

# Corporate Law

## Sample paper

## Suggested answers

### Important notice

When reading these answers, please note that they are not intended to be viewed as a definitive 'model' answer, as in many instances there are several possible answers/approaches to a question. These answers indicate a range of appropriate content that could have been provided in answer to the questions. They may be a different length or format to the answers expected from candidates in the examination.

- 1. Chris and John are mechanics who originally operated their respective businesses as sole traders. They decided to combine their experience and resources and formed a company called Clever Mechanics Ltd to run their new business. All of the assets of their respective businesses were transferred to the new company. The date of the certificate of incorporation was 10 January 2010. Chris and John are the only directors and shareholders of the company, holding 10,000 shares each, which have a nominal value of £1 each and are partly paid for to the extent of 50 pence per share. The business is run from the company's garage premises previously used by John, which he continues to insure in his own name.**

**On 1 January 2010, Chris ordered some motor parts from Dan costing £1,000. He signed the contract with Dan, 'For and on behalf of Clever Mechanics Ltd (in formation)'. Dan has not received any payment for these parts.**

**The company has been financed mainly by a £25,000 loan from South Bank plc and this was personally guaranteed by John. In addition, John's sister, Sue, invested in the company by taking a thousand 6% non-voting preference shares of £2 each in the company.**

**In May 2010, the company's premises were destroyed by a fire. John made a claim on his insurance policy but the insurance company has refused to indemnify him, and John does not understand why. This has caused the company to go into insolvent liquidation. The liquidator has discovered that Chris was a director of another company called Intelligent Mechanics Ltd, which went into liquidation in 2009. Following the liquidation of this company Chris was disqualified for a period of 3 years.**

### Required

**Advise Chris, John and Sue on their potential personal liability for the debts of the company and on any other matters that you feel are relevant.**

*(25 marks)*

## Suggested answer

Once Chris and John formed their company, Clever Mechanics Ltd became a separate legal personality in the eyes of the law from the date mentioned in the certificate of incorporation. See *Salomon v A Salomon & Co Ltd* [1897]. One result of this is that the company's debts are its own debts and, normally, Chris and John would have the benefit of limited liability.

Limited liability means that they would only be liable for any amounts unpaid on their shares. As they have both only partly paid for their shares, the liquidator can ask them for the unpaid amounts. Chris and John will have to pay £500 each to the liquidator to fully pay for their shares.

On 1 January 2010, Chris ordered some motor parts from Dan. This is a pre-incorporation contract as it is a contract purported to be made by a person before the formation of the company. Normally, a company's contracts are its own but until incorporation a company does not exist and it is not possible to contract with a non-existent person. These goods have not been paid for but the company itself will incur no liability even if the contract is ratified after incorporation. See *Kelner v Baxter* [1866]. Under the common law, Chris will be personally liable on the contract. See *Newbourne v Sensolid* [1954]. The position is now governed by s51 (1) Companies Act 2006 (CA 2006). This again will make Chris personally liable on the contract with Dan, subject to any express agreement to the contrary, which there does not appear to be on the facts of the question.

John has personally guaranteed the company's overdraft with South Bank plc and he will be personally liable for this amount under normal contract principles. This is an example of when the benefit of separate legal personality of the company, and also of limited liability, is lost.

Sue has invested £2,000 in the company and her liability will be limited to this amount. Assuming she has fully paid for her shares, she will incur no further liability.

The fire at the company's premises raises another issue relating to the separate legal personality of the company. The facts are similar to *Macaura v Northern Assurance Co* [1925] in which a timber estate owned by a company was destroyed by fire. It was held that the shareholder/director of the company had no insurable interest in the property and that the insurance company was entitled to refuse to indemnify him even though the policy was in his name. John should have transferred the policy into the name of the company on incorporation. The premises belong to the company and it should have insured the company. This principle has also been applied in *General Accident v Midland Bank Ltd* [1940] and *Levinger v Licences etc, Insurance Co* [1936].

Chris was previously disqualified in 2009 for three years. Acting whilst disqualified is a criminal offence of strict liability under s13 Company Directors Disqualification Act (CDDA) 1986. Chris will also be personally liable for the debts of the new company under s15 CDDA 1986. His liability is joint and several with that of the company and any other person who is liable for debts of the company.

The final issue relates to the use of the company name. Chris was a director of a previous company called Intelligent Plumbers Ltd which went into liquidation in 2009. The name of this company is a prohibited name under ss216, 217 Insolvency Act (IA) 1986 and cannot be used by a director of the company for a period of five years. The provisions apply to names which are the same or similar to the old company and are designed to prevent 'phoenix' companies arising out of the ashes of the 'dead', insolvent company. The words 'Intelligent' and 'Clever' have similar meanings and the court will consider the types of product dealt with, the locations of the business and the types of customers dealing with the companies, as well as those who are involved in the operations of the two companies.

A similar case is *Ad Valorem Factors Ltd v Ricketts* [2004] 1 All ER 894 (CA), in which the names 'Air Component Co Ltd' and 'Air Equipment Ltd' were held to fall within the provisions. See also *First Independent Factors Ltd v Mountford* [2008].

The effect of the provisions is that Chris will be personally liable, jointly and severally with the company, for all of the debts and liabilities of the new company incurred whilst he was involved in it. This is potentially very serious and it will be no defence for Chris to argue that no customers have been deceived.

2. **Alpha Ltd ('the company') is a private tutorial college. Alec, Christine and Barry are the only directors and shareholders of the company, each owning 100 shares. In addition, Alec has been appointed the managing director. The Articles of Association of the company contain the following clauses:**
- (a) In the event of a resolution being proposed at any general meeting of the company for the removal from office of any director, any shares held by that director shall carry the right to three votes per share.**
  - (b) Jake shall be the company secretary.**
  - (c) The managing director, Alec, shall have the power to veto any board decision relating to the teaching of any new course at the college.**

**In addition, there is a shareholders' agreement signed by the company and all of the shareholders that the company will not increase its share capital unless all of the parties to the agreement give their consent.**

**At a recent board meeting, Alec tried to exercise his veto after the board decided that the college should offer a new course but Christine and Barry ignored Alec's veto. They then called a general meeting which passed a resolution ratifying the decision of the board. The company will need to raise additional capital to run the course but Alec has stated that he will not consent to any increase in the company's share capital. Christine and Barry are now considering calling another general meeting to remove Alec as a director. Jake acted as the company secretary but has since been removed.**

### **Required**

**Advise Alec and Jake whether they can rely on any of the above Articles of Association or the shareholders' agreement.**

*(25 marks)*

### **Suggested answer**

Every company is required to have Articles of Association which is a constitutional document of the company setting out the internal rules of how the company is to be run and managed. See ss17, 18 CA 2006.

Under s33 CA 2006, the Articles of Association have contractual effect. It provides that: 'The provisions of a company's constitution bind the company and its members to the extent as if there covenants on the part of the company and of each member to observe those provisions'. This creates a contract between the company and the members and between the members themselves.

### **Clause (a)**

Under s168 CA 2006, a director can be removed at any time by the members by the passing of an ordinary resolution, notwithstanding any agreement between the company and the director.

In order to circumvent this provision, it is possible to attach weighted votes to the shares of a director whom it is proposed to remove. This is the purpose of clause (a). When the resolution is voted upon, Alec will have 300 votes as against the 200 of Barry and Christine with the result that s168 cannot be relied on to remove Alec. Judicial validity for this type of clause was given in the case of *Bushell v Faith* [1970]. An argument that the clause infringed what was the equivalent of s168 was rejected by the House of Lords; an ordinary resolution is still needed but the parties are free to agree on what weighting is to be attached to the votes. Furthermore, if Parliament had intended to prevent such clauses it would have done so in the wording of the section.

Alec can rely on clause (a).

### **Clause (b)**

The Articles of Association only bind the company and its members if the claimant is trying to rely on an article that affects him in his capacity as a member, *Hickman v Kent or Romney Marsh Sheepbreeders' Association* [1915]. An outsider cannot rely on the articles as a contract against the company, *Eley v Positive Government Security Life Assurance Co Ltd* [1876]. As Jake is an outsider, and not a member, he will not be able to rely on the articles. He will have to establish an extrinsic contract outside the articles if he is to have any remedy but he will not be able to rely on them as the sole basis of a contract to be the company secretary. See *Re New British Iron & Co Ltd* [1898].

### **Clause (c)**

Alec's power to exercise a veto at board meetings is given to him in his capacity as a director and, in this capacity, he will be considered as an outsider and beyond the protection of s33 CA 2006. In *Beattie v E & F Beattie Ltd* [1938], a director was unable to rely on an arbitration clause in the articles when he was sued for failing to account for company money in his capacity as a director: the fact that he was also a member made no difference.

However, the facts are similar to the earlier House of Lords decision in *Salmon v Quin & Axtens Ltd* [1909]. In this case, the managing director was able to rely on a veto given to him in the articles and he successfully sought an injunction preventing the company from acting on the resolutions. It has been suggested that the case can be reconciled with *Hickman*, (which requires the claimant to be affected in his capacity as a member), as long as the member specifically pleads his case in his capacity as a member, that he has the right to have the articles observed. However, despite its House of Lords status, this case is not easy to reconcile with the weight of authorities which would not allow Alec's claim as he is an outsider. However, another way of explaining the decision is that by failing to observe the articles and then ratifying that failure by an ordinary resolution, Barry and Christine effectively altered the articles by a simple majority instead of the required special resolution under s21 CA 2006.

On the way the authorities currently stand, it is unclear whether Alec can rely on clause (c) but a failure to observe the articles would give him a claim for unfairly prejudicial conduct under s994 CA 2006, see *O'Neill v Phillips* [1999].

### **The shareholders' agreement**

Shareholder agreements are very common in closely held companies such as this one. Their provisions could appear in the articles but are deliberately put into a shareholders' agreement, usually to attract confidentiality and enforceability.

A company has the right to increase its share capital under s612 CA 2006. Either the articles may authorise the directors to issue the shares or an ordinary resolution is needed to authorise the issue. However, the shareholders' agreement may practically prevent an increase unless all the parties to the agreement give their consent. In *Russell v Northern Bank Development Corporation* [1992], a similar agreement was upheld by the House of Lords who granted a

declaration that it was valid. Their Lordships stated that they would have granted an injunction against the other members from acting in breach of the agreement, had they asked for it. The agreement was held to be unenforceable against the company, which was 'blue-lined' (deleted) from the agreement. This was because the company itself cannot deny itself the right in s617 to increase its share capital. However, the enforceability of the agreement between the shareholders themselves produces the same result. Alec will be able to enforce the agreement and will have the usual contract remedies available; damages and injunctions.

**3. Magda plc ('Magda') recently created the following charges over assets:**

- (i) On 1 September, a floating charge over its stock of goods in favour of Beryl, to secure a loan by her of £50,000. This charge was not registered.**
- (ii) On 1 October, a floating charge over the entire undertaking of the business in favour of North Bank plc ('the bank'). The background to creating this charge was that the bank had granted an unsecured overdraft of £60,000 to Magda. The bank then asked for it to be secured and so the company paid the overdraft off with what little money it had and then immediately borrowed the money from the bank again, but this time on a secured basis. In consideration for granting the charge, the bank agreed to extend the overdraft facility to £70,000. The charge contains a clause which prohibits Magda from creating any further charges ranking equally with, or having priority over, the charge granted to the bank. This charge was registered on 10 October.**
- (iii) On 5 October, a charge which was expressed to be a 'first specific charge' over its book debts in favour of East Bank plc ('East Bank'). The charge contained the following clause:**

**"The company shall pay into an account with East Bank, designated for that purpose, all monies which it may receive in respect of the book debts, and shall not without the prior consent of East Bank in writing make any withdrawals or direct any payment from the said account."**

**This charge was registered on 8 October.**

**In addition to these charges, Magda has borrowed £50,000 from First Finance plc. The rate of interest charged by First Finance plc is 35 per cent.**

**Required**

**In the event that Magda goes into liquidation, discuss the nature and validity of the:**

- (a) 1 September charge. (7 marks)**
  - (b) 1 October charge. (6 marks)**
  - (c) 5 October charge. (7 marks)**
  - (d) Loan with First Finance plc. (5 marks)**
- (Total: 25 marks)**

**Suggested answer**

A floating charge is equitable in nature and is taken over the company's fluctuating assets such as stock in trade or book debts. The essential characteristics of a floating charge were identified by Romer J in *Re Yorkshire Woolcombers Association* [1902] as:

- (i) a charge over a range or class of assets;
- (ii) that change from time to time; and
- (iii) which allows the company to deal with the asset without the consent of the lender.

Subsequent cases have stressed that it is the third characteristic that is the badge of a floating charge. See *Agnew v Commissioner of Inland Revenue* [2001].

A fixed charge, also known as a specific charge, on the other hand, may either be legal or equitable in nature and is usually granted over the company's fixed assets, such as land and buildings. An example is a legal mortgage over the company's factory to secure a loan. The lender will have a security interest over the property immediately once the charge is created. Crucially, the company is not allowed to deal with the charged asset without the lender's consent.

**(a) 1 September charge.**

(7 marks)

The floating charge created on 1 September in favour of Beryl is currently defective as it has not been registered with the Registrar of Companies. Floating charges should be registered within 21 days of creation, s870 CA 2006. Failure to do so renders the charge void as against a liquidator, administrator and any other creditor of the company. In addition, any money secured by the charge becomes immediately repayable and the lender becomes an unsecured creditor, s874 CA 2006.

Late registration is possible by an application to the court under s873 CA 2006 but the now registered charge will take subject to any properly registered charges previously created. In addition, the court will not make an order for late registration if the application is made after winding up of the company has commenced.

**(b) 1 October charge.**

(6 marks)

The floating charge created on 1 October has been registered. However, the danger for the bank is that it may be open to attack under s245 IA 1986 if the company goes into liquidation within 12 months of the creation of the charge.

This provision is designed to prevent a company from granting a floating charge to secure existing debt. North Bank plc is an 'unconnected' person but if the charge holder was a 'connected' person, the time period is increased from 12 months to 2 years.

However, if new money is advanced at the same time as the charge is created, then the charge is valid to that extent.

The floating charge and £70,000 has been structured to make it appear that the whole amount is new money but on similar facts. In *Re GT Whyte & Co Ltd* [1983], the court held that in substance, the transaction simply involved the substitution of an unsecured loan by a secured loan which did not involve new money. The facts in the question are different as the bank has extended the overdraft facility by £10,000 in consideration of granting the charge, so it will be valid for this amount.

The floating charge created on 1 October also prohibits the creation of further charges over the company's property. This type of clause is known as a negative pledge. They are designed to prevent a subsequent fixed charge holder obtaining priority under the normal rule that a later

fixed charge has priority over an earlier floating charge. They only bind subsequent lenders if they have actual, and not just constructive, notice of the negative pledge clause. See *Wilson v Kelland* [1910].

**(c) 5 October charge.**

(7 marks)

The charge over book debts created on 5 October is properly registered. The first issue is whether the charge over the book debts really is fixed or whether it is in fact only floating, for the label given to a charge is not conclusive. See *Re Brightlife Ltd* [1987] and *Re Armagh Shoes Ltd* [1992].

Book debts are a fluctuating range of assets and it may seem at first as if a charge over them can only ever be floating. However, following the landmark decision in *Siebe Gorman Ltd v Barclays Bank* [1979] it was held that it is conceptually possible to have a fixed charge over book debts as long as the lender retains a sufficient degree of control over the book debts. However, on the facts of *Siebe Gorman*, the degree of control by the lender was held to be sufficient. However, this case was overruled recently by the House of Lords in *Westminster Bank plc v Spectrum Plus Ltd* [2005]. Following this decision, it seems that for there to be a fixed charge over book debts, once the debts are collected, they must be paid into a separate 'blocked' bank account which can only be operated with the lender's consent. The wording of the charge in the question does this and is taken from the wording of the charge in *Re Keenan Brothers Ltd* [1986], in which the Irish Supreme Court held that it created a fixed charge.

The final point to consider is whether East Bank take subject to the charge created in favour of North Bank plc by virtue of the negative pledge. It was mentioned earlier that this is dependent on actual notice. The problem is that if East Bank searches the register between 5 and 8 October, it would not discover the existence of the floating charge granted to North Bank plc, as their charge was not registered until 10 October. This demonstrates the problem of 'invisibility of charges' which is inherent in the current system and which determines priority by the date of creation but then allows a 21 day registration period. The result is that East Bank will not have actual notice of the negative pledge and will not be bound by it.

**(d) Loan with First Finance plc.**

(5 marks)

This raises a legal issue about whether the loan could be challenged by a liquidator on the ground that it amounts to an extortionate credit transaction under s244 IA 1986.

A liquidator can examine a credit agreement for up to three years before the commencement of winding up and apply to the court for an order that it is extortionate. If granted, the agreement can be set aside by the liquidator.

To determine whether an agreement is extortionate, regard is had to the risk accepted by the finance company and whether the terms required grossly exorbitant payments or otherwise grossly contravened ordinary principles of fair dealing.

The burden is on the finance company to prove the agreement is not exorbitant.

4. Sarah is the company secretary of Beta plc, ('the company'), a non-listed public company. She seeks your advice on the following matters.
- (a) The company has 100,000 £1 preference shares and 500,000 £1 ordinary shares. The Articles of Association provide that the preference shares carry the right to a 12 per cent preference dividend and a prior right to the return of their capital on a winding up. They have no right to vote except at class meetings. The board of directors wants to reduce the preference dividend from 12 to 8 per cent.
  - (b) The company plans to allot an additional £30,000 ordinary shares with a nominal value of £1 to Roger, for £1.30 each. Roger cannot afford to pay for the shares in full and has suggested that the company allows him to pay £1 per share, and that he acts as the company's legal adviser for the next three months in order to pay for the premium. Alternatively, he has suggested that the company re-registers as a private limited company. Roger will then arrange a loan of £39,000 from his bank which will be guaranteed by the company.

#### Required

#### Advise Sarah:

- (a) On the proposed dividend reduction and on any procedural matters necessary to implement it.

(12 marks)

#### Suggested answer

The rights of the preference shareholders are contained in the company's articles and amount to class rights. There is a presumption of equality between shareholders in a company, which means that they have the same rights and liabilities as every other shareholder. See *Birch v Cropper* [1899]. However, this presumption is displaced where a company issues different shares with different rights attached.

A reduction in the percentage dividend payment from 12 to 8% will amount to a variation of class rights. A variation is permitted as long as the correct procedure is followed in s639 CA 2006. This provides that class rights can be varied by following any variation provisions laid down in the articles and if there are none, then by obtaining the consent of the class i.e. of the preference shareholders. Consent is obtained either by getting consent in writing of at least three-quarters in nominal value of the issued preference shareholders or by a special resolution at a separate general meeting of the preference shareholders. See s630(4) CA 2006.

Minority shareholders of the class holding at least 15% of the preference shares may object to the variation to a court. They must not have voted in favour of it and the objection must be made within 21 days of the consent to the variation being obtained.

If this consent is obtained then a further special resolution of the company's shareholders entitled to vote (i.e. not including the preference shareholders) will need to be passed to alter the articles. See s21 CA 2006.

Particulars of the variation will have to be sent to the registrar within one month of the variation from the date when the variation was made. See s637 CA 2006. A copy of the amended articles must also be sent within 15 days after the amendment takes effect. See s26 CA 2006.

**(b) On the validity of the plans to allot the additional ordinary shares to Roger.**

*(13 marks)*

**Suggested answer**

This part of the question raises three issues:

- (i) The shares are being issued at a premium. A premium is the difference between the nominal value of the shares of £1.00 and the market value of £1.30. This amount will have to be credited to a share premium account which is treated in most respects as part of the company's capital and subject to the maintenance of capital doctrine. See s610 CA 2006.
- (ii) Under s582 CA 2006, shares can be paid for in money or monies worth. Roger wants to partly pay for the shares by acting as the company's legal advisor. This is not permitted as s585 CA 2006 prohibits, in the case of a public company, the doing of work or performing services as payment for its shares. A breach of the section will result in Roger being liable for the premium plus interest.
- (iii) It is unlawful for a public company to give financial assistance to a person for the purpose of allowing that person to purchase its shares. See 678 CA 2006. Assistance is widely defined in s677 and includes the giving of guarantees. The prohibition does not apply to private companies and so guaranteeing Roger's loan would be permissible if Beta plc registers as a private company.

The procedure to re-register as a private company is laid down in s97 CA 2006. It is:

- The members pass a special resolution.
- An application is made to the registrar in the prescribed form with a copy of the altered articles and the special resolution and a statement of compliance.
- If the registrar is satisfied the documents are in order a new certificate of incorporation is issued which is conclusive evidence that the requirements for re-registration have been complied with.

**5. Mytec plc ('the company') designs and installs computer software. At a recent board meeting, the following resolutions were passed:**

- (a) To purchase a plot of land from Stuart, the husband of Mary, one of the company's directors, for £200,000. Mary did not disclose that the land is owned by her husband.**

*(6 marks)*

**Suggested answer**

Directors owe a range of duties to their company. Their duty is to the general body of shareholders rather than to individuals. See *Percival v Wright* [1902]. The duties of a director were largely codified in the CA 2006.

Mary is under a duty to promote the success of the company. This is a subjective test; as long as she acts in good faith and believes she is promoting the long term success of the company, she will not be in breach. See *Re Smith and Fawcett Ltd* [1942].

By failing to disclose her interest in the property, Mary may be promoting her own personal interests rather than those of the company.

Mary will also be in breach of s177 CA 2006. This requires her to disclose the nature and extent of any interest she has, whether direct or indirect, in a proposed transaction or arrangement with

the company. The disclosure also applies to arrangement or transactions with connected persons, such as her husband.

A disclosure does not have to be made if the other directors are aware of her interest in the property or if it cannot be reasonably regarded as likely to give rise to a conflict of interest.

As the value is also over £100,000, the proposed purchase is also a substantial property transaction within s191 CA. The result is that it must be approved by the members in a general meeting of the company by ordinary resolution. Again, Mary's husband would be a connected person for this purpose, necessitating shareholder approval.

**(b) To reject a proposed contract with Riverside University to install a new computer system in its library. The board did not feel that there was enough profit in the contract to make it commercially viable. After the meeting, Derek, a director of the company, approached Riverside University and has been offered the contract in his personal capacity which he intends to accept.**

(7 marks)

### Suggested answer

Derek may also be in breach of s172 – the duty to promote the success of the company.

In addition, and more relevant, is a potential breach of duty under s175, the duty to avoid a conflict of interest. This duty, in s175(2), applies particularly to the exploitation of property, information or opportunity and it is immaterial whether the company could take advantage of it.

It may be thought that as the board has decided not to take the contract for the company's benefit, there is no longer a conflict. This has been held in some Commonwealth decisions but English law takes a much stricter view. See *Regal Hastings Ltd v Gulliver* [1967].

Derek will be in breach of the duty in s175 as the contract with the University will be regarded as a corporate opportunity.

Section 175 does permit the board to authorise Derek's conflict of interest. As Mytec plc is a public company, s175(5) provides that the board can only authorise the conflict if the articles contain a provision enabling the directors to do so.

**(c) To purchase some new computer equipment from iTech plc. This contract was negotiated by Ian, one of the company's directors, who, unknown to Mytec plc, has been paid a £5,000 commission for recommending iTech plc to the company.**

(5 marks)

### Suggested answer

This will amount to a breach of the duty in s176 – the duty not to accept benefits from third parties. This provision operates in place of the equitable principle that fiduciaries must not accept bribes or secret commissions. See *AG of Hong Kong v Reid* [1994].

There is an overlap here with the duty to avoid a conflict of interest in s175, but one difference is that there is no provision allowing for prior approval by the board.

**(d) To award Edward, a director of the company, £100,000 compensation for loss of office.**

(7 marks)

### Suggested answer

Compensation for loss of office is dealt with in ss215, 216 CA 2006. Such payments are not permitted unless they are approved by the members by an ordinary resolution. An exception is if

the payment is a 'small payment' under s221 CA 2006, i.e. it does not exceed £200. These provisions do not apply to payments made under a legal obligation, for example, contractual, redundancy or unfair dismissal payments; they are designed to cover only gratuitous payments for loss of office.

Finally, it should be pointed out that breaches of duty can be ratified under s239 CA 2006 by the members, excluding any votes held by the director. In addition, the court can sometimes relieve a director from breach of duty if they have acted honestly and reasonably under s1157 CA 2006. See *Re D'Jan of London Ltd* [1990].

**6. Rubero plc (the company) is an importer of electrical equipment and was formed in 1990. It has two directors, Albert and Bob, and three shareholders, Albert, Bob and Clive.**

**The company's financial problems began in late 2007 when it lost its major customer. Since that time it has exceeded its overdraft on many occasions, its cheques have been returned unpaid, and trade customers have been paid either late, or not at all. The company made a loss in 2008 and 2009 but made a profit in 2010, following which the directors recommended a dividend that the general meeting declared shortly afterwards.**

**In November 2009, the directors started importing spare parts for motor cars. They did so in the hope of avoiding liquidation, even though no mention of this was made in the company's objects clause in the Article of Association. This did not turn out to be profitable and caused the company to lose a further £60,000.**

**By August 2010 the directors realised that there was no alternative to the company going into liquidation as the company could no longer pay its debts as they fell due. The directors intend to put the company into a members' voluntary winding up. Before doing so, they have ensured that any money that has been received by the company has been used to reduce the company's overdraft with West Bank plc, which they have personally guaranteed.**

**Required**

**(a) Advise the directors why a members' voluntary winding up is not possible.**

*(5 marks)*

**Suggested answer**

A company may be wound up if it is solvent or insolvent. There are two types of winding up; voluntary and compulsory winding up.

A voluntary winding up is commenced by passing a special resolution of the members and can be subdivided into two types; a members' and a creditors' voluntary winding up.

There can only be a members' voluntary winding up if a statutory declaration of solvency has been made by the directors, in which they state that they are of the view that the company is able to pay its debts for the next 12 months. If no such declaration is made, then it will be a creditors' voluntary winding up.

A members' voluntary liquidation is not possible for Rubero plc as the company can no longer pay its debts as they fall due and is therefore not solvent. The directors will therefore be unable to make the statutory declaration required for a members' voluntary winding up.

(b) If the company goes into compulsory liquidation by the court, explain what action a liquidator could take to swell the assets of the company available for distribution.

(20 marks)

### Suggested answer

The function of a liquidator is collect in the assets of the company, realise them and then distribute them to the creditors. See s143 IA 1986. In carrying out this duty, the liquidator will want to swell the assets of the company available for distribution in so far as he can do so.

Under s212 IA 1986, the liquidator can commence misfeasance proceedings against officers of the company, that is, against its directors for breach of duty.

Albert and Bob may have committed wrongful trading. This is dealt with in s214 IA 1986 and occurs when the directors of a company carry on its business at a time when they knew or ought to have known that there was no realistic prospect of avoiding insolvent liquidation. They will be judged both by the standard of a reasonable director and also by the knowledge skill and experience that they actually possess. See s214(4). If found to have traded wrongly, the directors can be ordered to make a personal contribution to the assets of the company available for distribution by the liquidator. Only a liquidator can commence such proceedings.

The company has been experiencing financial difficulties since 2007 and it seems likely that Albert and Bob knew or ought to have realised that there was no reasonable prospect of avoiding liquidation.

A claim by the liquidator for fraudulent trading, under s214 IA 1986, is unlikely to succeed as the liquidator would have to prove the business was carried on with intent to defraud creditors. This requires the liquidator to prove actual dishonesty involving real moral blame, which is very difficult. See *Re Patrick and Lyon Ltd* [1933].

By engaging in an *ultra vires* activity, the importation of motor parts, the directors are in breach of their duty under s171 CA 2006. This requires the directors to act in accordance with the company's constitution, which Albert and Bob have not done. Section 212 IA 1986 allows the liquidator to sue a person on behalf of the company and Albert and Bob may be liable for the £60,000 losses caused by this diversification.

The directors may also have wrongly recommended the payment of a dividend. Dividends can only be paid out of distributable profits and previous years' losses must be made good before a current year profit can be distributed as a dividend. The losses of 2008 and 2009 will have to be made good before the profit of 2010 can be distributed as a dividend. In addition, as Rubero plc is a public company, s831 CA 2006 states that a public company can only make a distribution up to the amount by which its net assets exceed the aggregate of its called up share capital and undistributable reserves. Essentially, this requires a public company to deduct its net **unrealised** losses from its net **realised** profits to determine whether it can declare a dividend.

If the payment of the dividend is unlawful, then the directors, Albert and Bob, are jointly and severally liable to repay it. See *Flitcroft's Case* [1882] and *Bairstow v Queen's Moat Houses* [2001].

Liability may also be incurred by shareholders under s847 CA 2006 for the repayment of an unlawful dividend, where they know or have reasonable grounds for believing that the dividend is unlawful. See *It's a Wrap (UK) Ltd v Gula* [2006]. An additional basis of shareholder liability is that the shareholder holds the payment as a constructive trustee. See *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1986]. Shareholder liability would also encompass Clive.

The final issue is whether the decision to reduce the company overdraft, which they have personally guaranteed, amounts to a preference which can be set aside by the liquidator under s239 IA 1986.

A preference is where the company, through its directors, does something which puts a creditor in a better position in the event of the company going into liquidation. The company must be insolvent at the time of giving the preference and the liquidator can look back two years, in the case of a bank, from the commencement of the winding up, which is taken to be the date the winding up petition was granted or the special resolution was passed.

The test for a preference is whether or not the company was influenced by a desire to produce the preference result. See *Re MC Bacon Ltd* [1990]. The desire seems to be to put the bank in a better position due to the personal guarantees given by Albert and Bob. If it is a preference, then the court can order the bank to repay the money to the company for distribution by the liquidator to the creditors.

*The scenarios included here are entirely fictional. Any resemblance of the information in the scenarios to real persons or organisations, actual or perceived, is purely coincidental.*