its formation – s. 546.

26.3.1.4 Called-up, uncalled and reserve share capital

Called-up capital is the part of issued capital for which the company has called upon the holders to pay, plus any share capital paid up without being called and any part of the share capital to be paid for on a specified date in the future. The uncalled capital is the amount owing on shares which members have not yet been called upon to pay – *s. 547 CA 2006*. The reserve capital is the part of uncalled capital on which the company has resolved not to make a call unless the company is wound up.

26.3.1.5 Equity share capital

S. 548 CA 2006 defines equity share capital as a company's "issued share capital excluding any part of that capital that, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution."

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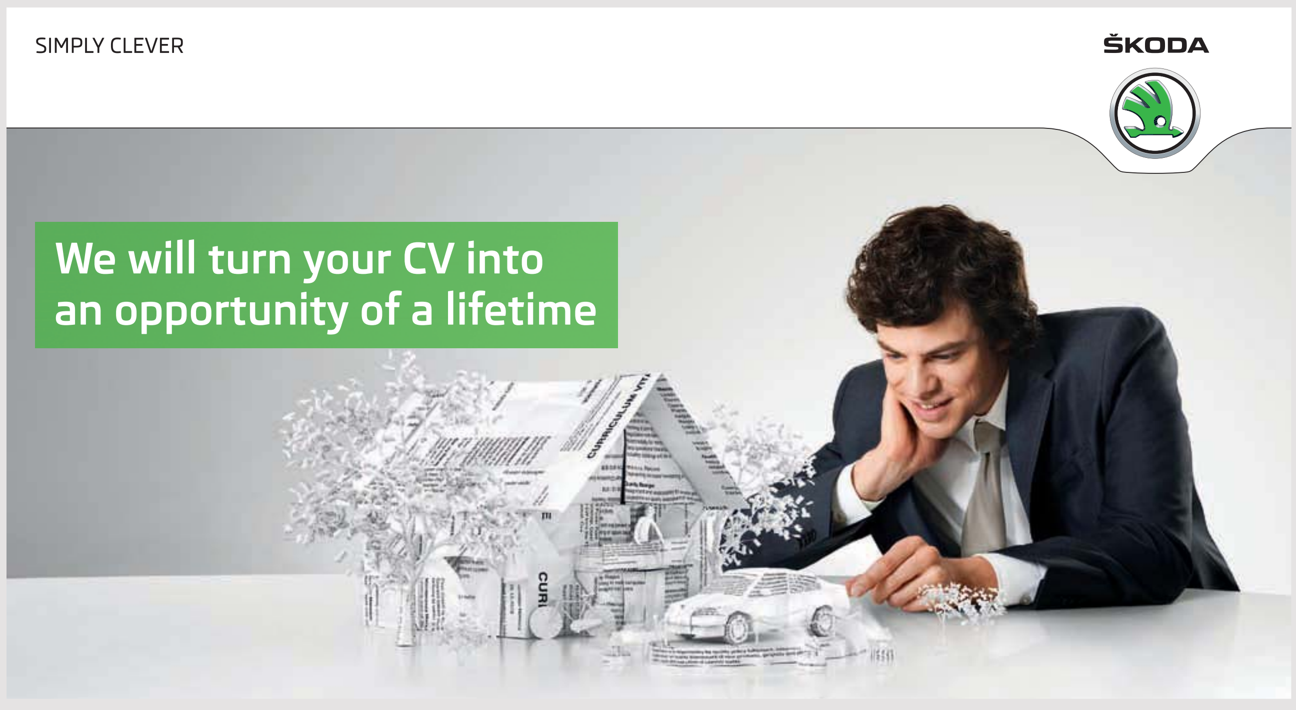
26.4 CLASSES OF SHARES

A company may, and usually does, create shares of different types and characteristics, meaning that all shares may not rank equally. Different types of shares are referred to as 'classes'. Classes of shares show the rights attaching to each type of shares and accruing to its holders. Shares are said to belong to the same class "if the rights attached to them are in all respects uniform" – *s. 629 (1) CA 2006.* The rights that attach to shares include the right to dividend; the rate of dividend and whether dividend is cumulative; the right to vote in companies' general meetings and to participate in their decision-making. Others are the right to a share of surplus assets during solvent liquidation and the order of priority; and the right to a return of capital on solvent liquidation and the order of priority. However, not all shares have all these rights. The rights attaching to different types of shares are known as 'class rights' and these would usually be specified in the articles of association. The rights would also be stated in the terms of issue of the shares in question. As stated by Scott LJ in *Cumbrian Newspapers Group Ltd. v. Cumberland and Westmorland Printing Co. Ltd* [1986] 2 All ER, "a company, which by its articles confers special powers on one or more of its members in the capacity as member or shareholder, thereby constitutes the shares being held by that member or members, a class of shares. The rights are class rights."



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26.4.1 ORDINARY SHARES

Ordinary shares could be described as the standard or default shares of a company. Thus, where shares are issued without division into different classes, they are all regarded as ordinary shares; and where shares with special rights are created, the remaining shares are classed as ordinary. Again, where shares are created without a particular description, they are regarded as ordinary shares. Most of the shares of a company are usually ordinary. Ordinary shares normally carry a right to vote, a right to share in surplus assets, and a right to return of capital. There is usually no automatic right to dividend unless the board of directors declares dividend. In other words, if the board does not declare dividend, the shareholders are not, subject to certain exceptions, generally entitled to receive any even though the company had made a profit.

Dividends are payable to ordinary shareholders after the preference shareholders have been paid. Ordinary shares are also referred to as "equity shares" because they confer an unlimited right to share in the surplus profits and assets of a company after all liabilities have been settled. There may be different classes of ordinary shares. Some may be created with reduced or enhanced voting rights. For example there may be class A, class B, and class C ordinary shares with varying voting rights of, say, one vote per share, two votes per share, or five votes per share.

26.4.2 PREFERENCE SHARES

These are shares with preferential rights. The preferential rights usually relate to the payment of dividends and return of capital. This means the shareholders of that class have a right to be paid dividend, and to recover the capital during solvent liquidation, before other shareholders. Usually the rate of dividend is stated in the articles or in the terms of issue as a percentage of the nominal value of the shares. Preference shareholders have a right to their dividend at the stated rate. However, like ordinary shareholders, preference shareholders are only entitled to dividend if the directors have declared a dividend.

The right to dividend is deemed to be 'cumulative' unless otherwise stated. This means that if dividend is not paid in any year, they are carried forward to the following year. Usually the shares will be expressly described as 'cumulative preference shares'. This right may be lost if a company goes into liquidation unless the terms of issue safeguarded the payment of accumulated dividends on liquidation. Some preference shares may have a right to share in surplus assets of the company along with the ordinary shares. This type of preference shares is called "participating preference shares". Some preference shares may also have a preference on the return of capital on winding up. These rights must be clearly stated in the terms of issue.

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The advantages of preference of shares include the certainty of rate of dividend, in that holders are paid the agreed rate of dividend irrespective of the size of the company's profits. Another advantage is priority on the return of capital, in that the invested share capital would be returned to the holders before they are returned to ordinary shareholders. This type of shares, compared to ordinary shares, may seem a more stable investment especially for investors who do not want to exercise control over a company or share in its long-term success. Disadvantages of preference shares include the fact that if the company makes large profits, the ordinary shareholders may receive more dividend than the preference shareholders whose rate is fixed. In addition, because of the fixed rate of dividend, the holders of this type of share may lose out in real terms in times of inflation. Moreover, the holders do not (unless otherwise agreed) usually have voting rights at general meetings; accordingly they are not able to exercise much influence over their companies' affairs, except on matters concerning their class.

26.4.3 REDEEMABLE SHARES

These are shares issued by a company with a right to buy them back at a stipulated future time and at a stipulated rate of interest. These types of shares are used to raise short-term funds without intending to make the holders permanent members of the company. Redeemable shares may not be issued unless the articles permit or does not prohibit their issue. They may also not be issued unless the company has issued other shares that are not redeemable – *s. 684 CA 2006.* Redeemable shares cannot be redeemed unless they are fully paid for – s. 686(1).

26.4.4 BONUS SHARES

These are shares issued to existing shareholders of a company out of the un-issued shares of the company in proportion to their current shareholding. These shares are paid for by the company from its reserve funds, especially the Share Premium Account. These shares are also referred to as "capitalisation issue".

26.5 VARIATION OF CLASS RIGHTS

The terms under which a class of shares were issued may be altered or varied. This is known as variation of class rights and may be done by:

a) Converting one class of shares to shares of another class – e.g. from preference to ordinary or vice versa;
b) Altering the rights to vote, the right to dividend, the right to return of capital, or the right to share in surplus assets accruing to a particular class of shares; or
c) Altering a provision in the articles on the procedure for alteration of class rights, or insertion of new provision on alteration – *s. 630(5) and s.631 (5) CA 2006.*

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The procedure for variation of class rights depends on whether or not the articles of association make provisions for it. Where the articles make a provision for variation, that procedure must be followed – *s. 630(2) CA 2006.* Where the articles make no provision, variation may be done by (a) the written consent of three-quarters of the shareholders or members of that class, or (b) special resolution of a general meeting of shareholders or members of that class – *s. 630(4) and s. 631(4) CA 2006.*

However, under sections *633 and 634 CA 2006,* members of a class of shares have a right to object to the variation of the rights of that class and may appeal to the court to cancel the variation. The court may either approve the variation or cancel it. In order to be able to object, the objectors: must account for at least 15% of the issued shares or membership of that class; must not have voted in favour of the variation; and must apply to the court within 21 days of the variation. The basis of the objection may be procedural, in that the stated procedure for variation under the CA has not been followed; or substantial, in that it is "unfairly prejudicial" to the class as a whole, because, for example if it is fraudulent or oppressive. However, the following do not amount to variation of class rights:

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a) Issuance of more shares of a class to outsiders thereby diluting the voting powers of existing shareholders

In *White v Bristol Aeroplane Co. Ltd* [1953] Ch 65, it was held that the issuance of bonus ordinary and preference shares to existing ordinary shareholders only did not amount to the variation of the rights of the existing preference shareholders.

b) Subdivision of shares of a particular class thereby creating more voting rights to the detriment of shareholders of another class (E.g. a company may subdivide 10,000 shares of £1.00 each of a particular class to 20,000 shares of 50p each. This would double the voting power of the holders of those shares).

In *Greenhalgh v. Arderne Cinemas Ltd* [1946] 1 All ER 512, a company had two classes of ordinary share of 50p and 10p each. The company subdivided each 50p share into five shares of 10p each, thereby multiplying the voting rights of that class by five. The holder of the 10p shares objected to this on the ground that his class rights were varied wrongly. It was held that the subdivision did not amount to the variation of the plaintiff's class rights.

c) Creation of a new class of shares with priority over an existing class of shares.

26.6 ALLOTMENT OF SHARES

Allotment of shares means the allocation of the shares to potential shareholders upon application and the entering of their names in the register of shareholders. In private companies with one class of shares, there is no need for directors to be given specific authority (either by resolution or in the company's articles by the members) to allot shares (s. 550 CA 2006). The directors are deemed to have the necessary authority to allot new shares of that class unless the articles of association say otherwise. In other cases, directors are given power either by the articles or the members to allot shares. This power is given for a specified period (not more than 5 years) and is subject to renewal. The authority must state the maximum number of shares to be allotted; directors cannot issue shares in excess of the maximum number allowed by the members or the articles (ss. 549 and 551). It is a criminal offence to allot shares without proper authorisation, even though the allotment would remain valid. All allotment of shares must be registered and must be notified to the Registrar of Companies (ss. 554 and 555).

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26.7 PRE-EMPTION RIGHT

Members of a company normally have a right of pre-emption. This means that if the company wishes to allot new ordinary shares wholly for cash, the existing ordinary shareholders would be offered them first in proportion to the shares they currently hold in the company. The offer would be on the same terms, or on more favourable terms than, the existing allotment. This practice, which is also known as rights issue, is used, among other things, to maintain the balance of shareholding in a company. If the existing members would not or could not buy them, the shares could then be offered to outsiders. Companies may however, remove a right of pre-emption in their articles. Moreover, pre-emption does not apply to bonus shares; shares give under an employee share scheme; or shares offered for non-cash consideration. Provisions on pre-emption are contained in *ss. 560–577 CA 2006*.

26.8 MAINTENANCE OF SHARE CAPITAL

A company must maintain its share capital. This means that the company can only use the capital in ways permitted by the Companies' Act 2006, i.e. essentially for its normal business activities. A company's capital need to be maintained essentially in order to have money available for the settlement of a company's creditors upon insolvency or liquidation. There are many rules in the Companies Act 2006 for the maintenance of capital, but these apply more strictly to public companies. The rules include the requirement that a company cannot issue its shares at discount; the rule that shares must be paid for in cash or equivalent; the prohibition of purchase by company of its own shares; and the restrictions on the ability of a company to assist anyone financially in the purchase of its own shares. Others are the restrictions on the ability of a company to reduce its capital; the restrictions on the redemption of shares; and the requirement that dividends must be paid only from profits.

26.8.1 NO DISCOUNT ON SHARES

Each share in a company has a pre-determined nominal or face value. Where the shares are allotted at less than their nominal value, they are said to be issued at a discount. A company is generally not allowed to issue its shares at a discount – *s. 580 CA 2006*. If anybody is allotted shares at a discount, he is liable to pay the balance plus interest at the going rate. Shares may however be issued at a premium. A premium is the difference between the nominal value of a share and its selling price. If a £1.00 share is sold for £1.50, there is a premium of 50p. If a company issues shares at a premium, the premium has to be transferred to a special account called the "*Share Premium Account*" – *s. 610 CA 2006.*

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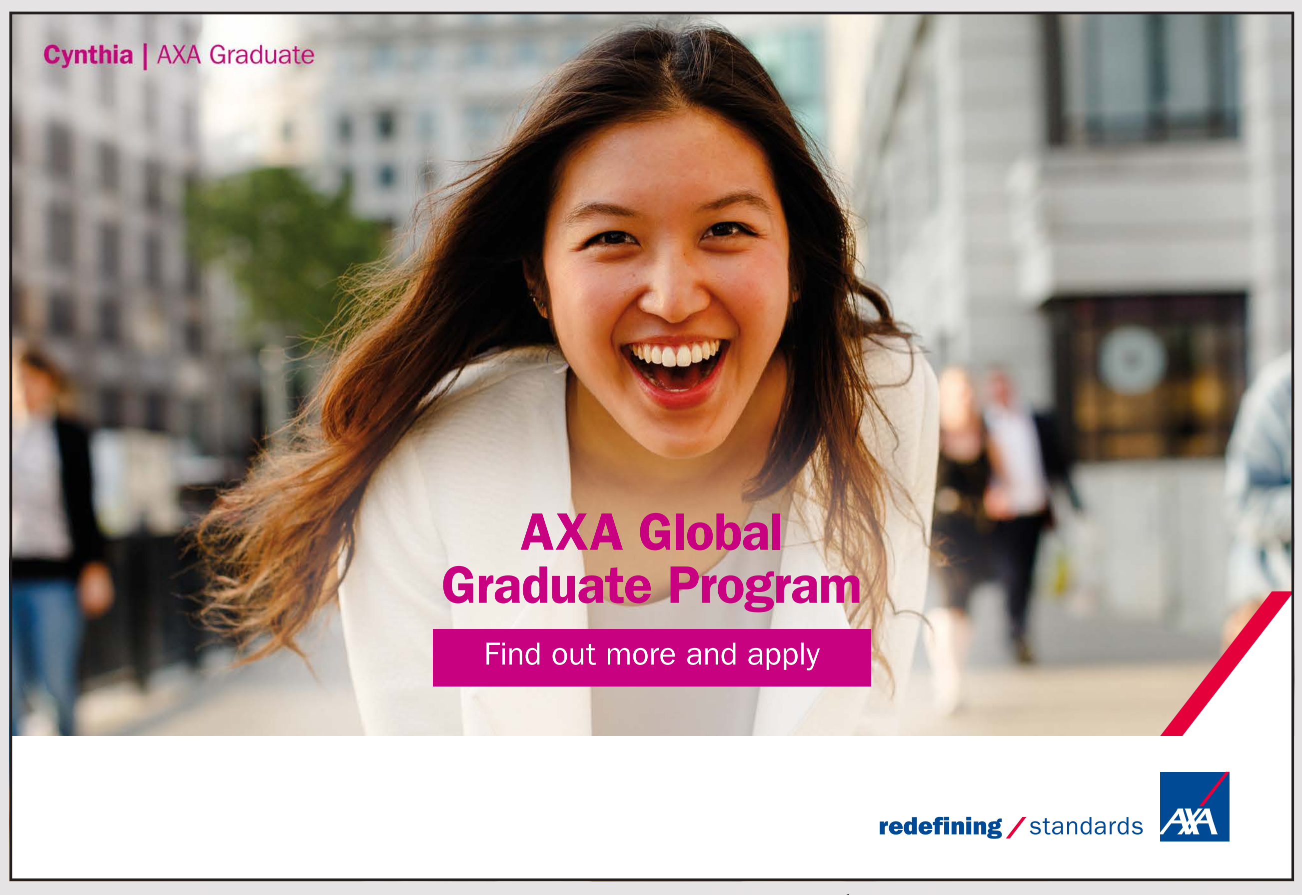
This account may only be used for the purposes permitted by the Companies Act. These are payment for bonus shares given to existing shareholders; payment for shares given to employees under an employee share scheme; payment for the expenses of new share issues or any commissions in respect thereof; and payment for redeemable shares. Dividend cannot be paid out of this fund.

26.8.2 PAYMENT FOR SHARES MUST BE IN MONEY OR MONEY'S WORTH

Generally, companies' shares should be paid for with money or money's worth. This means that the thing used for payment, if not money, must be capable of valuation in monetary terms. Thus, the payment could be in kind – e.g. services, goodwill, expertise, property and goods – *s. 582 CA 2006.* A private company may issue shares to somebody in return for the future performance of work or service. A public company cannot do so – *S. 585 CA 2006.* Where a private company issues shares for payment in kind, the court is not usually concerned whether the payment was adequate unless some fraud, bad faith or blatant overvaluation of the assets is involved. In the case of a public company, an independent valuation of the payment usually has to be made to determine whether it was adequate or not – *s. 593(1) CA 2006.*



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Shares may be issued as fully paid-up or partly paid-up. However, a public company cannot allot shares as partly paid-up unless 25% of its shares have been paid for – except where the shares are allotted under an employee share scheme – *s. 586 CA 2006*.

26.8.3 COMPANY NOT TO ACQUIRE OWN SHARES

A company is forbidden from acquiring its own shares. If a company purports to buy its own shares, that purchase would be void and the company and the officers responsible would be committing an offence – *s. 658 CA 2006.* Shares must be paid for and the payment forms part of the capital of the company. If a company buys its own shares, no payment would be received for those shares and the capital of the company would be diminished to the value of that purchase. Under *s. 659 CA 2006,* there are some exceptions to this rule, and they concern shares acquired as a result of lawful reduction of capital, shares acquired following a court order, and shares acquired following forfeiture or surrender by owners who have failed to pay for them. If a plc acquires forfeited shares, it must cancel them and reduce its share capital by their value – *s. 662 CA 2006.*

26.8.4 COMPANY NOT TO GIVE FINANCIAL ASSISTANCE FOR PURCHASE OF OWN SHARES

Giving of financial assistance to enable somebody buy shares in a company may be in the form of cash, gift, security, guarantee, loans, indemnity, release/waiver, novation, reducing or discharging liability incurred from purchasing shares, and any financial assistance that materially reduces the company's net assets, or financial assistance given when the company has no net assets – *s. 677 CA 2006.* A private company is allowed to give financial assistance to anybody for the purchase of its shares – *s. 682 CA 2006.*

Subject to certain exceptions, a public company is generally prohibited from giving financial assistance for the purchase of its shares or those of its holding or subsidiary company – *s. 678 & 679* CA 2006. It is an offence for them to do so – *s. 680 CA 2006*. A public company may only give assistance (*ss. 681 & 682 CA 2006*):

- Where it does not affect the company's net assets
- Where it is giving from the company's distributable profits
- Where giving loans is the company's business and the loan was given in the normal course of business
- Where it is given under an employees' share scheme or to help former employers to buy shares

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However, a plc would not be regarded as giving assistance where:

- The main purpose of the assistance was not for the purchase of the shares, or the assistance was incidental to the main purpose, and the assistance was given in good faith – *s. 678 (2)(4).*
- There has been a distribution of assets by way of lawful dividend or during winding-up
- Bonus share were allotted.
- Redeemable shares were re-purchased.
- There has been a lawful reduction of capital.
- Things had been done by court order or by a liquidator in the course of insolvency or winding-up.

26.8.5 RESTRICTIONS ON REDEMPTION OF SHARES

Although a company may repurchase its redeemable shares, such repurchases are subject to the following restrictions (*ss. 684–733 CA 2006*):

- Only fully paid shares may be redeemed or repurchased.
- Any redemption or repurchase must be paid for in full at the time of redemption or repurchase.
- Private companies may only redeem from capital if it is solvent (i.e., it has more assets than liabilities). To this end, directors must make a statutory declaration of solvency, which must be backed by a statement of account showing the company's ability to pay its debts as they fall due.
- Public companies may only pay for the shares and any premiums on them from distributable profits or from the proceeds of a fresh share issue and must deduct the value of the repurchase from the Share Premium Account.
- Following the redemption, the company concerned must cancel the shares and reduce its issued share capital accordingly. It must also transfer an equivalent sum to an account called the Capital Redemption Reserve Fund, and notify the company registrar of the redemption.

26.8.6 RESTRICTIONS ON THE REDUCTION OF CAPITAL

A company's share capital may be reduced in different ways. In particular, it may be reduced if any money unpaid on shares is extinguished or reduced by the company; if excess paid-up capital is returned to shareholders; or if a part of paid-up capital which has been lost or which is un-represented by available assets is cancelled – *s. 641 CA 2006.*

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A private company limited by shares may only reduce its capital by means of a special resolution supported by a statement of solvency signed by its directors. The statement would affirm that the company would be able to pay all its debts within twelve months of the reduction. It is an offence to make a false or misleading statement of solvency – s. 643. Any reduction will not be allowed unless at least one shareholder remains in the company – *s. 641 CA 2006.*

A public company may reduce its capital by special resolution subject to confirmation by the court – *s. 641 CA 2006.* The court may only confirm the reduction if it is satisfied that the company's creditors have been paid, have consented to the reduction, or that their debts have been secured with the company's assets – s. 648. Creditors of the company are entitled to object to the reduction – s. 646. Whenever a reduction of capital has been done, notice of the special resolution, insolvency statement, a statement of the company's capital, and the court order must be filed with the Registrar of Companies within 15 days – s. 644.

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In *Trevor v Whitworth* [1887] 12 App Cas 409, Lord Watson explained the rationale for these restrictions as follows:

> Paid up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining on call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid up, except in the legitimate course of its business.

26.8.7 COMPANY NOT TO PAY DIVIDEND FROM CAPITAL

Dividend refers to the part of a company's profits that are distributed to shareholders. Shareholders are not entitled to dividend unless a dividend has been recommended by the directors and declared by the company. The articles would normally specify how dividends might be declared; but directors are usually given this power. Shareholders are entitled to declared dividend only on their paid-up shares. Under the Companies' Act, dividend may only be paid from a company's "distributable profits." This refers to a company's accumulated realised profits minus its accumulated realised losses. These profits must not have been previously distributed or capitalised, and the losses must not have been previously written off in an authorised reduction of capital.

For a plc, dividend may only be paid if its net assets are not less in value than the total value of its called-up capital and un-distributable reserves. The un-distributable reserves are the share premium account, the capital redemption reserve fund, any surplus between accumulated un-realised profits and accumulated unrealised losses, and any other un-distributable reserves under a statute or the company's articles – s. 831 CA 2006.

An investment company may pay dividend out of its accumulated and realised revenue profits only if:

- The profits have not been previously distributed or capitalised and the value is greater that the company's accumulated revenue losses (whether realised or unrealised) that have not previously been written off in a lawful reduction or reorganisation of capital; and
- The amount of its assets is at least equal to one and a half times the aggregate of its liabilities to creditors, and the distribution does not reduce that amount to less than one and a half times that aggregate – s. 832.

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If directors declare or recommend the payment of dividend otherwise than from distributable profits, they could be liable in negligence to make good the loss to the company, unless their mistake was honest and reasonable (e.g., where it was reasonably based on an inaccurate audited account). Any shareholder who knows or ought reasonably to have known that the dividend has been paid from capital could be liable to make a refund to the company.

26.9 CHAPTER SUMMARY

- Every company limited by shares must have a share capital, which is the value of all shares allotted by the company to its shareholders.
- Every company's share capital must be sub-divided into individual units of specified or nominal value.
- There are different classes of shares with varying class rights. The classes include ordinary, preference and redeemable shares. The rights attaching to these share may be varied in accordance with the provisions of the CA 2006.
- The shares of shareholders represent the extent of their interest, rights, liabilities and obligations in the company.
- The power to allot shares is normally stipulated in the articles of association and exercised by directors.
- Companies must maintain their share capital by using it properly for the purposes of the business.
- There are several rules for the maintenance of a company's share capital. A company must neither issue its shares at a discount; purchase its own shares, nor give financial assistance to enable persons to acquire its shares. In addition, all shares must be paid for with money or money's worth; share capital cannot be reduced, nor shares re-purchased except as provided for under the Act; and dividends may only be paid from distributable profits.

26.10 PRACTICE QUESTIONS

1. Name and explain the different classes of shares which may be available in a company
2. Mention at least four rights which a shareholder acquires by virtue of share ownership.
3. Which type of share would you most recommend to a prospective investor and why?
4. What is meant by issuing shares at a discount? Why is it important that a company should not buy its own shares?

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5. Kaspa plc has a share capital of £50million divided into 50 million shares of £1 each. Due to a substantial fall in its profits, demand for the company's shares has fallen and the company has not paid any dividend to its shareholders in the last three years. The company's board of directors now plans to take the following actions:
   a) A reduction of its share capital from £50million to £30million due to the significant fall in its business;
   b) An issue of new shares, including redeemable shares, to new investors on a "buy one, get one free" basis;
   c) In order to encourage investors to buy the shares mentioned above, the board wishes to allow payment in full or in part, and in cash or kind;
   d) An issue of £500,000 shares to its employees for free as a form of motivation;
   e) A payment of dividend of 20p per share to its shareholders from the company's share Premium Account in order to please the shareholders and prevent the dissolution of the board of directors.

   Advise the board of directors of Kaspa plc on whether it can legally undertake the above proposals and, where appropriate, the procedures for so doing.

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27 COMPANY LOAN CAPITAL

27.1 MEANING OF LOAN CAPITAL

Companies finance their businesses through share capital, shareholder contributions, profits or borrowing. Loan capital refers to all monies raised by a company through different forms of corporate borrowing and credit facilities, including, loans, overdrafts, debentures, and bills of exchange. A company has the power to borrow money to finance its business and activities. Since a company has legal personality, it can enter into contracts, including loan contracts, in its own name. A private company can borrow money once it receives its certificate of incorporation. A newly registered public company cannot, as we have seen earlier, start trading or borrowing unless its allotted share capital is at least £50,000.00, and it has received a trading certificate from the registrar of companies. Borrowing money is an essential part of a company's life as it helps to provide needed funds for business activities. The power of a limited company to borrow money is exercised by the board of directors as may be stipulated in the company's articles of association. Whether capital should be raised through shareholder contributions, the allotment of new shares or by way of borrowing is a strategic decision to be taken by the board of directors depending on the needs of the company and the prevailing market circumstances.

27.2 LEARNING OBJECTIVES

The objectives of this chapter are to enable readers to:

- Understand the meaning and constituents of a company's loan capital.
- Understand the meaning and characteristics of debentures and to distinguish them from shares.
- Understand the meaning of charges and why they may be created.
- Understand the two types of charges – fixed charge and floating charge – and their relative advantages and disadvantages for creditors and borrowers.
- Understand the priority of charges and the necessity for registration of all charges.

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27.3 DEBENTURE

As shares show the extent and nature of a person's interest in a company's share capital, debentures show their interest in its loan capital. A debenture is a formal document issued by a company under its official seal acknowledging or evidencing its indebtedness to a creditor and the terms of that indebtedness. A debenture holder in a company is not a shareholder of the company and does not have the usual rights of a shareholder. He is a creditor with a contract under which he loans money to a company in return for interest and with a right to have his capital returned at the stipulated time. A debenture holder has preference over a company's shareholders in the payment of interest and return of capital.

A debenture is transferable like shares and may be converted into shares upon the agreement of the company and the debenture holders. Debentures are usually redeemable at a specified time, although some may be perpetual or only redeemable on the happening of some events. Unlike shares, debentures may be issued at a discount and may be redeemed from capital. While a public company may offer debentures to the public, a private company cannot do so.

27.3.1 TYPES OF DEBENTURE

A debenture includes a *single debenture*, a *series of debentures, debenture stock*, and bonds, or any other form of security given by a company: Debenture stock means debenture capital or fund that can be divided into and held in any irregular amount. For example, a company may create a debenture stock of a certain amount out of which different debentures are issued to different creditors. A holder of a debenture stock may choose to transfer only part of it. For example, the holder could sell £1000 stock out of a stock of £2000. Where debentures are not issued as stock, they can only be transferred in block. In the preceding example, the holder has to sell all £2000 at the same time.

Debenture stocks, which may only be issued by public companies, are created using a debenture trust deed which would stipulate the terms and particulars of the debenture and appoint a trustee to represent the debenture holders.

27.3.2 RIGHTS OF A DEBENTURE HOLDER

A debenture holder has a right: to sue the company for the recovery of the debt; to petition the court for the compulsory winding up of the company for inability to pay its debts; or for an administration order. Where the debenture is secured by a company's asset, the debenture holder also has the right to take possession of and sell the asset or to apply to the court for foreclosure of the asset concerned. A foreclosure ends the right of the company to redeem the debt. If this happens, the debenture holder or chargee becomes the owner of the asset concerned.

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27.4 CHARGES

In company law, a charge is an interest in company's property held by a creditor as security for a loan. When a company borrows money or issues a debenture, it often has to use part or all of its assets to secure the loan so that if it fails to repay the loan or interests on it, the creditor could take, or recover the money from, the assets. Such a security is called a charge or a mortgage. Depending on how it arose, a charge may be legal or equitable. A legal charge is created in writing by a formal deed of charge or mortgage. An equitable charge occurs where a document creating the charge is not under seal; where there was no writing at all but the title documents to the assets concerned have been handed over to the creditor as proof of borrowing; or where the title to the charged property is itself equitable. To be valid, a charge over a company's assets must be registered with the registrar of companies. Based on its nature and characteristics, a charge may be fixed or floating. Whether a charge is fixed or floating is a matter of fact to be deciphered from the terms of the loan contract and all the circumstances of the cases; the mere description one way or another by the parties is not conclusive (*National Westminster Bank v Spectrum Plus Ltd and others* [2005] UKHL] 41; [2005] 4 All ER 209).

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27.4.1 THE FIXED CHARGE

A fixed or specific charge occurs where an asset is specifically earmarked and attached as security for a loan. Such a charge may be on fixed assets like land, buildings, plants, machinery or equipment, etc., or on movable assets like fleets of vehicles or stock in trade. It may also be on a company's book debts, provided the company is unable to deal with the debts (*National Westminster Bank v Spectrum Plus Ltd and others*). The key point is that once an asset is under a fixed charge, the company (chargor) would have no right to dispose of it without the prior permission or consent of the creditor (chargee). If such property were to be disposed of by the company without the consent of the creditor, the charge would follow the property to the buyer who takes it subject to the charge.

The holder of a fixed charge has the right, upon default in repayment, to take possession of, sell, or foreclose the charged asset. However, the creditor must realise the loans from the asset used to secure it and would bear the risk if depreciation or loss were to occur, hence the need for insurance. Moreover, if a company creates a fixed charge over its existing debts and goes into liquidation within 6 months thereafter, the charge would be void – *s. 245 Insolvency Act 1986*. A company may create more than one fixed charges on the same asset if its value permits it, in which case the charges will rank in priority according to the order of their creation. It may also create a fixed charge and a floating charge on the same assets. Where this happens, the fixed charge takes priority even if it was created later.

For a borrowing company, a fixed charge makes it easier to secure a loan, due to the greater assurance of the security, and to get better rates of interest from their creditors. A major disadvantage of fixed charge to the borrowing company is that it ties down the assets concerned, such that the company cannot dispose of it without the prior consent of the charge.

27.4.2 THE FLOATING CHARGE

A floating charge is an equitable charge on current and future class of assets of a solvent company. The assets are transient, changeable, or non-permanent in nature and the charge applies to them in the different conditions they happen to be from time to time. Thus, floating charges are typically created on a company's stock in trade, book debts, shares, or even on its entire undertaking or business. A floating charge remains dormant until the company ceases to be a going concern (i.e. until it stops being solvent), the chargee intervenes, or any other specified event (called crystallization) occurs. Before this, the company may dispose of the assets in the normal course of its business as if there was no charge on it (see *Re Yorkshire Wool Combers Association Ltd* [1903] 2 Ch 284; *Buchler v Talbot* [2004] UKHL 9; [2004] AC 298).

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Crystallization may be specified to occur:

- When the company fails to meet its obligations under the charge agreement and the creditor decides to call in the assets;
- If an agreed crystallization event happens (e.g. if the company defaults in payment of interests; if a plc re-registers as private company);
- If the company is liquidated;
- If the company ceases doing business prior to winding up;
- If the company uses the assets other than in the normal course of its business;
- If the company creates a superior charge on the assets;
- If the creditor appoints an administrative receiver

When crystallization occurs, the charge becomes a fixed equitable charge attaching to the class of assets concerned. As explained by Lord Hoffmann in *Buchler v Talbot* [2004] UKHL 9; [2004] AC 298:

> When a floating charge crystallises, it becomes a fixed charge attaching to all the assets of the company which fall within its terms. Thereafter the assets subject to the floating charge form a separate fund in which the debenture holder has a proprietary interest. For the purposes of paying off the secured debt, it is his fund. The company has only an equity of redemption; the right to retransfer of the assets when the debt secured by the floating charge has been paid off. It is this equity of redemption which forms part of the fund held on trust for the company's creditors which arises upon a winding up.

Upon crystallization, the chargee would take the charged assets in the condition in which they happen to at that time. Because the company can dispose of the charged assets in the course of business, their precise number and value cannot be accurately ascertained until crystallization. However, if a company creates a floating charge over its existing debts and goes into liquidation within 12 months thereafter, the floating charge would be void – *s. 245 Insolvency Act 1986.*

Although the company may dispose of the charged asset or create further charges on them, there may be a clause in the floating charge agreement preventing the creation of further charges that rank above or equally with the charge. This is called a 'negative pledge clause'. The negative pledge clause would strengthen the position of the floating charge holder by preventing the creation of a fixed charge, which would have been superior to it. Where, however, a company creates more than one floating charges over the same class of assets, the charges rank in priority according to the date of their creation.

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A floating charge does not give the holder the right to take possession of the charged assets. Instead, it confers a right to appoint a receiver if default has been made in the servicing of the loan. It also confers the right to petition for the compulsory winding up of the company for failure to pay its debts, or to petition for an administration order. For charges created before the coming into force of the *Enterprises Act 2002 (i.e., 15 September 2003),* the charge holder also has the right to appoint an administrative receiver whose function would be to take over the management of the company and realise its assets for the purpose of settling the debt owed to the charge holder and preferential creditors.

27.4.3 REGISTRATION OF CHARGES

Under *s. 860 CA 2006*, when a company creates a charge, whether fixed or floating, it must deliver to the Registrar of Companies the instrument creating it and a statement of the particulars of the charge. The particulars would include the date of creation, the amount of debt secured with the charge, the property charged, and the persons entitled to the charge. The company must do this within 21 days of the creation of the charge – *s. 870 CA 2006*. The Registrar on receipt of this statement and particulars would issue a certificate to the company and send copies of the particulars of the charge to the company and the chargee.

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Under *s. 860(1),* it is the duty of the company to register all charges created by it. Failure to submit a statement and particulars of a charge within 21 days, or the submission of inaccurate particulars, is an offence for which fines may be imposed on the officers of the company. However, the chargee may undertake to carry out the registration since it would be in his interest to do so – *s. 860(2) CA 2006.* Under *s. 873 CA 2006*, the court may allow registration after 21 days. It may also allow corrections in the details already registered. In both cases, the court will only act if the failure or error was accidental or inadvertent and if it is just and equitable to do so having regard to the circumstances and the interests of other creditors. A company must keep in its registered office copies of instruments creating charges, as well as a register of charges. These documents are open for inspection by members of the public – *s. 875 & 876 CA 2006.*

Under *s. 874 CA 2005*, failure to register a charge renders it void as far as other creditors, liquidators, or administrators are concerned, and converts the charge holder into an unsecured creditor. This is because registration gives warning and notice to future creditors of a company that particular assets have been used to secure a debt. Without registration, a company may continue borrowing money with the same assets above their value. It is an offence for officers of a company to fail to register a charge within the time stipulated by the Companies Act – s. 860(4)(5). In addition, priority of charges depends on whether and when they are registered.

27.4.4 PRIORITY OF CHARGES

Sometimes a company may use the same asset to secure more than one loan. For example, an asset may be the subject of more than one fixed or floating charge. It is also possible that one asset may be the subject of both a fixed charge and a floating charge. In these and similar circumstances, the law has to determine which charge holder takes priority if the company goes into insolvent liquidation. Provided the relevant charges have been duly registered, the general rules of priority are as follows:

- Legal fixed charges take priority in order of creation and have priority over all equitable charges.
- Equitable fixed charges take priority in order of creation.
- A fixed charge takes priority over earlier floating charges that have not crystallized.
- Floating charges take priority in order of their creation.
- A crystallized floating (which has become a fixed charge) takes priority over subsequent fixed charges.

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27.5 CHAPTER SUMMARY

- A company may raise capital by way of loans and all monies raised in this way are referred to as loan capital.
- Usually, a company borrows money or acknowledges its borrowings by giving debentures to its creditors who have rights against the company in respect of their loans and interest.
- Debentures are transferrable like shares but the holders are creditors rather than shareholders. Debentures could be issued at a discount, unlike shares.
- Debentures are often secured against company assets by way of charges. This entitles the holder to recover money from the company by exercising rights over the assets concerned. The charge may be fixed or floating although the same asset may be subject to both at the same time.
- A fixed charge attaches immediately to specific assets from which the debt may be realised upon default. A borrowing company cannot dispose of a fixed charge asset without the consent of the lender.
- A fixed charge may be created legally by the execution of all necessary documents and the completion of all formalities; or equitably by the mere deposit of title documents with a creditor.
- A floating charge does not attach immediately to any particular assets but applies to a class of transient assets which the borrowing company could and is expected to dispose of and replace as necessary in the normal course of business.
- A legal fixed charge is normally higher in priority to an uncrystallised floating charge. All other charges rank according to the order in which they are created.
- All charges must be registered at the Companies House and all companies must keep a register of charges. The validity and priority of charges depend on their being properly registered. An unregistered charge is not enforceable, and the holder thereof would become an unsecured creditor for the purposes of loan repayment.

27.6 PRACTICE QUESTIONS

1. State and explain three rights of a debenture holder.
2. Give three reason why a debenture might be a better form of investment than a company's shares.
3. Give three reasons why a debenture might be a worse form of investment than a company's shares.
4. Give three reasons why it might be better for a company to borrow money rather that raise capital from the issue of its shares.

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5. Northern Industries plc is considering the following methods of raising or securing loan capital:
   a) A legal mortgage of the company's land in favour Midland Bank as security for a loan of £1million;
   b) A first floating charge over the company's "assets and undertakings" to the extent of £500,000 in favour of Southern Supplies Ltd, its major trade creditor. The charge includes a "negative pledge" clause;
   c) A second floating charge over the company's assets to the extent of £100,000 in favour of Anglia Concerns Ltd. another trade creditor. The charge contains an "automatic crystallization clause" in the event that England fails to qualify for the next FIFA world cup tournament.

   Discuss:

   a) The significance of the respective charges and the steps, which may be taken by the creditors if Northern industries plc becomes insolvent.
   b) The order for repayment of the loans if Northern Industries plc eventually goes into compulsory liquidation.

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28 INSOLVENCY AND LIQUIDATION COMPANIES

28.1 INTRODUCTION

A limited company may run into difficulties, become insolvent, or need to close down its business for different reasons. However, the company cannot simply stop doing business and close its premises. Certain statutory rules must be followed to put the company's affairs in order before its existence could be ended. If a company is in financial difficulties, the members or directors may choose to take some steps to save it and keep it in business. The various steps that might be taken in these circumstances are covered by the rules relating to insolvency, administration, and liquidation of companies. Most of these steps are *insolvency* procedures, in that they take place only when a company has become insolvent. These include administration, receivership, administrative receivership, company voluntary arrangements, compulsory winding up, and creditors' voluntary winding up. Some other procedures take place when a company is still solvent. An example is the members' voluntary winding up.

28.2 LEARNING OBJECTIVES

At the end of the chapter, the reader should fully understand:

- The notions of solvency and insolvency of companies
- The measures which insolvent companies may take to get back to solvency, when and how they could be taken; and their effects
- How a company may be wound-up or liquidated
- The procedure for the winding up of companies and the powers and duties of the liquidator
- The consequences of the winding up of a company

28.3 COMPANY VOLUNTARY ARRANGEMENT

Company Voluntary Arrangement (CVA) is a mechanism by which a company in financial difficulties reaches an arrangement, compromise or composition with its creditors on the management or payment of its debts. A voluntary arrangement will involve things like rearranging or rescheduling the payment of a company's debts or modifying the terms of the loan agreement to make repayment easier. CVA is usually the first line of action for an insolvent company because, if successfully negotiated, it can allow a company to continue its business without disruption while it tries to come out of insolvency. The rules on CVA are contained *sections 1–7 Insolvency Act 1986.*

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CVAs are usually negotiated by a company's board of directors which remains in place during its operation. The members of the company and three-quarters of the company's unsecured creditors must approve the CVA. However, once the voluntary arrangement has been approved, the decision would be binding on all unsecured creditors of the company. If the company is in administration, the arrangement may be proposed by the administrator, and must also be approved by the members and three quarters of the unsecured creditors. If the company is already in liquidation, the liquidator may make the proposal. A proposal for a voluntary arrangement should be filed with the court although court permission is not required for the arrangement to take effect. A qualified insolvency practitioner must be appointed as a nominee to supervise the implementation of the voluntary arrangement.

28.3.1 EFFECTS OF CVA

For small companies, a moratorium comes into effect once a proposal for voluntary arrangement has been filed with the court. Moratorium means the general postponement of enforcement of all debts owed by the company. A 'small company' is a company whose annual turnover is not more than £5.6 million, whose annual balance sheet is not more than £2.8 million, and which has not more than 50 employees. The moratorium will prevent creditors who do not favour the arrangement from taking steps to undermine it by, for example, applying for winding up or administration or appointing an administrative receiver before the proposal is approved by the creditors. A CVA gives an insolvent company an opportunity to try and trade its way out of insolvency, however, its failure could result in the compulsory winding up of the company concerned.

28.4 RECEIVERSHIP

Receivership is the mechanism for the realisation of the assets of a company for the purpose of satisfying the debts secured with them, especially in the form of a floating charge. The officer responsible for this is called a receiver. Usually no court order is required for the appointment of a receiver since the debenture usually includes this right. Without such stipulation, a receiver can only be appointed by court order. The rules on receivership are contained in *Part III IA 1986*. The main concern of a receiver is the enforcement of the charge of the creditor who appointed him; he does not have to be concerned about the interest of the company as a whole. A receiver may however, be required to settle some preferential debts (such as employees' wages) before paying off the charge.

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A receiver does not owe fiduciary duties to the company as a director does, his interest being the welfare of the appointing creditor. He should however act with diligence and could be sued by the company if he abuses his position. A receiver appointed by a creditor is normally an agent of the company and therefore, has the right to enter into contracts and employ staff in the name of the company for the purpose of the receivership. This right ends if the company goes into the process of liquidation. A receiver must submit an account to the company on the conduct of his work.

28.5 ADMINISTRATION

An administrator is a person appointed to manage the affairs, business and property of an insolvent company with a view primarily to rescuing it from insolvency. Only qualified insolvency practitioners may be appointed as administrators. An insolvency practitioner is a person licensed by law to engage in insolvency practice. An administrator may be appointed by the courts on the application of the company, its directors, creditors or the holder of a floating charge on the entire undertaking of a company. The rules governing the administration of companies are contained in *s. 8 and Sch B1, Insolvency Act 1986*.

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28.5.1 PURPOSES OF ADMINISTRATION

The purposes of administration are three-fold. The first and primary purpose is t*o try to rescue the company as a going concern*. This means that the administrator must try to keep the company as a viable business enterprise. This objective must first be pursued unless it is not reasonably practicable. *The next and secondary purpose is to try and achieve a better result for the company's creditors than would be achieved by the winding-up* of the company. This objective should only be pursued when the first option is not reasonably practicable or a better result is envisaged. *The last purpose of administration is to realise the properties* of the company in order to pay off secured and preferential creditors. This is a last resort and would be undertaken only if the first two options are not reasonably practicable and the interests of creditors would not be harmed unnecessarily.

Before a court could make an administration order, it must be satisfied that the company is or is likely to be insolvent, and that administration is reasonably likely to achieve its purpose. According to Gibson J. in *Re Consumer and Industrial Press Ltd.* [1988] BCLC 177, at 178, this means that:

> The court must be satisfied on the evidence put before it that at least one of the purposes in s. 8(3) is likely to be achieved if it is to make an administration order. That does not mean it is merely possible that such purpose will be achieved; the evidence must go further than that to enable the court to hold that that the purpose in question will more probably than not be achieved.

28.5.2 EFFECTS OF ADMINISTRATION

Upon appointment, an administrator takes over the running of the company and its entire business. The directors of the company cannot exercise any functions that can interfere with the work of the administrator unless they are permitted to do so by the administrator himself. In addition, any outstanding petitions for the winding up of the company lapses; and any administrative receiver or receiver already in place must stand down. Furthermore, upon the appointment of an administrator, or upon filing an application or notice for his appointment, a period of moratorium comes into force. During this period no legal action for the recovery of debt, property or goods can be brought against the company; no execution can be levied against its property; and a landlord cannot retake possession of any property rented by the company. Moreover no winding up proceedings may be commenced against the company (unless by a court order). In short, rights over the company by third parties are frozen during this period.

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28.5.3 POWERS OF AN ADMINISTRATOR

An administrator must prepare and submit to the Registrar of Companies and the company's unsecured creditors, within eight weeks of appointment, his proposal for the company. The company's unsecured creditors must approve this proposal before the administration proper could commence. The approval should be done within 10 weeks. If the proposals were to be rejected, the court would make any order it thinks appropriate, including the termination of the administrator's appointment.

An administrator has all the powers, which the directors of the company and the administrative receiver could exercise. In particular, he could sell any of the company's properties, could enter into contracts, and could terminate contracts of employment.

> In *Re Transbus International Ltd.* [*2004*] *2 All ER 911,* it was held that an administrator is only required to comply with instructions and proposals actually approved by the creditors or the court; and that he is not required to actively seek directives from the court or creditors before he could act. He could "do anything necessary or expedient for the management of the affairs, business, and property of the company," without having to seek the approval of the court or the creditors.

An administrator is an agent of the company, and of the company's creditors and does not (unlike the administrative receiver) incur any personal liability for adopted contracts of employment.

28.5.4 DUTIES OF AN ADMINISTRATOR

An administrator is in a fiduciary relationship with the company. He owes a duty of care to the company and must carry out his responsibilities with care and in such a manner as an ordinarily qualified and diligent insolvency practitioner would do. He could be liable in damages if were to be negligent. He also has a duty to take reasonable steps to obtain the best price for the company's assets. In *Peskin v. Anderson* [2001] BCC 876, and in *Kyrris v. Oldham* [2004] BCC 111), it was held that an administrator does not owe a fiduciary duty or duty of care to unsecured creditors of a company unless there is a special relationship between them. Thus, the creditors are in the same position in this regard, as the company's shareholders with respect to directors' duties.

28.5.5 DURATION OF ADMINISTRATION

An administration comes to an end automatically after one year unless it is extended. It may be extended once for six months by all the secured creditors and a majority of unsecured creditors of the company. It may also be extended by the court for as long as it thinks necessary. However, administration may be terminated before one year by the administrator on his own motion, on creditors' instructions, or by court order.

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28.6 COMPULSORY WINDING UP

Where any or all of the above insolvency measures fail, a company's life may be formally brought to an end either by compulsory winding-up or voluntary winding up. A compulsory winding up occurs when a court makes an order that a company be wound up compulsorily. It is also called winding up by the court. This is an insolvency and liquidation procedure. The liquidator will normally be an officer of the court known as "the official receiver". Rules concerning compulsory winding up are contained in the *Insolvency Act 1986, Chapter VI*. On the appointment of the compulsory liquidator:

- The powers of the company directors end, and their functions are assumed by the liquidator;
- All employment contracts are terminated;
- The membership of the company is frozen
- No dealings in the company's shares or securities are allowed;
- All floating charges crystallize

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Under *s. 122 IA 1986*, an order for compulsory winding up may be made:

- When a company by special resolution applies for the company to be wound up;
- Where a public company fails to obtain a trading certificate after one year of being incorporated;
- Where a company does not start business for more than one year after incorporation or stops doing business for more than one year;
- Where the number of members in a public company falls below two;
- Where in a voluntary arrangement, the period of moratorium fails to resolve the company's situation;
- Where the company is unable to pay its debts; or
- Where it is just and equitable to wind up the company

28.6.1 WINDING UP FOR INABILITY TO PAY DEBTS

However, the most important circumstance for the compulsory winding up of a company are due to inability to its debts. A company is to be regarded as being unable to pay its debts in any of the following circumstances:

- if it fails to comply with a statutory demand to pay a debt of more than £750 within 21 days
- if the execution of a judgement debt owed by the company fails partly or completely due to unavailability or insufficiency of assets
- if it is proved that the company could not pay its debts as they become due (inability to pay the debts of the creditor who petitioned for the winding-up would be enough)
- if it is proved that the company's liabilities exceed its assets

28.6.2 WINDING-UP ON THE JUST AND EQUITABLE GROUND

Another important circumstance for the compulsory winding up of a company is on the ground that it is just and equitable to do so, but this may be done only as the last resort. This may happen as result of the oppression of minority shareholders; because the sole purpose for establishing the company has been defeated and cannot be realised; where there is a complete deadlock in the company; and where a company had been formed for an illegal or fraudulent purpose.

In small companies regarded as quasi partnerships where the trust, friendship, and understanding on the basis of which the company was formed have been destroyed and a minority shareholder is being oppressed, that minority may petition for compulsory winding on the just and equitable grounds.

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In *Ebrahami v Westbourne Galleries Ltd* [1973] AC 360, the company was formed by E and N on the basis of equality in both management and profit sharing. Subsequently N brought his son into the company as an equal shareholder and director. Later N and his son colluded to remove E as a director. They also stopped paying dividends but paid themselves directors' remuneration. They further used the company's import network to trade on their own account. In despair, E petitioned the court to wind up the company on just and equitable grounds. It was held that company should be wound up on the just and equitable ground.

In *Ebrahimi v Westbourne Galleries Ltd*, the House of Lords laid out the circumstances under which an order for just and equitable winding up may be made for the benefit of a minority shareholder:

- The company must be regarded as a quasi-partnership. In other words, it must have been formed or continued on the basis of personal relationship and confidence and these personal relationship and confidence have been destroyed. This type of company will usually be small and private.
- There has to be an understanding that the shareholders would be involved in management and this agreement has been breached.
- There is a restriction on the transfer of a member's shares such that an aggrieved member could not dispose of his shares
- Winding up is the only way the dispute could be resolved

Where the sole purpose for which a company was set up has been defeated and can no longer be realised, it may also be wound up on the just and equitable grounds.

In *Re Abbey Leisure* [1990] BCLC 342, a company was formed on the understanding that its sole purpose was the acquisition, refurbishing and management of a nightclub. The nightclub was acquired but subsequently sold. The plaintiff petitioned for the 'just and equitable' winding up of the company on the ground that the purpose for forming it had been defeated by the selling of the nightclub. It was held that the company should be wound up on the just and equitable ground.

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A company may also be wound up on the just and equitable ground where there is a complete deadlock in its management, such that progress would be impossible.

> In *Re Yenidge Tobacco Co Ltd* [1916] 2 Ch 426, the two shareholders of the company where also its only directors. The enmity between the two was so strong that they could not bear to speak to each other and only communicated at board meetings by passing notes through the secretary. One of the shareholders/directors petitioned for winding up. It was held that the company, being a quasi-partnership, should be wound up due to the complete breakdown in the relationship of the shareholders/directors.

Lastly, a company may be wound up on the just and equitable grounds where it was formed for a fraudulent or illegal purpose. In this situation, the Registrar of Companies would make the petition for the winding up on grounds of public policy.

28.6.3 APPLICATION FOR COMPULSORY WINDING UP

Under s. 124(1) *IA* 1986, application for compulsory winding up may be made by:

- The company's creditors
- The contributories to the company's capital (where the number of members have been reduced to below two)
- The company or its directors
- Supervisor of a voluntary arrangement
- An administrative receiver
- An administrator
- The Secretary of State for Trade and Industry (where plc has failed to obtain a trading certificate within one year of incorporation)
- The Official Receiver
- A liquidator

28.6.4 POWERS OF THE LIQUIDATOR

The powers of the liquidator are extensive. They include the power:

- To do everything necessary for winding up the company and distributing its assets
- To pay the debts of the company and to sign any documents and issue cheques, bills of exchange, promissory notes on behalf of the company
- To distribute any surplus assets of the company after paying the debts to the shareholders and others entitled to it
- To enter into arrangements and compromise with creditors with regard to the company's debts
- To take legal action on behalf of the company and to defend any such action
- To carry on the business of the company as is necessary to wind it up beneficially
- To sell any of the company's properties
- To recover money from any contributories of the company

However, a liquidator owes a fiduciary duty to the company and must act within his powers and without negligence. He could be held personally liable for negligence.

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28.7 VOLUNTARY WINDING UP

Voluntary winding up is one not ordered by a court but initiated by the company itself or by its creditors. There are therefore two types of voluntary winding up – members' voluntary winding up and creditors' voluntary winding up. The rules on voluntary winding-up are contained in *Chapter II and III Insolvency Act 1986.*

28.7.1 MEMBERS' VOLUNTARY WINDING UP

In members' voluntary winding up, the members themselves resolve to have the company wound up and appoint a liquidator to this effect. There is no need to involve the court or the company's creditors. However, court confirmation would give the winding-up EU-wide recognition. Members' voluntary winding up can only happen if the company is still solvent. A member's voluntary winding up occurs:

- Where the period for which the company was set up has expired or an event has happened which the articles provide would lead to the winding up of the company. In these cases only an *ordinary resolution* is required.
- Where the members pass a *special resolution* that the company be wound up voluntarily. The members may pass this resolution simply because they want the company to cease business for any reason.

The members will then appoint a liquidator, who must be a qualified and registered insolvency practitioner, to wind up the company. At the end of three months following his appointment, the liquidator will call a meeting of the members and give an interim report of the exercise. At the end of the liquidation exercise, the liquidator will present a final account to the members and notify the Registrar of Companies of the company's liquidation. The registrar will, after three months, remove the company's name from the companies register, thereby bringing its life to an end.

Since members' voluntary winding-up may take place if a company is solvent, the directors of the company must make a declaration of solvency before the passing of the winding-up resolution. This is a statement affirming that the company would be able to pay all its debts and interests on them within 12 months of the resolution. A statement of account detailing the company's assets and liabilities must accompany this declaration. The declaration of solvency and the accompanying documents must be submitted to the Registrar of Companies with 15 days of the passing of the winding up resolution. It is an offence for directors to give a false or misleading declaration of solvency. If the debts of the company and any interests on them were not paid in full within the time stated in the resolution, this is evidence that the directors have presented a false declaration of solvency and may therefore be punished.

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28.7.2 CREDITORS' VOLUNTARY WINDING UP

Where members have passed a special resolution for voluntary winding up but the directors of the company fail to submit a declaration of solvency and the accompanying statements before the passing of the resolution, the winding up automatically becomes a creditors voluntary winding-up. The company in this circumstance is deemed to be insolvent and the winding-up becomes an insolvency procedure. A meeting of the company's creditors must be convened within 14 days of the meeting of the members. The creditors would be provided with list of the company's creditors and the amounts owed to them. They would also be provided with a statement of the company's assets and liabilities.

The creditors would then appoint a liquidator to carry out the winding up unless they decide to approve the one earlier appointed by the members. Where members had appointed a liquidator, he may, before the creditors have made their own appointment exercise the powers of a liquidator. However, the powers of such a liquidator are, unless otherwise authorized by a court, limited to taking control and preserving or protecting the company's property and selling only perishable goods. The creditors would also appoint a liquidation committee to oversee the liquidation and receive the report of the creditors. On the appointment of a liquidator, the directors' functions cease as their duties are transferred to the liquidator, whose powers are similar to those under compulsory winding up.

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28.8 CHAPTER SUMMARY

- When a company becomes insolvent, it is likely to take some measures to come out of it. Its creditors may also take steps either to recover their money or to help restore the company to solvency.
- Some of the measures through which an insolvent company may be rescued as a going concern are Company Voluntary Arrangement and administration.
- Creditors may also resort to receivership (and in limited circumstances, administrative receivership) in order to recover their money.
- Where it is not possible to restore an insolvent company to solvency, the only options left may be to liquidate it.
- The person responsible for the winding-up of a company is known as the liquidator. The liquidator may be appointed by companies' members or creditors depending on the nature of the winding-up.
- Liquidation of companies may be compulsory or voluntary, the type depending on the persons making the petition and the ability or otherwise of the company to pay its debts.
- Although compulsory liquidation of companies is primarily because of inability to pay its debts as they become due, it may also happen for other reasons, such as where a company was formed for fraudulent or illegal purpose, where a company has failed to meet certain requirements of the Companies Act, and where it is just and equitable to do so.
- The liquidation of a company formally terminates its life as well as its membership.
- Upon liquidation, the liabilities of the company would be met from its assets and any monies due to it from contributories. Whatever could not be paid would not be recovered.

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28.9 PRACTICE QUESTIONS

1. Administration and Company Voluntary Arrangement are procedures which might be adopted by an insolvent company. Explain these procedures, their operation, and how they are likely to aid the recovery of a company as a going concern.
2. Distinguish between compulsory liquidation and voluntary liquidation of a company
3. Peter has been employed by Floxy Ltd as a sales executive for the past 20 years. During this time Peter has made investments in the company in the form of shares and debentures. He owns 10,000 ordinary shares of £1 each, which are paid up to the extent of 75%. The debentures, to the value of £10,000, are secured by a fixed charge against the land on which Floxy Ltd's factory is built. It has been announced that Floxy Ltd would be going into immediate insolvent liquidation, owing considerable amounts of money to trade creditors. As a result of the suddenness of the decision to liquidate the company, none of the employees received wages for their last month in the company. In Peter's case this amounts to £5,000.

   Advise Peter as to his rights and liabilities in relation to Floxy Ltd in regard to his investments and wages.

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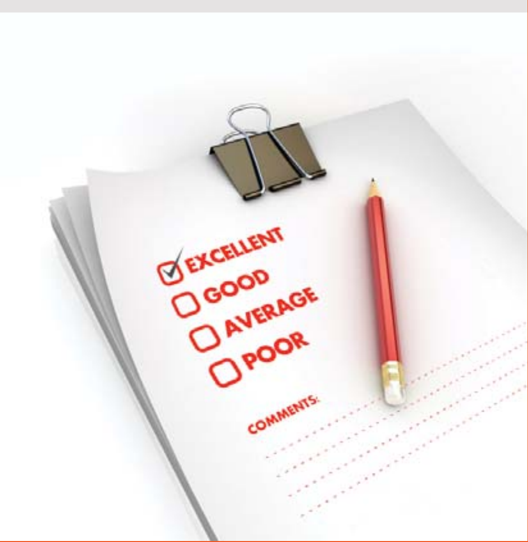

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PART 6: WRONGDOINGS IN BUSINESSES

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29 FRAUDULENT, WRONGFUL AND INSIDER TRADING

29.1 INTRODUCTION

When a company goes into insolvent liquidation, it may be necessary to consider whether its directors and other officers have by their actions, contributed to the company's financial woes. If they have, they may be punished and/or required to contribute to the assets of the company for the settlement of its creditors. There are different provisions for bringing errant company officials to account upon winding-up. The officials may also be prosecuted criminally for any fraud at any time, whether or not the company is being wound up. Furthermore, company officials or employees may wrongfully exploit information gained from inside the company to personally benefit from, or exploit, the company's shares or securities by way of insider trading or market abuse. This chapter considers these wrongful activities and the way the law deals with them.

29.2 LEARNING OBJECTIVES

At the end of the chapter, the reader should clearly understand:

- The types of fraudulent, wrongful or criminal activities that might take place in a company, especially by its officials, and why it is necessary to deal with them
- The differences between fraudulent trading and wrongful trading and the consequences of these on companies
- The liabilities of company officials for fraudulent and wrongful trading
- The meaning of insider trading and how the crime and civil wrong may be committed
- The criminal and civil liabilities that could be incurred for insider trading

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29.3 FRAUDULENT TRADING

Generally, fraud means dishonestly obtaining a material advantage by unfair or wrongful means. Fraudulent trading occurs where directors or other officers of a company engage in trading with intent to defraud creditors of their company, any other creditors, or for any fraudulent purpose. It implies that the directors or officers dishonestly engage in and obtain benefits from a transaction without intending to pay for them or with intent to cheat the other parties to it. What amounts to fraudulent trading is a question of fact depending on the circumstances of each case but it must involve dishonesty and moral blame. Some examples include:

- Obtaining goods on credit without intending to pay for them
- Receiving monetary deposits from customers without intending to supply them with goods
- Obtaining loans from lenders by false accounting or documentation
- Defrauding the Inland Revenue Service

There is no need for a line of fraudulent transactions; the offence may be committed even if only one creditor is defrauded as long as the intent is present.

> In *Morphites v. Bernasconi (2003)* EWCA Civ 289, it was held that the defrauding of a single creditor by a single transaction could properly be described as the carrying on of a business with intent to defraud creditors.

However, the fact that a company continued to do business while insolvent is not enough to establish fraud. The directors may be trading with the hope of turning the company's fortunes around. Failure to turn the company around does not without more amount to fraud.

As Buckley J observed in *Re White and Osmond (Parkstone)* Ltd (1960) (unreported, HC):

> There is nothing to say that directors who genuinely believe that the clouds will roll away and the sunshine of prosperity will shine upon them again and disperse the fog of their depression are not entitled to incur credit to help them get over the bad time (This is the so-called "sunshine test").

Similarly, paying some creditors ahead of others is not fraudulent. There are criminal and civil liabilities for fraudulent trading.

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29.3.1 CRIMINAL LIABILITY FOR FRAUDULENT TRADING

S. 993 CA 2006 provides as follows:

1) If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, every person who was knowingly a party to the carrying on of the business in that manner is liable to imprisonment or fine, or both.
2) This applies whether or not the company has been, or is in the course of being wound up.

An offence is committed under s. 993 if the business of a company was carried on with intent to defraud creditors of the company, creditors of any other person, or for any fraudulent purpose. Any fraud against any creditors in the course of the company's business is covered by this provision. Creditors of a company include suppliers of goods or services and lenders of money to it. It does not matter whether the debts are payable immediately or at a future time.

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Dishonesty and real moral blame in accordance with current notions of fair-trading among ordinary and honest people must be established in order for the offence to be committed. The person concerned must realise, by those standards, that he was being dishonest. Recklessness, unreasonableness or negligence is not sufficient to establish an offence. If the director or officer participated in the business without knowing that it was intended to defraud a creditor, he would not be liable. Knowledge implies that the person concerned was aware of the nature and intent of the business at the time of the transaction, or deliberately turns a blind eye to relevant information or facts which indicate fraud, or was recklessly indifferent or careless as to the facts.

Section 993 covers "every person who was knowingly a party to the carrying on of the business with intent to defraud". Therefore, it covers those who knowingly *took active part* in the business, including directors, officers having managerial control, third parties and financiers who facilitate the fraudulent business, and creditors who knowingly receive money made from fraudulent trading. Ordinary employees and a company secretary who does administrative work, even though he failed to give expected advice, are not covered by the provision – *Re Maidstone Building Provisions Ltd* (1971) 1 WLR 1085.

The offence under s. 993, which may be invoked whether or not a company is being wound up, may be tried either summarily (without a jury in the magistrate court) or by indictment (with a jury in the Crown court). The maximum punishment for the offence is 10 years imprisonment with or without fine. A person convicted of fraudulent trading may be disqualified from acting as a company director under the *CDDA 1986, s. 2(1*). A person may also be disqualified under the *CDDA, s. 4 (1) (a)* if it appears that he is guilty of fraudulent trading even though he has not been convicted.

29.3.2 CIVIL LIABILITY FOR FRAUDULENT TRADING

Provisions for civil liability for fraudulent trading is made under s. 213 *IA* 1986. The essence of the provision is that the courts may order a director or officer who took part in fraudulent trading to contribute money to a company's assets. It is not intended for punishment. S. 213 provides that:

1) If *in the course of winding up of a company* it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.
2) The court, *on the application of the liquidator* may declare that any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned *are to be liable to make such contributions (if any) to the company's assets as the court thinks proper.*

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The provisions are similar to that under s. *993 CA 2006* discussed above in that before somebody can be made liable, fraud and knowledge must be proved as in the criminal case. However, civil liability can only be invoked during the winding up of a company, and only by the liquidator. The persons found to be knowingly involved in the fraudulent trading can only be ordered to contribute money to the assets of the company to help in paying its creditors as may be determined by the court. Contributions by the directors or officers concerned is compensatory not punitive and should not exceed the amount of losses incurred due to the fraudulent trading.

29.4 WRONGFUL TRADING

Wrongful trading assigns liability to directors in the absence of fraud when a company goes into insolvent liquidation. Under s. 214 IA 1986, the court may, on the application of a company liquidator, order a director (including a shadow director) to contribute money to the assets of a company being wound up. S. 214 applies where:

- A company goes into insolvent liquidation, and
- A director of the company knew or ought to have concluded that there was no prospect of the company avoiding insolvent liquidation, and
- The director did not take every step that ought to have been taken to minimise losses to the company's creditors.

In determining whether a director knew or ought to have known that the company cannot avoid insolvent liquidation, and whether he took every step to minimise the losses of the creditors, the standard to be used is both objective and subjective. The test would be whether the director had acted as a *reasonably diligent person* having the general knowledge, skill, and experience of a person carrying out the functions of a director; and having the general knowledge, skill and experience of the particular director. So a director is expected under this provision to possess reasonable knowledge, skill and experience. If a director lacks these, he would still be judged by the standard of a reasonably competent director. However, if he possesses a high level of skill, experience and knowledge, he would be expected to apply them in his decision-making. This is the two-fold objective and objective test.

Unlike in fraudulent trading, there is no need to prove that the company or director concerned did business with intent to defraud creditors. *What is to be proved is that the director had not taken every step necessary to safeguard the interest of creditors.*

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> In *Re DKG Contractors Ltd* [1990] BCC 903, a company had a contract to do some work. One of its directors carried out the work himself with his own equipment and workers while the company paid him. In the last 10 months of its life, the company was insolvent but within this period, a further sum of £400,000 was paid to the director. In the course of creditors' voluntary liquidation, the liquidator applied to the court to recover this money. It was held that the director was liable for wrongful trading since creditors were entitled to have the company's assets kept intact.

Where a director is found liable for wrongful trading, the court will order him to contribute money to the assets of the company as it considers appropriate. The contribution is designed to compensate for the loss suffered by the company/creditors and not to punish the director. The director may also be disqualified from taking a directorship in another company.

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The dilemma for directors is determining when an insolvent company has no reasonable prospect of avoiding insolvent liquidation. Should they close shop once a company becomes insolvent, or should they carry on business in the hope of making the company solvent again? As noted by Chadwick J in *Secretary of State for Trade and Industry v Taylor* (1997) 1 WLR 407, at 414:

> The companies legislation does not impose on directors a statutory duty to ensure that their company does not trade while insolvent; nor does that legislation impose an obligation to ensure that the company does not trade at a loss… Directors may properly take the view that it is in the interest of the company and of its creditors that although insolvent, the company should continue to trade out of its difficulties. They may properly take the view that it is in the interest of the company and its creditors that some loss-making business should be accepted in anticipation of future profitability. They are not to be criticised if they give effect to such views properly held. *But the legislation imposes on directors the risk that trading while insolvent may lead to personal liability. Section 214 imposes that liability where the director knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid insolvent liquidation (emphasis added).*

It seems therefore that the prudent thing directors should do when they conclude that insolvent liquidation is likely is to consult an insolvency practitioner for advice, and then act on the advice, call in administrators, or apply for voluntary winding up. A director can defend himself against an allegation of wrongful trading by showing that he took every step necessary to minimise the losses to the company's creditors once he realised the company has no reasonable prospect of avoiding insolvent liquidation. What amounts to "every step" is a question of fact depending on the circumstances of each case.

29.5 INSIDER TRADING AND MARKET ABUSE

Insider trading refers to a situation where persons closely connected to a company use information available to them because of their position to profit from trading in the company's shares or securities. This practice is unfair on other investors who do not have the same information and damages public confidence in the stock market. People who can engage in insider dealer include directors, secretaries, auditors, solicitors, or ordinary employees of the company. Insider trading constitutes both a civil wrong and a criminal offence.

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Market abuse includes insider trading and other activities and statements that unfairly distort or manipulate the investment market. Under the *Financial Services and Markets Act (FSMA) 2000*, the following forms of abuse are recognised:

- Misuse of inside information (insider trading)
- Market distortion by the behaviour or conduct of somebody
- The giving of false or misleading impression about the supply and demand, and the values of investment;
- The giving of reckless, misleading, false, or deceptive statement or forecast;
- Engaging in a misleading course of conduct in order to influence another person's investment decision

29.5.1 CIVIL LIABILITY

The *Financial Services and Markets Act (FSMA) 2000* provides for civil liability for insider trading and market abuse. The penalties for insider trading under the FSMA 2000 are fines as may be determined by the Financial Services Authority, publication of the person's name, conduct of investigation (See s. 123–129). Under s. 123(2), a person may defend himself from liability by showing (a) that he believed on reasonable grounds that his behaviour did not contravene the provisions; or (b) that he took all reasonable precautions and exercised all due diligence to avoid behaving in a way which fell within the provisions.

29.5.2 CRIMINAL LIABILITY

The *Criminal Justice Act 1993 (Part V)* prescribes criminal liability for insider trading in the following circumstances:

- Where somebody with privileged information on company's securities uses the information to personally trade in the company's securities (referred to as insider dealing;
- Where an insider discloses privileged information to another person to enable them trade in company securities (referred to as "improper disclosure or tipping";
- Where anyone uses information that is not generally available (referred to as misuse of information – s. 52.

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The punishment for insider trading under the Act includes fines and terms of imprisonment ranging from 6 months to 7 years (s. 61). However, under s. 53, a person may defend himself by providing evidence showing that:

- He did not know or expect that the information would lead to profit;
- He believed the information had already been circulated to the public;
- He would have done what he did even if he did not have the information;
- He did not expect the person to whom he gave the information to deal in the company's securities or that he did not expect any profit to be made from the dealing.
- He is a Market Maker or employed in the business of Market Making (i.e. he is a professional stockbroker – Schedule 1(1)).

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29.6 CHAPTER SUMMARY

- Fraudulent trading occurs when directors or other officers of a company engage in any transaction with a view to defrauding creditors or any other person.
- Fraud is an essential element of fraudulent trading and must be proved before any person could be found guilty or liable. Liability for fraudulent trading may be criminal and civil.
- Criminal liability may arise at any time following police investigation, arrest and conviction. Liability here would be in the form of imprisonment, fine or both, as a well as possible disqualification.
- Civil liability for fraudulent trading arises only during liquidation at the instance of a company's liquidator for the purpose of getting financial contributions from the officers concerned.
- Wrongful trading occurs where directors of insolvent companies undertake transactions that lead to the incurring of more liabilities without doing all that might be necessary to safeguard the interest of its creditors. Fraud or dishonesty is not required for liability.
- Liability for wrongful trading is only civil – the directors concerned may be required by the court, at the instance of the liquidator, to contribute money to the company for the payment of its liabilities.
- Insider trading occurs when a person connected with a company uses inside information, which is not available to the public, to profit or enable others to profit from a company's shares or securities. Insider trading is both a crime and civil wrong.
- The crime of insider trading may be committed by dealing with inside information to make profit on a company's shares/securities, giving others inside information to enable them profit from the shares/securities; or misusing inside information which is not available to the public. Punishment for insider trading includes imprisonment and/or fine.
- Market Abuse involves activities designed to undermine or distort the stock market or unduly influence investment decisions. It involves the misuse of inside information; the distortion of the market; or the giving of reckless, false, deceptive or misleading information. It also involves the giving of false or misleading impression of supply or demand or the value of investments, or engaging in a misleading course of conduct in order to influence investment decisions.
- The civil liabilities for insider trading or market abuse may be fines, publication of name and/or investigation.

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29.7 PRACTICE QUESTIONS

1. Distinguish between fraudulent trading and wrongful trading.
2. Kingsbury FC Ltd is a premiership football club. The last annual account of the club shows that it has a debt of £60million and assets of £20million as at the current financial year. The club was at the bottom of the premier league table with a real prospect of relegation to the lower league. In an attempt to avoid relegation, the directors of Kingsbury FC, in the following transfer window, bought two international strikers for a total of £25 million under a contract to pay them £80,000 a week. The transfer was financed with a loan from Mersey Bank. Despite the investments in new players, the club was relegated and is now being wound up. Its liabilities now stand at £100 million with no change in the value of its assets.

   Discuss the propriety of the actions of the directors of the club.

3. Explain the meaning and different manifestations of Insider Trading.

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30 MONEY LAUNDERING, BRIBERY AND PHOENIX COMPANIES

30.1 INTRODUCTION

For obvious reasons, the law prohibits money laundering and bribery. Companies and businesses are required not only to refrain from these criminal activities but also to put in place measures and procedures for their prevention, detection and reporting. Companies and businesses could face criminal charges and convictions for taking part in these crimes or for failure to ensure that their employees did not take part in them. These rules are designed to discourage financial crimes in business and maintain the integrity of the business environment. Moreover, it is an offence for directors of liquidated insolvent companies to become directors in other companies rising from the ashes of the former for a period of five years without the permission of the court. This rule, which tackles the so-called "phoenix" company phenomenon, aims to prevent directors from dishonestly mismanaging a company and using the name, goodwill and assets of that company in a "new" company to the detriment of the creditors of the old.

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30.2 LEARNING OBJECTIVES

At the end of this chapter, the reader should:

- Appreciate the need to criminalise money laundering and bribery and how this has been accomplished
- Understand the nature of the offences of money laundering and bribery
- Understand how individuals, companies and organisations may commit the offences
- Understand how individuals, companies and organisations may avoid the commission of the offences
- Be aware of the illegal practice of setting up "phoenix" companies and the attempt of the law to tackle it

30.3 MONEY LAUNDERING

Money laundering is the process by which the proceeds of crime are converted into assets that appear to have a legal or legitimate source. The aim of disguising the source of the assets is to allow the holder to enjoy it free from suspicion. The *Proceeds of Crime Act 2002 and the Money Laundering Regulations 2007* prohibit money laundering. The *Proceeds of Crime Act* imposes obligations upon professionals, such as accountants, auditors and solicitors to report money laundering to the authorities; to have systems in place for the training of staff; and to keep records of transactions.

The *Money Laundering Regulations 2007* is a secondary regulation that implements the *Third Money Laundering Directive of the European Union (2005/60/EC)*. The Regulations cover most financial firms such as banks, building societies, money transmitters, bureaux de change, cheque cashers, and savings and investment firms. It also covers legal professionals, accountants, tax advisers, auditors, insolvency practitioners, estate agents, casinos, high value dealers when dealing in goods worth over 15,000 Euro and trust or company service providers. The Regulations require firms to put in place measures that will help prevent money laundering. Accordingly, they require firms:

- To ensure that they know their customers by conducting customer identification and verification and constant monitoring;
- To keep, where applicable, records of identity; and
- To train their staff on the requirements of the Regulations.

Various regulators and professional bodies have been given supervisory authority under the Regulations. These include the *Financial Services Authority* and the *Office of Fair Trading*. The Financial Services Authority supervises all financial firms covered by the Regulations while the Office of Fair Trading supervises all consumer credit firms and estate agents.

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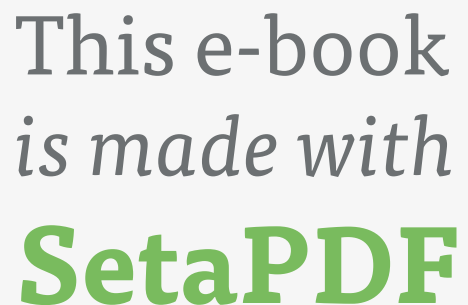
30.3.1 PHASES OF MONEY LAUNDERING

Money laundering usually comprises three distinct phases, namely:

- *Placement*, when the initial disposal of the proceeds of criminal activity into an apparently legitimate business activity or property.
- *Layering,* where money is transferred from business to business, or place to place, in order to conceal its initial source.
- *Integration*, which is the culmination of the previous procedures through which the money takes on the appearance of coming from a legitimate source.

30.3.2 MONEY LAUNDERING OFFENCES

The *Proceeds of Crime Act 2002* categories of criminal offence, namely laundering, failure to report, and tipping off.



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30.3.2.1 Laundering

The offence of laundering involves concealing, disguising, converting, transferring or removing criminal property from England, Wales, Scotland or Northern Ireland – s.327. Concealing or disguising criminal property includes concealing or disguising its nature, source, location, disposition, movement or ownership, or any rights connected with it. The Act defines "Criminal property" as property that the alleged offender knows (or suspects) constitutes or represents benefit from any criminal conduct. Criminal conduct' means any conduct that constitutes an offence in the UK, or which would constitute an offence if it occurred in the UK. The maximum penalty for laundering is 14 years' imprisonment – s. 327.

30.3.2.2 Failure to report

Under s.330 individuals carrying on a 'relevant business' may be guilty of an offence if they fail to disclose knowledge or suspicion of money laundering where they know or suspect, or have reasonable grounds for knowing or suspecting, that another person is engaged in laundering the proceeds of crime. This offence only relates to individuals who are acting in the course of business in the regulated sector. Any individual who is covered by s.330 is required to make disclosure to a nominated money laundering reporting officer within their organisation or directly to the Serious Organised Crime Agency (SOCA) as soon as is practicable. The maximum penalty for this offence is 5 years imprisonment and/or fine.

30.3.2.3 Tipping off

Under s. 333, it is an offence to make a disclosure likely to prejudice money laundering investigations. It therefore covers the situation where a professional informs a client that a report against him has been submitted to SOCA. Tipping off is punishable by a maximum sentence of 5 years imprisonment with or without fine.

30.4 BRIBERY

Bribery is governed by the *Bribery Act 2010* that came into force on 1 July 2010. The Act creates offences relating to bribing another or receiving bribe from another.

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30.4.1 OFFENCES OF BRIBING ANOTHER

An individual or organisation may commit bribing.

A person commits an offence:

a) If he offers, promises or gives a financial or other advantage to another person *with the intention of inducing that person to perform a relevant function or activity improperly, or in order to reward another person for the improper performance of such a function or activity*. The person to whom the advantage is offered, promised or given may or may not be the person who will perform the activity concerned. It also does not matter whether the advantage was given, offered or promised directly or through a third party – s. 1.
b) If he offers, promises or gives a financial or other advantage to another person when he knows or believes that the acceptance of the advantage would itself constitute the improper performance of a relevant function or activity. It does not matter in all the above cases whether the advantage was given, offered or promised directly or through a third party – s. 1.
c) If he, directly or indirectly, bribes a foreign government official with the intention of gaining a business advantage – s. 6.

A commercial organisation (companies and partnerships) would commit an offence if a person associated with it bribes another person with the intention of obtaining or retaining a business advantage for the organisation unless the organisation has proper systems in place to prevent bribery – s. 7. A person is associated with a commercial organisation if he performs services for or on behalf of the organisation in whatever capacity (for example as employee, agent or subsidiary).

30.4.2 OFFENCES OF BEING BRIBED

Under s.1, person is guilty of receiving bribe if:

a) He requests, agrees to receive or accepts a financial or other advantage with the intention that a relevant activity would be performed improperly either by himself or another person.
b) He requests, agrees to receive or accepts a financial or other advantage and the request, agreement or acceptance itself constitutes the improper performance by him of a relevant function or activity (whether he knows or believes that the performance of the function or activity is improper or not).

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c) He requests, agrees to receive or accepts a financial or other advantage as a reward for the improper performance (whether by himself or another person) of a relevant function or activity (whether he knows or believes that the performance of the function or activity is improper or not).
d) In anticipation of or in consequence of requesting, agreeing to receive or accepting (directly or indirectly) a financial or other advantage, a relevant function or activity is performed improperly by the person, or by another person at his request, assent or acquiescence (whether or not they know or believe that the performance of the function or activity is improper).

Under s. 11, the penalty for individuals convicted of bribery range from fines to a maximum of 10 years imprisonment. For companies, the penalty of fine up to an unlimited amount.

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30.4.3 THE RELEVANT ACTIVITY

Activities covered by the act are those:

a) Concerning public office, business (including any trade or profession) or anybody of persons (whether corporate or not), or a person's employment; and
b) In which the person performing the function/activity occupies a position of trust, and is expected to perform it in good faith and impartially.

It does not matter whether the activity or function is connected with, or performed in, the UK. This section has no associated Explanatory Notes.

30.4.4 DEFENCES

An individual may avoid conviction:

- If his conduct is necessary for the proper function of the intelligence service – s.13.
- If his conduct is necessary for the proper function of the armed forces in active service – s. 13.

For a commercial organisation, it is a defence that it has in place "adequate procedures" to prevent bribery. This may include implementing anti-bribery procedures. It is important that firms consider what adequate procedures are most appropriate for their firm given the risks they face and the way they run their business. These procedures should be proportionate to the risk posed – s. 7(2).

30.5 RESTRICTION ON THE RE-USE OF INSOLVENT COMPANIES' NAMES

S. *216 and s. 217 Insolvency Act 1986* deals with the phenomenon of "Phoenix" Companies. This is the improper re-use of the name or assets of an insolvent and liquidated company by its directors to do business as a "new" company. This practice may provide an incentive for directors to run down a company in order to divert its name, goodwill and properties to a new venture. This may be to the detriment of the liquidated company's creditors. The sections apply where a person was a director or shadow director of a company at any time in the period of 12 months ending with the day before the company went into liquidation. They prevent the person from being a director of a company with a similar name, or a name that suggests an association with the previous company, without the leave of court. The provisions apply for the five years following liquidation. It is a criminal offence punishable by imprisonment and/or fine to contravene these provisions. In addition, any directors concerned would be personally liable for any debts the new company incurred when he was involved in its management.

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30.6 CHAPTER SUMMARY

- Companies, individuals and businesses are required to refrain from money laundering.
- Money laundering involves activities designed to "clean" or disguise dirty money or its origins and pass it off as legitimate earnings.
- The phases of money laundering are placement, integration or layering.
- Companies and businesses are required to train their staff and put procedures in place for the purpose of preventing, detecting and reporting money laundering activities to the relevant authorities. They could be guilty of an offence if they fail to do so.
- The offence of money laundering may be committed by laundering, failure to report or tipping off.
- Public office holders, companies, businesses and individuals in positions of trust and confidence and who are required to be fair and impartial in their work are forbidden from giving or receiving bribes in order to influence or undermine the performance of any activity or in order to gain or grant business advantage.
- It is a defence to a charge of bribery that the money or financial advantage was giving for the purposes of the work of the intelligence services or armed forces. It is also a defence that a company or business has put in place adequate procedures for the prevention of bribery.
- Finally, directors of liquidated insolvent companies are forbidden from being directors in new companies using the names of, or names suggesting association with, those companies for a period of five years unless they obtain the permission of the court.

30.7 PRACTICE QUESTIONS

1. State and explain the phases of money laundering.
2. Explain the responsibility of banks and other financial institutions in relation to money laundering.
3. Chris Motors Ltd deals in new luxury cars. One day, a man who identified himself as Malachi came into the showroom and offered to buy five Rolls Royce cars at £350,000 each for cash. He wanted the cars to be shipped immediately overseas. He looked anxious and was in a hurry to conclude the transaction. The manager of Chris Motors Ltd is uneasy about the transaction. However, business had been very slow lately and he was keen to sell the cars.

   Advise the company on what it should do in these circumstances giving the law on money laundering and the provisions of the *Proceeds of Crime Act 2002*.

4. State and explain the two different ways in which the crime of bribery may broadly be committed and any defences that may be relied on by accused persons.

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PART 7: AGENCY LAW

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31 AGENCY LAW

31.1 INTRODUCTION

An agent is someone who legally acts on behalf of another called the principal. The acts of an agent done in the course of employment are deemed to be those of the principal who would be bound by them. If authorised to do so, an agent may do anything which the principal is entitled to do. Agency is very important because it removes the need for all business or contractual transactions to be undertaken by individuals, companies or businesses personally. They could do so through other people even in different places where they could not, otherwise be physically present. Agency also enables persons and businesses to use professional experts to enter into contractual relationships. Thus, agency enables the rule of privity of contract – that only persons who are parties to a contract would normally have a right to enforce it – to be by-passed. A person may sue or be sued under a contract even though they were not direct parties to it.

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31.2 LEARNING OBJECTIVES

At the end of this chapter, the reader should fully understand:

- The meaning of agency and the importance of the law of agency
- The types of agency and how agency relationships may be created
- The nature of the authorities agents may have
- The duties and rights of agents
- The circumstances under which agents may incur personal liability for their acts or wrongdoings
- How an agency relationships may come to an end the effects thereof

31.3 TYPES OF AGENTS

An agent may be appointed to handle all the affairs of his principal (universal agent), represent the principal in all businesses of a given type (general agent), act for the principal in a particular transaction (special agent), or provide services on behalf of the principal (professional agent). Examples of agents include company directors, partners in a partnership firm, travel agents, estate agents, employment or recruiting agents, and shopkeepers or assistants, and solicitors (and other persons) who act as attorney for others. Agents also include banks that handle and process payments and other monetary transaction for customers, agents who negotiate and agree deals for professional footballers, auctioneers and other mercantile agents who handle and sell goods for others.

Many agents could be classified as commercial agents. Under the *EU Commercial Agents (Council Directive) Regulations 1993/3053* (as amended by *Council Directive 1993/3173*), commercial agents are self-employed intermediaries with a continuing authority to negotiate and conclude the sale or purchase of goods on behalf of another person. The following are however, not to be regarded as commercial agents:

- A person who negotiates and/or concludes a contract for the provision or purchase of services
- A person who did not negotiate sales, but merely sells goods on behalf of another person
- Distributors of goods in their own right
- Sellers of goods from mail order catalogues to friends and family members

31.4 ESTABLISHMENT OF AGENCY RELATIONSHIP

A principal – agent relationship may arise by express appointment, implied appointment, estoppel, necessity or ratification.

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30.4.1 EXPRESS APPOINTMENT

In this situation, the agent is appointed expressly orally, in writing or by a combination of both. Generally, there is no special form for the express appointment of agents, however agents for some transactions must be appointed in a particular form. For example, agents for the sale or purchase of land must be appointed in writing – *ss. 53 & 54 Law of Property Act 1925.* Agents required to execute a deed must be appointed by deed; and agents given a power of attorney must be appointed according to the provisions of the *Power of Attorney Act 1971.*

31.4.2 IMPLIED APPOINTMENT

In this case, the agent is not expressly or formally appointed but the conduct of the principal indicates the existence of an agency relationship.

> In *Hely-Hutchinson v. Bray Ltd* [1968] 1 QB 573, a company chairman acted as its managing director, though not appointed as such, and signed a guarantee on behalf of the company. It was held that the board of directors had given the chairman an implied authority to act as agent of the company.

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In *Panorama Developments Ltd v Fidelis Fabrics Ltd* [1971] 2 QB 711, a company secretary hired a luxury car in the name of his company even though it was for his personal use. The company refused to pay for the hire. It was held that since the secretary had the authority to hire the car in the company's name, he was impliedly an agent of the company.

31.4.3 AGENCY BY ESTOPPEL

An agency by estoppel is deemed to have been created when somebody holds out or represents another person as acting on his behalf and a third party relies on that fact and alters his or her position. In that situation, the person holding out would be prevented (estopped) from denying that the one he held out was his agent.

In *Spiro v Lintern* [1973] 1 WLR 1002, the defendant allowed his wife to induce the claimant to buy his house even though he did not give her express authority to do so. After the claimant had spent his own money repairing the house, the defendant refused to sell it to him. It was held that the defendant should sell the house to the claimant and that he was estopped from denying that his wife was his agent.

Agency by estoppel also arises where an employer, by word or conduct, represents an employee as having authority do something or act in a particular manner even though the employee does not actually have such authority and a third party relies on that representation. The employee in this situation would be deemed to have apparent or ostensible authority to do the said act.

In *Freeman and Lockyer v Buckelhurst Park Property Ltd* [1964] 2 KB 480, a director in the defendant company contracted with the claimant, an architectural firm, to draw up a building plan for it. The defendant was however denied planning permission for the building; it therefore refused to pay the claimants for the building plan. The defendant argued that the director who signed the contract was not authorised by the company to do so. It was held that the defendant was liable to pay the claimant. Since the defendant had permitted the director to act as if he were its managing director, and the claimants have relied on that representation, the company could not deny his authority to sign the contract.

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31.4.4 AGENCY BY NECESSITY

An agency by necessity occurs where somebody acts on behalf and for the benefit of another in an emergency situation even though there was no express or implied authority to do so. This may occur as an extension of an existing agency or a creation of a new agency relationship where none previously existed. Agency by necessity would occur if:

- There was an emergency or pressing need for action, and
- There was no practical way of communicating with the principal, and
- The agent's action was for the benefit of the principal, and
- The agent acted in good faith.

> In *Great Northern Railway Co v Swaffield* [*1873–74*] *LR 9 Ex 132,* the defendant transported his horse on the claimant's railway carriage but nobody collected it when it arrived at the designated station. The claimant had to put the horse in a stable overnight. On two occasions when the defendant came to collect the horse, he refused to pay the stable owners the cost of keeping it and left without it. Subsequently, he demanded that the horse be sent to his address with re-imbursement for his expenses and loss of time. The horse was in the stable for 4 months before the claimant eventually paid the stable charges, dispatched the horse to the defendant, and sued him for the expenses. It was held that the claimant was entitled to recover the expenses. According to Kelly CB, "it was necessary for the railway company to incur the expenditure. 'They had no choice unless they would leave the horse at the station or in the high road to his own danger and the danger of other people." (At p. 136)

If there was no emergency, or if the principal could have been contacted, agency by necessity would not arise as *Springer v Great Western Railway* [*1921*] *KB 257* demonstrates.

> The defendant received a shipment of tomatoes, some of which belonged to the claimant. The vessel had arrived some days late and dispatch to the claimant was additionally delayed by the strike action of the defendant's workers. Because of these factors, some of the tomatoes were in bad condition. The defendant decided to sell the whole shipment of tomatoes locally without consulting the claimant, even though he could have been contacted and his consignment was still relatively sound. The claimant sued the defendant for breach of contract of shipment. It was held that the defendant was liable. He had no right to sell the claimant's consignment without contacting him for instructions.

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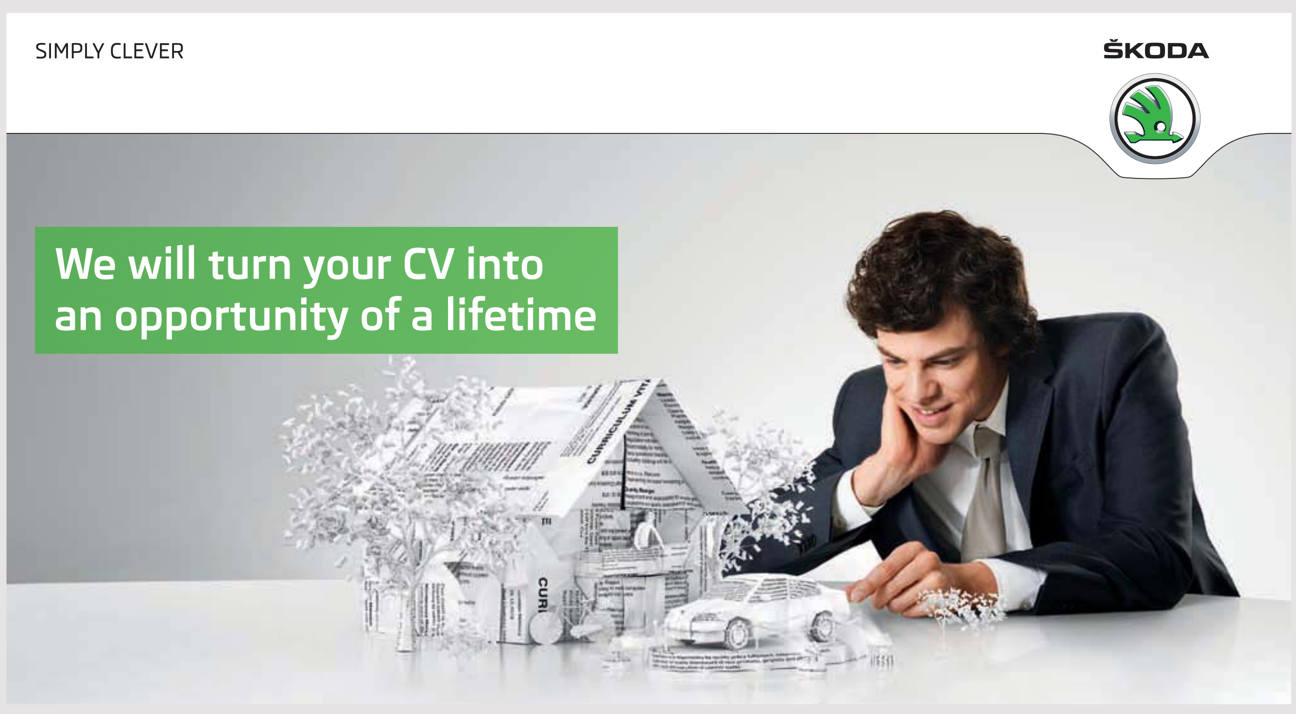
A similar decision was reached in *Sachs v Miklos [1948] 2 KB 23*

> In 1940, the claimant stored some furniture in the 1st defendant's house free of charge. Subsequently, the 1st defendant lost contact with the claimant. Between 1943 and 1945, the 1st defendant, being in need of his space and not wishing to store the furniture any longer, wrote to the claimant twice using an address he got from latter's bank. He also attempted to reach the claimant on the phone to no avail. The 1st defendant then handed the furniture to the 2nd defendant auctioneer, who sold it for £151. In 1946, the claimant returned and asked for the furniture and was given the money. By this time however, the price of furniture had risen significantly. The claimant sued the defendants for conversion. It was held by the Court of Appeal that the defendants were liable and that they were not agents by necessity since there was no emergency warranting the sale without consultation.



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31.4.5 AGENCY BY RATIFICATION

A person may ratify the act of another who had acted on his behalf even though at the time of acting there was no agency relationship or, if there was, it did not extend to the act performed.

> In *Bolton Partners v Lambert* [1889] 41 ChD 295, S was the agent of the claimants. The defendant made an offer to S to buy the claimant's property and S accepted it on behalf of the claimants even though he was not authorised to make a contract for the sale of the property. Later, however, the defendant withdrew his offer, but subsequent to the withdrawal, the claimants ratified the acceptance of the offer by S. The claimant sued the defendant for specific performance of the contract. The claimants were held entitled to specific performance. Their ratification related back to the acceptance by S, so the withdrawal by the defendant was ineffectual.

There cannot be any ratification, however, if the principal had no capacity to do the transaction concerned; if the transaction was illegal or void; or if the ratification was made after a reasonable time had passed.

> In *Keiner v Baxter* [1866] LR 2 CP 174, a company promoter entered into a contract on behalf of the company he was forming. After the incorporation, the company failed to pay the contract price. It was held that the pre-incorporation contract was not capable of being ratified since the company was not in existence at the time of the contract. The promoter could not be the agent of non-existent principal.

> *Owners of the Ship "Borvigilant" v Owners of the Ship "Romina G"* [2003] EWCA Civ 935 – An oil tanker belonging to the defendant collided with a tug belonging to the claimant, thereby sinking it and killing some of the crew. At the time of the collision, the tug was chattered by the National Iranian Oil Company (NIOC) which had entered a tug requisition contract with the defendant. The contract provided in part that the owners of the tug would have the benefits of, and would be bound by, the conditions of the contract to the same extent as NIOC. The claimant claimed that NIOC was its agent, purported to ratify the agreement with the defendant, and sought to rely on that agreement. It was held by the Court of Appeal that NIOC had implied actual authority to enter the tug requisition contract on behalf of the claimant, and that the claimant could ratify the agreement since the defendant was aware that NIOC was acting as the claimant's agent.

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31.5 AGENTS' AUTHORITY

The authority of agents to bind their principal may be actual or ostensible. Where an agency arises be express appointment or ratification, the agent would have actual authority (express or implied) to act on behalf of the principal. *Express actual* authority arises from specific provisions of the agency agreement. *Implied actual* authority arises from customs and practices common in the agent's trade or profession unless third parties have been made aware that the agent does not have the authority. If third parties have not been made so aware, the principal would be bound even if he had forbidden the agent from exercising such authority.

Apparent or ostensible authority arises where an agent has not been expressly appointed and has not been given express authority to act (such as in implied agency and agency by estoppel). If the principal, by word or conduct, represents a person to third parties as his agent and those third parties rely on that representation and deal with the person as an agent, the principal would be bound by the acts which the agent had done on his behalf. This rule does not apply if the third party knows that a person was not an agent or has no authority to act for the principal (see *Lockyer v Buckelhurst Park Property Ltd* above).

> In *Armagas Ltd v Mundogas SA (The Ocean Frost)* [1986] 2 WLR 1063; [1986] AC 717 (HL), Lord Keith explained the principle of apparent or ostensible authority as follows:
>
> > Ostensible authority is general in character, arising when the principal has placed the agent in a position which in the outside world is generally regarded as carrying authority to enter into transactions of the kind in question. The acts of the purported agent are not themselves evidence and are irrelevant to establish such agency as against the principal.
>
> In *Doncaster Metropolitan Borough Council v Racing UK Ltd* [*2005*] *All ER 278 (CA)*, Racing UK Ltd signed a broadcasting contract with S who was acting on behalf of the Doncaster MBC. S was the owner of Doncaster Racecourse Ltd, the company managing the Doncaster Racecourse, which was owned by Doncaster MBC. When the council refused to honour the broadcasting contract, Racing UK Ltd sued to enforce it on the ground that S was the council's agent. It was held that the council was bound by the contract with S who had ostensible or apparent authority. It had held S out as its agent and persons who dealt with him believed they were dealing with the council.

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Moreover, an agent is deemed to have the authority to exercise the type of authority normally or usually exercised by people in his position even if the principal had restricted his authority, unless the restriction had been communicated to third parties dealing with the agent. This is sometimes referred to as "usual authority".

> In *Edmunds v Bushel* & Jones [1865] LR 1 QB 97, a person appointed to manage a business was forbidden from accepting bills of exchange in the name of the firm even though accepting such bills was normally part of a manager's role. The manager accepted a bill of exchange in the name of the firm. It was held that the principal was liable since the agent was acting within his usual authority.

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Watteau v Fenwick [1893] 1 QB 346 – The defendant brewers owned a public house (beerhouse) which was under the control of a manager and the holder of the operating license. The name of the manager also appeared on the door of the premises. The defendants forbade the manager from purchasing and selling in the premises certain goods which were to be supplied to him only by the defendant. In spite of this agreement, the manager ordered the forbidden articles from the claimants on credit but failed to pay for them. Upon discovering that the defendants were the owners of the business, the claimant sued them for their price. It was held that the claimant was entitled to recover the money from the defendant. As principals, they were liable for all the acts of the manager that were within the kind of authority normally conferred on agents of that type even though he was never held out as agent by the defendants, and even though he had exceeded his actual authority.

31.6 DUTIES OF AGENTS

Agents are in fiduciary relationship with their principals and are bound by a number of duties. These include the duty to personally perform their responsibilities; to obey the principal; to act with care and skill; to provide adequate information; and to maintain confidentiality. Agents also have a duty to avoid or declare conflict of interest; not to make secret profits; and to render account to the principal.

31.6.1 DUTY OF PERSONAL PERFORMANCE

A paid agent has a duty to personally and fully perform the agency agreement or contract unless the act required is illegal or void. An agent cannot delegate his duties to another person without the express or implied consent of the principal. He may however delegate where there is an emergency, where the work is non-skilled, or where delegation is a usual practice in the profession or industry concerned.

John McCann & Co v Pow [1975] 1 All ER 129 – The defendant owner of a flat appointed the claimants as agents for the sale of the flat while reserving the right to sell it if he found a buyer. Without informing the defendant, the claimants briefed another estate agent who advertised the property. A buyer, who unknown to the owner, was introduced to the property by the sub-agents, purchased the property from the owner. The claimants sued for commission on the sale. It was held that the claimants were not entitled to any commission, because as "sole agents", they were not entitled, without the express permission of the principal, to appoint a sub-agent.

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31.6.2 DUTY OF OBEDIENCE

An agent does no act for himself but for his principal and must therefore follow the principal's instructions. Provided the agent has followed instructions, he is not liable for any losses suffered by the principal in the course of the agency. If however an agent fails to obey instructions, he may be personally liable for losses sustained by his principal.

> In *Bertram, Armstrong & Co v Godfrey* [1830] I Knapp 381, at 383, it was held that:
>
> > When an agent acts under a general authority, he is bound to act for his principal as he would act for himself; when he acts under a particular authority, and for a special purpose, he has no discretion. If he thinks fit to accept such a commission, he must perform that commission according to his duty (John Leach MR).

In *Turpin v Bilton* [1843] 5 Man & G 455; 134 E.R. 641, an agent was instructed by his principal to insure the principal's ship. The agent failed to do so and the ship was subsequently lost. It was held that the agent was liable to pay damages to the principal.

31.6.3 DUTY OF CARE AND SKILL

In the performance of his responsibilities under the agency agreement, an agent is required to exercise reasonable care and skill. The standard of care is that expected of a reasonable agent in his position. An agent could be liable in negligence if he fails to live up to that expectation. If a person is not a paid agent, he is not bound to perform any duties, but if he chooses to do so, must perform without negligence. However, where a person was acting on another's behalf purely in a family or social situation, no duty of care may arise.

> In *Chaudhry v Prabhakar [1988] 3 All ER 718*, the claimant who recently passed her driving test and knew nothing about cars procured the defendant, a friend who had some knowledge of cars, to help her find a suitable used car. The defendant found and recommended to the claimant a car which the latter bought. It turned out that the car had been involved in a serious accident, was badly repaired, and un-roadworthy. With the crumpled and straightened bonnet indicating that the car might have been involved in an accident, the defendant conceded that he had been negligent. It was held that:
>
> > An agent, even a volunteer, owed a duty of care appropriate for those circumstances. The measurement was objective, not subjective. The defendant knew he was to be relied upon and the circumstances (a crumpled bonnet) suggested that further enquiry was required. The relationship may be material. If they are friends, the court may find that the arrangement was purely social, and according to the circumstances, did not give rise to a duty of care.

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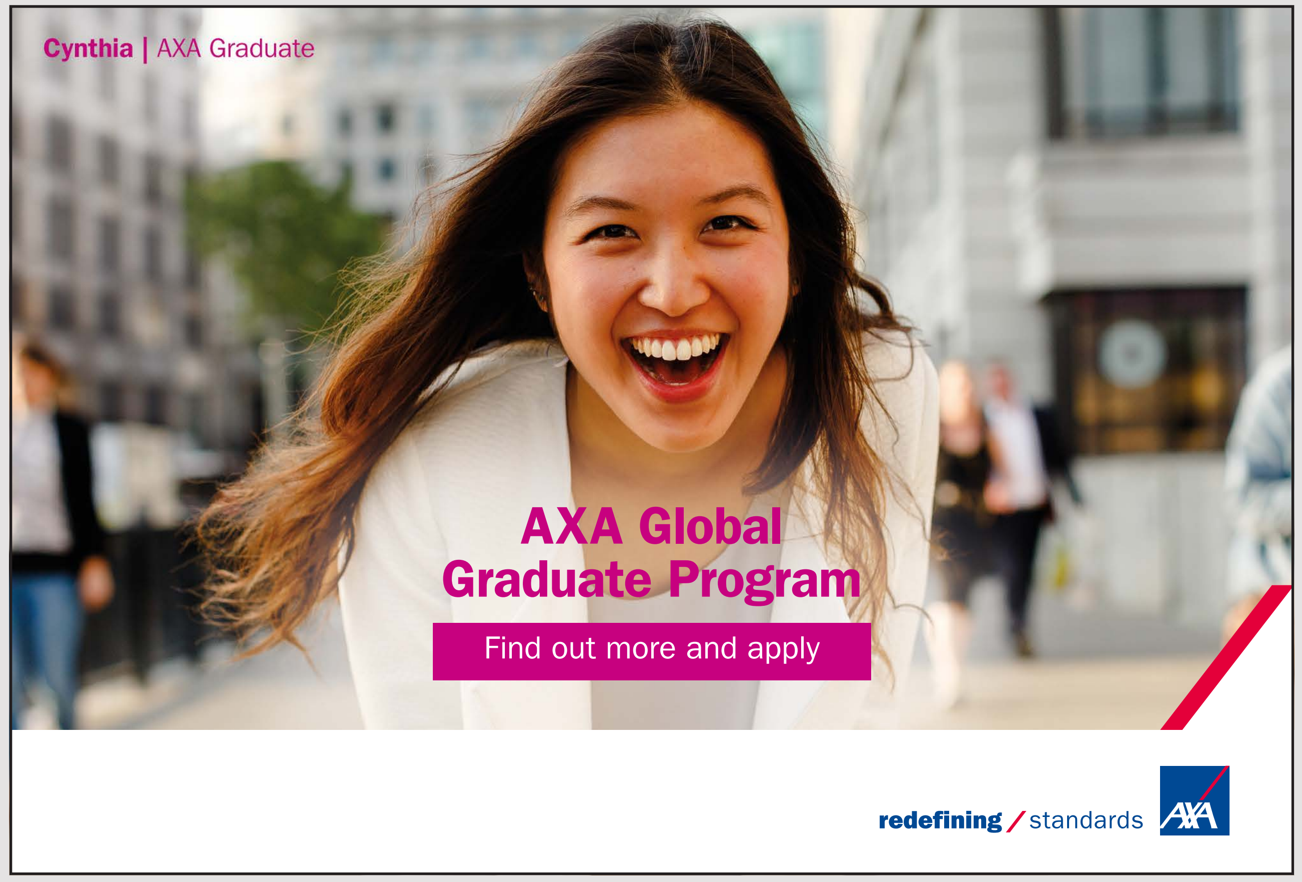
31.6.4 DUTY TO PROVIDE INFORMATION

An agent is under a duty to furnish the principal with information regarding any contracts or transactions he enters into on his behalf, or which is relevant to the agency agreement. An agent must also provide the principal with accurate records of his transactions.

> In *Keppel v Wheeler* [1927] 1 KB 577, estate agents were employed to sell the claimant's property. The agents obtained an offer for the property which the claimant accepted "subject to contract". However, before the property was sold, another person offered to buy the property at a higher price from the prospective purchaser. The agent did not disclose this new offer to the claimant, believing that his duty had been fully discharged. It was held that the agent was in breach of duty to the claimant and liable to pay as damages the difference between the sale price and the new offer. The agent's duty continued until the sale of the property was finally concluded.



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31.6.5 DUTY NOT TO MAKE SECRET PROFITS

Being in a fiduciary relationship, an agent must act bona fide and in the interest of the principal and must not make secret profits. An agent may not, for example accept commission from both parties to a transaction without the consent of his principal. He may not also accept bribe from a third party in the performance of his work. Where an agent has made secret profits or has taken a bribe, the principal is entitled to dismiss him, recover the profits made, cancel the transaction involved, refuse to pay the agent's commission, or sue the agent for an account of the profits.

In *Boston Deep Sea Fishing and Ice Co Ltd v Ansell* [1888] 39 Ch.D. 339, Bowen LJ emphasised the position of agents as follows:

> There can be no question that an agent employed by a principal or master to do business with another, who, unknown to that principal or master, takes from that other person a profit arising out of the business which he is employed to transact, is doing a wrongful act inconsistent with his duty towards his master, and the continuance of confidence between them. He does the wrongful act whether such profit be given to him in return for services which he actually performs for the third party, or whether it be given to him for his supposed influence, or whether it be given to him on any other ground at all; if it is a profit which arises out of the transaction, it belongs to his master, and the agent or servant has no right to take it, or keep it, or bargain for it, or to receive it without bargain, unless his master knows it.

The courts have consistently applied this rule in a long line of cases as illustrated below:

> *Hippisley v Knee Bros* [1905] 1 KB 1 – Agents printed advertisements for which they were given a discount by the printers. They however, charged the principal the full amount for the printing and kept the difference. It was held that the agents were in breach of duty and should surrender the discount to the principal.
>
> *Rhodes v Macalister* (1923) 29 Com. Cas. 19 – An agent had been employed to find a seller for certain mineral rights on the agreement that if he found a seller for a price below £9000, he would keep the difference as commission. The agent found a seller for £6625 and claimed the £2375 difference. Unknown to the principal however, the agent had negotiated with the seller to be paid another commission on the transaction. It was held that the agent was in breach of duty:

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> There seems to be an idea prevalent that a person who is acting as agent or servant of another is committing no wrong to his employer in taking a commission or bribe from the other side, provided that in his opinion his employer or principal does not have to pay more than if the bribe were not given. There cannot be a greater misconception of what the law is, or what the duty of a servant or agent towards his master or principal in reference to such matters is, and I do not think the rule can too often be repeated or its application more frequently insisted upon. (Banks LJ at p. 20)

Boardman v Phipps [1967] 2 AC 46 – The defendant was a solicitor for the claimant trust, which owns substantial shares in a company. When the trust was unwilling to buy more shares in the company, the defendant/solicitor bought many for himself and subsequently made a huge profit from them. It was held that the defendant/solicitor was in breach of duty and liable to account for them to the claimant. He had made the investment based on information he acquired as an agent.

Imageview Management Ltd v Jack [2009] EWCA Civ 63 – The defendant, a professional footballer, appointed the claimant as an agent to act on his behalf in respect of finding a new football club. Under the agreement, the defendant would pay the claimant 10% of his earnings every month as commission. The claimant negotiated a two-year contract for the defendant with Dundee United FC. However, unknown to the defendant, the claimant had also claimed money from Dundee United as fee for getting a work permit for him. When the defendant found out about this, he ceased to pay the monthly commission. The claimant sued for the commission while the defendant counterclaimed for the money the agent received for the work permit and a refund of all the commission he had paid to him. It was held that the agent was in breach of duty. Judgment was given to the defendant in respect of the commission and work permit money.

31.6.6 DUTY TO AVOID OR DISCLOSE CONFLICT OF INTEREST

Because of his fiduciary position, an agent should avoid situations where his personal interests conflict with those of his principal; and if such a situation arises, to disclose the conflict. According to Lord Cairns in *Parker v. McKenna* (1874) L. R. 10 Ch. 96, at 118, "No man can in this Court, acting as an agent, be allowed to put himself into a position in which his interest and his duty will be in conflict." An agent should not sell his property to the principal, or buy the principal's property without disclosing his interest to the principal. The principal is entitled to cancel any contract made in conflict of interest; to recover any profits made by the agent; or to withhold the agent's pay. This rule is absolute; it does not matter that the agent might have no intention to defraud.

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Armstrong v Jackson [1917] 2 KB 822 – A stockbroker was instructed by the claimant to buy shares for him in a certain company. The stockbroker, who unknown to the claimant was a promoter and shareholder of the said company, sold his own shares to the claimant without disclosing to him his connections with the company or the fact that he owned the shares. It was held that the stockbroker was in breach of his duty as agent to avoid or disclose conflict of interest and that the claimant was entitled to avoid the transaction.

An agent, except an estate agent, is not entitled to work for two conflicting principals at the same time without full disclosure to both.

Kelly v Cooper [1993] AC 205 (HL) – An estate agent instructed by the claimant to sell his property was also acting as an agent for the owner of an adjacent property. The agent did not disclose this fact to the claimant. The agent sold both properties to the same purchaser. The claimant sued the agent for breach of duty to avoid conflict of interest and to disclose any conflict of interest. It was held that there was no breach in this type of situation and that the agent was entitled to keep the confidentiality of his principals.

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The judgment in *Kelly v cooper* was followed in *Rossetti Marketing Ltd Diamond Sofa Co Ltd* [2012] EWCA Civ 1021.

> In this case, it was held that, "as a general proposition, an agent could act for two principals with conflicting interests only where either both principals agreed, or where the agent fell within the "residential estate agents" category as described in *Kelly v Cooper* [1993] AC 205."

31.6.7 DUTY TO ACCOUNT

An agent is under a duty to render due account to the principal of all transactions relevant to the agency relationship. To this end, the agent is expected to keep adequate records of the transactions; to separate his properties from those of the principal; and to allow the principal access to necessary records, including documents and computers.

31.6.8 DUTY OF CONFIDENTIALITY

An agent is required to maintain the confidentiality of his principal in respect of matters learned in the course of the agency. This duty continues even after the agency has ended, although it may not apply to matters involving illegality. In *Bolkiah v KPMG* [1999] 2 WLR 215, the House of Lords held that:

> A solicitor has an absolute duty to his clients, and to former clients, to protect their confidence and could not later act for an opponent. An accountant providing litigation support is bound by the same duties, an information barrier, a so-called Chinese Wall, erected within the firm is liable to be insufficient. The duty extends beyond that of refraining from deliberate disclosure, and includes the duty not to put the client at risk: a fiduciary cannot act at the same time both for and against the same client, and his firm is in no better position.

31.7 REMEDIES FOR AGENTS' BREACH OF DUTY

Where an agent has been found to be in breach of duty, the principal would be entitled to:

- Terminate the agency without notice,
- Sue for damages for breach of duty,
- Sue for account and recovery of commission and any secret profits made, and
- Regard the agent as constructive trustee in respect of secret profits made

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In *FHR European Ventures Ltd v Cedar Capital Partners LCC* [2015] 1 AC 250, the claimants had sued the defendants for a secret commission they had taken while acting as their agents. At the High Court and Court of Appeal, the claimants succeeded in their action and obtained an order against the defendants. However, they had been refused a proprietary remedy for the sum received. It was held by the Supreme Court that an agent who received a secret commission or bribe in breach of his fiduciary duties held it in trust for his principal who was entitled to a proprietary remedy in respect of it.

31.8 RIGHTS OF AGENTS

An agent has a number of rights enforceable against the principal. These include the right to the agreed remuneration or commission, the right to indemnity, and the right to a lien over the principal's property.

31.8.1 RIGHT TO REMUNERATION OR COMMISSION

The principal must pay the agent his remuneration or commission for the work done. Where no specific remuneration is stated, the agent is entitled to the payment of a reasonable sum. However, an agent is entitled to be paid a commission only if he has performed his functions as agreed in the agency agreement or if he was responsible for a contract being signed with a third party, unless the parties had agreed otherwise. A principal can deal personally with his property even it meant depriving the agent of the opportunity to earn a commission.

In *Luxor Eastbourne Ltd v Cooper* [1941] AC 108, a company instructed an estate agent to find a buyer for its property. The agent was to be paid commission if he introduced a person who bought the property. The agent found a prospective purchaser but the company did not complete the sale of the property to him due to objections by some of its directors. Subsequently, the company sold the property to a buyer who was not introduced by the agent. The agent claimed commission on the sale on the ground that there was in implied term in the agency agreement that the principal would not do anything "to prevent the satisfactory completion of the transaction so as to deprive the respondent of the agreed commission."

It was held that the agent was not entitled to the commission, and that a property owner was under no implied obligation not to deal with his property in a manner that might deprive his agent of the opportunity to earn a commission.

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31.8.2 RIGHT TO INDEMNITY

The principal is under a duty to indemnify the agent for reasonable expenses incurred in the execution of the agency. No indemnity is due, however, for expenses incurred outside instructions or in breach of duty.

31.8.3 RIGHT TO LIEN

An unpaid agent is entitled to a lien over the principal's property lawfully in his possession. This means that the agent is entitled, if he so wishes, to retain the property until he is paid any commission or remunerations due to him from the agency.

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31.9 LIABILITY OF AGENTS

An agent may not generally be sued for the contract entered on behalf of the principal or for actions taken in the proper execution of the agency. The proper defendant (and claimant) would the principal. In addition, a principal would be vicariously liable for wrongful acts done by his agent to third parties in the normal course of his duties. The agent may however be sued personally if:

- He agrees to accept personal responsibility,
- He executes a deed in his own name,
- He signs a bill of exchange in his own name,
- The principal does not exist or was not disclosed by the agent (see *Keiner v Baxter* above)
- He is in breach of warranty of authority, i.e. where the person purporting to act as an agent does not have a valid authority as such.

31.10 TERMINATION OF AGENCY

An agency relationship may be terminated by either party before the agreement comes to an end with or without stipulated notice, although the terminating party may be liable for breach of contract. However, where termination was made by the principal and this fact is not made known to third parties, the agent might still be able to exercise ostensible authority. An agency agreement may also be terminated by frustration, or by the death or insanity of the principal or agent. The insanity of an agent terminates the agency and the agent's actual authority but does not terminate his ostensible authority unless the third party concerned knows of the insanity. The bankruptcy of the principal terminates the agency, but the bankruptcy of the agent does not necessarily do so unless it prevents him from acting as agent.

Upon the termination of an agency relationship, all existing entitlements of the agent would have to be paid while all his future rights and entitlement would be extinguished. Commercial agents are entitled to compensation for termination of the agency under regulation 17 and 18 of the *Commercial Agents (Council Directive) Regulations 1993.* An agent who acts after termination incurs personal liability to third parties. In addition, the principal would not be bound by actions of a terminated agent except in circumstances where ostensible authority is deemed to exist.

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31.11 CHAPTER SUMMARY

- Agents act on behalf of others and are able to bind them to transactions.
- Agency may be universal, general or particular in nature depending on the types of transactions the agent is empowered to undertake.
- Agency relationship may be created expressly, by implication, necessity, ratification or estoppel.
- The authority of an agent may be actual (express or implied) or apparent (ostensible) or usual.
- Agents are bound by many duties, including duty of personal performance; duty of obedience; duty of care and skill; duty to avoid or disclose conflict of interest; duty of confidentiality; duty to render account; duty to provide information; and duty not to make secret profits.
- Agents have a number of rights, including rights to commission or remuneration; right to indemnity for losses or expenditures incurred, and right to a lien on the principal's property in their possession in the course of duty.
- If agents act in breach of duty, they could suffer consequences including loss of commission, termination of the agency, liability to pay damages, liability to render account or to hold any gains for the principal as constructive trustee.
- An agency relationship may come to end by termination, or by the death, insanity or bankruptcy of either party, or by frustration.
- If the agency agreement were to be terminated wrongly, the other party may sue for damages for breach of contract.
- Upon termination by the principal, the agent would be entitled to payment for work already done, while future entitlements would cease.
- If an agent acts after the termination of the agency, he would incur personal liability and the principal would not be bound by his actions, except where ostensible authority is deemed to persist.

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31.12 PRACTICE QUESTIONS

1. State and explain five ways in which an agency relationship may be created.
2. Distinguish between the actual and ostensible authority of an agent.
3. State and explain five main duties of an agent.
4. Discuss the position of partners as agents of one another and their firms.
5. Discuss the position of company directors as agents of their companies and not of the members.
6. Jonathan was an estate agent appointed by Solomon to manage his three properties in Donchester. Under an oral agreement, Jonathan had the power to collect rents and undertake minor repairs in the properties. David was a tenant in one of the properties and in arrears of rent for three months. He was evicted from the property by Jonathan without any court order. Some of his personal belongings were damaged and lost in the process. David wishes to sue Solomon for assault and battery and for his lost and damaged property. Solomon insists that Jonathan was personally responsible for these acts which he said were beyond his authority.

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ENDNOTES

1. See article 2 of schedule 1, 2 & 3 Companies (Model Articles) Regulations 2007.

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