Corporate Law
November 2010

Suggested answers and examiner’s comments

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.

Examiner’s general comments

There was no marked difference in the pass rate and standard of the answers for this examination session, compared to the most recent previous sittings for this paper.

Candidates who score well on the Section A questions tend to do better overall and only rarely have candidates passed the Section B questions having failed those in Section A.

Some candidates continue to write lengthy answers for the Section A questions which deprives them of valuable time needed for answering the Section B questions.

The stronger candidates, as always, were able to cite authorities to support their answers and this session, generally, more candidates were doing so.

A good number of candidates are still writing answers that are far too brief and general to attract a pass mark.

Many of the above comments have also been made in previous reports.
Section A

1. (a) Distinguish between a company limited by shares and a company limited by guarantee.

   (4 marks)

   Suggested answer

   A company limited by shares is the most common type of registered company and is the usual commercial, profit making vehicle for limiting the liability of its members. The members’ liability is limited to the amount, if any, that remains unpaid on their shares, so they know that they will never be asked to pay more than the full subscription price of their shares. See s3(2) Companies Act 2006 (CA 2006). A company limited by shares enjoys a separate legal personality so that the company’s debts are its debts and not those of the members.

   A company limited by guarantee is no longer permitted to have a share capital and they can only be formed as private companies. They have members rather than shareholders whose liability is limited to the amount that they have guaranteed to contribute to the company’s assets in the event of winding up. See s3(3) CA 2006. They are not suitable for commercial, profit making trading ventures and are found mainly in the not-for-profit sector, such as clubs, societies and charities, and to carry out semi-official functions, particularly in the field of regulation of the financial services market. Such companies also enjoy the advantage of separate legal personality.

   Examiner’s comments

   This question was well answered and nearly every candidate distinguished between a company limited by shares and one limited by guarantee. However, the uses of these two types of company were not always provided in answers.

   (b) When will a company be treated as a subsidiary of a holding company?

   (4 marks)

   Suggested answer

   Under s1159 CA 2006, a company is treated as a subsidiary of a holding company if the holding company:

   (i) Holds a majority of the voting rights in it.
   (ii) Is a member of the subsidiary and has the right to appoint or remove a majority of its board of directors.
   (iii) Is a member of it and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in it.

   In addition, a company will be a wholly owned subsidiary if it has no other members except its holding company or its holding company’s subsidiaries, or persons acting on behalf of its holding company or its subsidiaries.

   Examiner’s comments

   This question produced some mixed answers. The better answers identified all of the criteria for being a subsidiary company but the weaker answers were too general and vague and simply referred to various levels of control without explaining how control is established.
(c) What is a ‘pre-incorporation contract’? Explain why a company is generally not liable under such a contract.

Suggested answer

A pre-incorporation contract is one which is purported to be made on behalf of a company not yet formed.

The company itself is not normally liable on such a contract because it does not exist at the time of the purported contract. If a company does not exist, it cannot contract and for this reason the company, after formation, cannot adopt or ratify pre-incorporation contracts. Instead, the individual who purported to enter the contract on behalf of the company is personally liable, unless there is express agreement to the contrary. See Phonogram Ltd v Lane [1981] and s51 CA 2006.

Examiner’s comments

Part (c) was answered well by most candidates.

(d) Explain how a provision in the Articles of Association may be entrenched.

Suggested answer

This is dealt with in s22 CA 2006. A company’s articles may contain provisions for entrenchment so that the provisions can be amended or repealed only if conditions are met, or procedures complied with, that are more restrictive than passing a special resolution. They may, for example, require unanimity or the consent of a particular member or members.

Entrenchment provisions can only be made in the company’s articles on formation or by altering the articles to include the entrenchment provisions by unanimous agreement of the members.

Examiner’s comments

This question was not answered very well. Few candidates appeared to understand how provisions may be entrenched in the Articles of Association and many resorted to writing sometimes lengthy accounts about the Articles generally and the s33 contract.

(e) For the purpose of insider dealing, who is an ‘insider’?

Suggested answer

This is dealt with in s57 of the Criminal Justice Act 1993.

To be an insider, a person must have, and know that he has, insider information.

The person must also have the information through an inside source which will be satisfied if he has it through:

(i) Being a director, employee or shareholder of an issuer of securities (a company).
(ii) Having access to the information by virtue of his employment, office or profession.
(iii) A direct or indirect source from a person in (i) or (ii) above (sometimes known as a tippee)

Examiner’s comments

Part (e) produced some mixed answers. The better answers focused on who is an insider for the purposes of insider dealing but the weaker ones did not answer the requirement of the question
and wrote about insider dealing in very general terms. This question produced some long answers which was unnecessary and attracted little credit.

(f) Explain the extent to which, if any, shares or debentures can be issued at a discount.

(4 marks)

Suggested answer

It is not permitted to issue shares at a discount, that is, at a price below the nominal or ‘par’ value of the shares. If the shares have a nominal value of £1, the company must receive £1 and not, say, 75p which is then treated as full and final payment for the shares. If shares are issued at a discount, then the owner is liable to pay the amount of the discount plus interest. See s580 CA 2006.

Unlike shares, debentures can be issued at a discount unless they are convertible into shares which would allow the no discount rule in relation to shares to be side stepped. See Moseley v Koffyfontein [1904].

Examiner's comments

This question was answered reasonably well. Most answers included that shares cannot be issued at a discount but some answers confused this matter with the issue of partly paid shares. Again, most candidates appeared to understand that debentures, in contrast, can be issued at a discount.

(g) What is meant by the ‘right of pre-emption’ on the allotment of shares?

(4 marks)

Suggested answer

Pre-emption rights are governed by ss570-577 CA 2006. The right of pre-emption gives equity shareholders (essentially ordinary shareholders) the right of first refusal to take up any new equity shares in proportion to their existing shareholding.

The offer of new equity shares must be made on the same or more favourable terms than the eventual offer to the public.

The offer to the existing shareholders may be made in hard or electronic form and they have at least 14 days in which to accept or reject the offer.

Pre-emption rights can be excluded, broadly speaking, either by provisions in the articles, in the case of a private company, or by passing a special resolution.

Examiner's comments

This question was answered reasonably well and the majority of candidates explained the basic right of pre-emption.

(h) What must directors do when they become aware that they are interested in a proposed transaction or arrangement with the company?

(4 marks)

Suggested answer

This is dealt with in s177 CA 2006.
The director must declare the nature and extent of that interest to the other directors. Any declaration must be made before the company enters into the arrangement or transaction in question. A declaration need not be made if it cannot be reasonably regarded as likely to give rise to a conflict of interest or if the directors already know of the interest.

Examiner's comments

For part (h), the vast majority of candidates appeared to know that this raised an issue of disclosure and many identified the relevant section in the CA 2006. However, not many candidates gave any more detail and a number of answers consisted of a general account of all the statutory duties of a director. Such answers lacked focus and attracted little credit.

(i) Distinguish between an ‘administrator’ and an ‘administrative receiver’. (4 marks)

Suggested answer

An administrator is an insolvency practitioner and manages the company’s affairs, business and property for the benefit of its creditors. They are appointed either by the court, the company and its directors or the holders of floating charge. The main duty of an administrator is to rescue the company as a going concern or to achieve a better result for the creditors than if the company was wound up.

An administrative receiver is appointed by the holder of a debenture secured by a floating charge. They manage the whole of the company’s property for the benefit of the floating charge holder. They have the power to sell the assets of the company covered by the floating charge for the benefit of the floating charge holder.

The Enterprise Act 2002 restricted the power of a floating charge holder to appoint an administrative receiver and that the floating charge holder’s usual remedy is now to appoint an administrator.

Examiner's comments

Part (i) was not answered very well as answers tended to confuse administrators and administrative receivers with the different types of winding up and liquidators. However, most answers had a general idea that administration involved trying to avoid liquidation.

(j) What is a company voluntary arrangement and how is one established? (4 marks)

Suggested answer

A company voluntary arrangement (CVA) is an alternative to winding up a company. A CVA is a scheme for making arrangements with creditors which is legally binding on the creditors, even if they do not all agree. They are supervised by a nominee, who is an insolvency practitioner.

A proposal is first made to the company and its creditors, usually by its directors working with the insolvency practitioner. If the company is in administration or liquidation, the proposal is made by the administrator or liquidator.

The nominee will, within 28 days of receiving the CVA proposal, submit a report to the court stating whether the CVA has a reasonable prospect of being approved and implemented. He will also state whether meetings of the company and its creditors are needed to consider the scheme. The meetings of members and creditors will then be held. Members must agree to the proposal by simple majority and creditors by a three quarters majority in value. If approved, the CVA binds everyone who was entitled to vote and attend the meeting.
The nominee can apply for a moratorium until creditor approval is obtained. This is to prevent a single creditor applying for a winding up order which would scupper any proposal for a CVA.

Examiner's comments

This question was not answered very well. Similar to part (i), answers tended to confuse company voluntary arrangements with the different types of winding up, particularly members' voluntary liquidations.

Section B

2. On 2 January 2009, Lemon Ltd (‘the company’) borrowed £200,000 from North Bank plc. The company granted North Bank plc a debenture secured by a fixed charge over its premises. Due to an oversight, this charge has never been registered.

Bob, one of the company’s directors, has helped the company financially by making a number of unsecured loans to it. By February 2010, these loans totalled £100,000 and on 1 February 2010, Bob agreed to lend the company another £50,000 in return for a debenture secured by a floating charge over the company’s stock in trade. The charge is expressed to cover all existing debt as well as the £50,000 of new money. Bob was worried that the company might go into liquidation but believed that being a floating charge holder would put him in a stronger position compared to the company’s unsecured creditors. The charge was duly registered.

On 1 March 2010, the company borrowed a further £150,000 from First Securities plc. The company granted First Securities plc a debenture secured by a fixed charge over its book debts, which was duly registered. The company has been allowed to control the book debts by collecting them and using the proceeds to buy additional stock and equipment.

The company went into liquidation on 1 June 2010.

Required

Advise the liquidator on the nature and validity of the above charges.  

(20 marks)

Suggested answer

The fixed charge granted to North Bank plc

A fixed charge, also known as a specific charge, may either be legal or equitable in nature and is usually granted over a company’s fixed assets, such as land or buildings. An example is a legal mortgage over the company’s premises to secure a loan. North Bank plc (the bank) has a security interest here over the property immediately when the charge is created. Crucially, the company will not be allowed to deal with the charged asset without the bank’s consent. The benefit of taking a fixed charge is that fixed charge holders are paid off first in the liquidation of a company.

However, this charge has not been registered as required by s860 CA 2006. Registration should have been done within 21 days of the date of creation, s870 CA 2006. The liquidator should be advised that:

(i) Failure to register the charge amounts to a criminal offence committed by the company and every officer in default.

(ii) Failure to register the charge also results in civil consequences. Under s874 CA 2006, the failure renders the charge void (so far as any security on the company’s property or
undertaking is conferred by it) against a liquidator, an administrator and a creditor of the company. In addition, the money secured by the charge immediately becomes repayable and the lender now ranks as an unsecured creditor.

There is a provision allowing for late registration of charges but this requires a court order and is not possible once the company is in liquidation, s873(2) CA 2006.

**Bob’s Loans**

Bob’s unsecured loans of £100,000 mean that he would be treated by the liquidator as an unsecured creditor in the company’s liquidation.

But in February 2010, Bob agreed to lend another £50,000 to the company in return for a debenture secured by a floating charge over the company’s stock in trade. The charge was properly registered. Debentures are issued by companies to evidence loans which they have made and may or may not be secured by either a fixed or floating charge, s738 CA 2006.

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 arrange 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.

The floating charge created on 1 February has been registered. However, it may be open to attack by the liquidator as the company went into liquidation four months later. The liquidator will rely on s245 Insolvency Act 1986 (IA 1986) which allows him to look back for up to two years when the floating charge is granted to a ‘connected person’, such as a director. This provision is designed to prevent a company from granting a floating charge to secure existing debt. However, as £50,000 of new money was provided by Bob at the same time as the charge was created, the charge is valid to that extent.

So, the liquidator will have to treat Bob as a secured creditor and the charge is valid to the extent of £50,000.

**The charge granted to First Securities plc**

The charge over book debts created on 1 March is properly registered. The issue here 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].

Books 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. On the facts of *Siebe Gorman*, the degree of control by the lender was held to be sufficient. However, this case was overruled by the House of Lords in *Westminster Bank plc v Spectrum Plus Ltd* [2005]. Following this decision, it seems that for there to 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. Where the company is allowed to control the book debts and use the proceeds in the course of its business, it will amount to a floating charge only.
The liquidator should, therefore, be advised that the ‘fixed charge’ granted to First Securities plc is, in law, only a floating charge and it will be subject to the prior claims of properly registered fixed charges, the expenses of the winding up and the preferential creditors.

Examiner’s comments

This question was answered reasonably well. Most candidates identified the relevant issues but the weaker answers did not provide the necessary detail or authority. For example, a number of answers correctly identified that the charges needed to be registered but did not provide any more information at all about that issue. It was pleasing to note that many candidates referred to the Spectrum Plus decision of the House of Lords on fixed charges over book debts. Common errors included treating the Crown as a preferential creditor and stating that directors cannot lend money to their own company.

3. Alan, Bob and Clive were originally sole traders who carried on separate businesses as driving instructors. They decided to combine their experience and form a limited company, Drive Ltd (‘the company’), which was registered in September 2007. They became shareholders, each owning 5,000 ordinary shares with a nominal value of £1, and are the only directors. Clive was unable to pay for his shares in full and so was allowed to partly pay for them at the rate of 50 pence per share. In addition, the company was partially funded by a £15,000 unsecured loan from Bob.

Before the company was formed, Alan was given the task of finding suitable office premises. He purchased property for £120,000 with the intention of transferring it to the company upon incorporation. However, he has not done so, as it is now worth £150,000 due to an increase in property prices.

The company did not prosper and went into liquidation in April 2010. Prior to this, Alan, Bob and Clive convinced the company’s bank that they were in negotiations with a buyer for the company. This was not true, and was intended to mislead the bank in order that the latter would not call in the company’s overdraft. They also arranged, on behalf of the company, a £15,000 loan from Easycredit plc, with an interest rate of 47%. This money was then immediately used to pay off Bob’s unsecured loan.

Required

Advise the liquidator on the legal issues arising out of the above facts. (20 marks)

Suggested answer

The legal issues arising out of the facts are as follows:

(i) When Alan, Bob and Clive formed Drive Ltd they created a company which enjoys a separate legal personality. This was established in Salomon v A Salomon & Co Ltd [1897]. Some of the consequences of incorporation mean that the company can own its own property, sue and be sued, commit crimes and torts, and be an employer and employee. The company’s debts are also its own debts and the liability of the shareholders is limited to the amount unpaid on their shares. As Clive has only partly paid for his shares, the liquidator can ask him for the outstanding amount: £2,500.

(ii) Alan, Bob and Clive are the company’s promoters. A promoter was defined in Twycross v Grant [1877] by Cockburn CJ, as ‘a person 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’. Finding suitable premises for the company is a promotional activity and Alan is clearly acting in his capacity as a promoter.
As a promoter, Alan owes various duties to the company that he is promoting as he stands in a fiduciary relationship with the company. Alan is under a duty to account for any profit he makes in his capacity as a promoter unless he has disclosed it to an independent board of directors or the shareholders and they have given their consent. See Erlanger v New Sombrero Phosphate Co [1878] and Gluckstein v Barnes [1900].

The liquidator can bring an action against Alan under s212 IA 1986 for breach of duty. Such proceedings are known as misfeasance proceedings and the liquidator is able to bring the action in the name of the company against Alan.

(iii) Alan Bob and Clive may have committed fraudulent trading when they misled the bank about the sale of the business. This can result in civil and criminal proceedings. The civil aspect of fraudulent trading is dealt with in s213 IA 1986 and occurs when any person carries on the business with intent to defraud creditors. Only the liquidator can bring the action but the standard of proof is a heavy one; it has to be proved that they were actually dishonest and not just that they were acting unreasonably. See Re L Todd (Swanscombe) Ltd [1990].

Only the liquidator can bring a civil action but criminal proceedings can be commenced outside the insolvency context regardless of whether the company is insolvent or not. If found to have traded fraudulently, the court can order Alan, Bob and Clive to make such contribution (if any) to the company's assets as the court thinks proper.

(iv) The £15,000 loan from Easycredit plc raises two issues. The first is that the interest rate of 47% may make the loan an extortionate credit transaction. In which case, it may be set aside by the court on the application of the liquidator.

The liquidator can challenge such transactions going back three years from the date the company goes into liquidation. The transaction is extortionate if it either:

- Requires grossly exorbitant payments to be made whether unconditionally or only in certain events in exchange for credit.
- It grossly contravenes ordinary principles of fair trading.

However, account will be taken of the risk that was taken by Easycredit plc when providing the credit. Factors such as past credit history and the urgency of the loan may be taken into account. If satisfied that it is extortionate, the court can set aside or vary the terms of the agreement.

The second issue is that the Easycredit plc money has been used to pay off the unsecured loan of £15,000 to Bob and this may be challenged by the liquidator as a preference in favour of Bob contrary to s239 IA 1986.

A preference is the doing of anything by the company (through its directors) which has the effect of putting its creditors (in this case, Bob) in a better position in the event of liquidation, than he would have been in had that thing not been done, s239 (4)(b) IA 1986.

As Bob is treated as a connected person, the relevant period during which the preference can be upset is two years before the commencement of liquidation.

The leading case is Re MC Bacon Ltd [1990] in which the court held that the company must have been motivated a desire to produce the preference result. This desire is presumed in the case of a connected person unless Bob can prove the contrary, which seems likely.

The court can make any order it thinks fit for restoring the position to what it would have been if the company had not given that preference. This would typically require the creditor (Bob) to repay the money.
Examiner's comments

This question was not very well answered. The main problems included not identifying the legal issues and not giving sufficient detail or explanation to attract the available marks. A common error was to treat the partly paid shares as an issue at a discount. Very few candidates identified the purchase of the office premises as involving a potential breach of promoters' duties. The preference point in relation to Bob was also not often included in answers. While most candidates appreciated in answers that an interest rate of 47% may amount to an extortionate credit transaction, few stated the criteria by which such transactions are judged.

4. (a) With reference to decided cases and statutory provisions, explain the circumstances when a court can make a disqualification order against a director.

(15 marks)

Suggested answer

Introduction

The disqualification of company directors is governed by the Company Directors Disqualification Act 1986 (CDDA 1986). The CDDA provides for disqualification under various grounds and in Official Receiver v Brady and Others [1999] it was held that companies, as well as individuals, could be subject to disqualification orders. A person may be disqualified by court order following a trial or a person may give the Secretary of State an undertaking that they will not act as a director.

Grounds

(i) Under ss2-5, a disqualification order may be made for general misconduct in relation to companies.

This includes disqualification following conviction of an indictable offence (s2), for persistent breaches of companies legislation (s3), for fraud, fraudulent trading or breach of duty revealed in a winding up (s4), and following a summary conviction for failing to make returns to the registrar, (s5).

Under s2, the maximum period of disqualification is 15 years and is illustrated by R v Goodman [1994] in which a director of a public company was disqualified for 10 years following his conviction for insider dealing.

Under s3, the maximum period of disqualification is 5 years and is illustrated by Re Arctic Engineering Ltd [1986]. There is a presumption that a person is in 'persistent default' if he has been convicted three times in the previous five years of failing to file, deliver or send account books or documents to the registrar as required by the legislation.

Under s4, the maximum period of disqualification is 15 years and under s5, is 5 years.

(ii) Under s6 for unfitness.

This is the most common ground for disqualifying a director. It requires a court to be satisfied that the person has been a director of an insolvent company and that his conduct makes him unfit to be concerned in the management of a company. Whether the company is insolvent is a question of fact but there is considerable uncertainty over what amounts to unfitness, but the test seems to be an objective one on a balance of probabilities. See Re Bath Glass Ltd [1988] and Re Living Images Ltd [1996]. The court is helped by a list of factors that it can take into account in Schedule 1 of the CDDA, such as breaches of duty, misuse of funds and failing to keep proper accounts, but it can take into account any factor it thinks relevant.
Under s6, the court must disqualify once it has found the director to be unfit: there is no discretion. The minimum period is 2 years and the maximum is 15 years.

The leading case is Re Sevenoaks Stationers Retail Ltd [1990] in which the court divided the disqualification period into three brackets:

- 10 years plus (for serious cases).
- 6-10 years (for serious cases not meriting the top bracket).
- 2-5 years (for not very serious cases).

(iii) *Disqualification for breach of competition law.*

(iv) *Other cases of disqualification – these include disqualification following a finding of wrongful trading (s10).*

(b) **What are the consequences of such an order being made?**

(5 marks)

**Suggested answer**

Consequences of an order:

(i) Under s1, a person whom a disqualification order has been made shall not, without leave of the court, be a director, act as a receiver of a company's property or in any way, whether directly or indirectly, be connected in the promotion, formation or management of a company. In addition, the person cannot act as an insolvency practitioner. The prohibition under the order is, therefore, much wider than just being unable to act as a director.

(ii) If a person acts in contravention of an order, he commits a criminal offence (s13) and may be jointly and severally liable for the debts of the company (s15).

(iii) Following the disqualification order, a director may apply to the court for leave to act under s17. If leave is granted, it will usually be subject to conditions, such as the appointment of an independent chartered accountant to the board as an executive director. See Re Lo-Line Electric Motors Ltd [1988] and Re Chartmore Ltd [1990].

**Examiner's comments**

This was the least popular question and produced some very mixed answers. The stronger answers gave concrete examples of disqualification with reference to the CDDA and case law. The weaker answers tended to drift away from the question required and wrote about directors’ duties. Candidates sometimes included material that was more appropriate to the other part of the question but when they did so credit was given. This question produced some very brief and superficial answers.
5. Explain what is meant by the ‘separate legal personality’ of a company. With reference to decided cases, illustrate when the courts will lift the veil of incorporation. (20 marks)

Suggested answer

From the moment mentioned in its certificate of incorporation, a company enjoys its own legal personality. A veil of incorporation is said to be drawn over the company, separating it from its members, directors and employees. This was decided in the landmark ruling of the House of Lords in *Salomon v A Salomon & Co Ltd* [1897], which established the complete separation between a company and those involved in its operation.

The consequences of the veil of incorporation and legal personality are that the company can sue and be sued, can commit crimes and torts, and the company can be an employer and employee. See *Lee v Lee’s Air Farming Ltd* [1961]. In addition, the company is said to enjoy perpetual succession and the members have no insurable interest in the company’s property. See *Macaura v Northern Assurance Co Ltd* [1925].

Another consequence of the separate legal personality of a company is that the liability of its members is usually limited to the unpaid amount, if any, on their shares.

Corporate personality and limited liability offer considerable advantages to those who choose the company as their business medium and will usually result in the company being liable for its own debts and actions rather than imposing liability on the directors and members. It can also be a powerful weapon in the hands of a person determined on fraud or defeating a legitimate claim by a creditor.

Sometimes, therefore, the corporate veil is lifted by the courts. When a court does this it is usually to make someone other than the company liable for its debts. Just when the courts will do this is discussed below, but it is important to note that it is difficult to predict when they will do so; the only principle that can be gleaned is that the courts will look at the reality of the situation. Very often the corporate veil remains firmly in place, as can be seen in the case of *Williams v Natural Life Health Foods Ltd* [1998]. In this case, a managing director of the company was held not liable for the negligent advice given by the company as he had not assumed a personal responsibility for the advice.

The court has been willing to lift the veil when the company has been used improperly, as a vehicle for fraud or as a façade concealing the true facts. The classic case to illustrate this is *Gilford Motor Co v Home* [1933]. The court refused to allow a director to compete with his previous employer in breach of contract by hiding behind the personality of a new company. Similarly in *Jones v Lipman* [1960], the vendor of a house transferred it to a new company to avoid completion and the court ordered specific performance against the company and the vendor. See also *Trustor v AB v Smallbone* [2001].

Where there is a group of companies, each company in the group is treated as a separate legal personality. If one member of the group fails, the creditors can look to that member only and not to other companies in the group. See *Re Southard Ltd* [1979]. In *Adams v Cape Industries plc* [1990], the employees of a subsidiary of Cape were injured by the subsidiary after being exposed to asbestos poisoning. The subsidiary went into liquidation and was unable to satisfy the judgement against them. It was held that the employees could not enforce the judgement against the parent, Cape.

Another category when the veil can be lifted is agency and trust. If one company is the agent of another, then that other may be liable for what it does. In *Salomon* it was argued that Salomon & Co Ltd was the agent of Mr Salomon so that Mr Salomon was personally liable for the company’s debts, but this was rejected by the House of Lords. It is, therefore, very difficult to establish an agency relationship. However, an illustration can be seen in *Re FG Films Ltd* [1954]. The court refused to declare that the company had made ‘British film’ for tax purposes.
because the finance and expertise had been provided by an American company whose President was also the major shareholder and director of the company. The company was the agent of the American company.

An illustration of a trust case is Littlewoods Stores Ltd v IRC [1969] where it was held that a subsidiary company held an asset on trust for the holding company, Littlewoods, because Littlewoods had provided the purchase price. The result was that Littlewoods could not take advantage of the separate legal personality of the subsidiary to avoid the tax consequences of ownership of the asset.

The courts will also lift the veil on public policy grounds. In Daimler v Continental Tyre & Rubber Co [1916], the House of Lords lifted the veil of a registered English company when its shareholders and directors were found to be German nationals.

The courts will also lift the veil when they are applying a statutory provision. Again, the effect of the statutory provision is usually to make someone other than the company liable for its debts. The main examples are:

(i) Section 213, 214 IA 1986. These provisions cover fraudulent and wrongful trading. If a director is found to have traded wrongly, they can be ordered to make a personal contribution to the debts of the company. The same is true of fraudulent trading, except that it is not limited to directors but applies to 'any person' who carries on the business of the company with intent to defraud creditors. See Re L Todd (Southcombe) Ltd [1990] and Re Produce Marketing Consortium Ltd [1989].

(ii) Section 15 CDDA 1986. Here, if a person acts whilst disqualified as a director, then they are jointly and severally liable with the company for its debts.

(iii) Sections 216, 217 IA 1986. If a director uses a prohibited name then they are personally liable for the debts of the company. A prohibited name is any name by which a company was known in the 12 months prior to its going into liquidation. A director of that company is prohibited from using the name for a period of five years.

(iv) Under s767 CA 2006, a director may again incur personal liability if a public company commences trading without a commencement of trading certificate.

To conclude, it is difficult to find a single guiding principle for lifting the corporate veil. One view is that all that can be said is that, unless there are compelling considerations of justice and fairness, the courts will follow the Salomon decision.

**Examiner's comments**

This was the most popular question but was, surprisingly, not always well answered. The main problem was answers not referring to the cases to support the points being made. Some candidates wrote lengthy accounts about the Salomon decision but did not say how it had been applied in later cases. However, most answers appreciated that the courts will rarely lift the corporate veil. At the top end, there were some very strong answers full of illustrations accompanied by intelligent commentary.
6. Purple Ltd has three directors, Brahms, Liszt and Williams. They are also shareholders but they do not hold a majority of the shares. They seek your advice on the legal issues arising out of the following situations which have occurred:

(a) Brahms, the finance director, caused the company to lose £10,000 by his practice of signing blank cheques and then passing them to his personal assistant, Chopin, to complete and forward to creditors. Chopin has made certain cheques payable to himself and has used the money to pay off his debts.

(b) Liszt has been given a four year fixed-term service contract.

(c) At a recent board meeting, the directors resolved not to take proceedings against Chopin to recover the £10,000 or report the matter to the police. Williams wanted to vote against the resolution but was told not to by Brahms, who has a very domineering personality.

(d) The majority shareholder has written to the company secretary, Grieg, asking him for advice on the legal position in relation to these matters. Without further reference to the board, Grieg instructed a firm of solicitors to prepare the advice at a cost of £1,000, which the board is refusing to pay.

Required

Advise the directors.

(Total: 20 marks)

Suggested answer

(a) The blank cheques

By signing blank cheques, Brahms is in breach of his duty under s174: the duty to exercise reasonable skill and care. By allowing Brahms to do this, the other directors will also be in breach of this duty. The facts are similar to the case of Dorchester Finance v Stebbing Ltd [1989]. Under s175, the directors will be expected to exercise the standard of a reasonable director in their type of company. Their individual knowledge, skill and experience may increase this standard thus reversing the previous low standard of care set out by the court in Re City Equitable Fire Assurance Co Ltd [1925].

Brahms will be liable for the losses the company has incurred as a result of the breach of this duty but, as the proper claimant, it will be for the company to commence the proceedings, Foss v Harbottle [1843].

This duty may also be ratified by the shareholders, s239 CA 2006.

(b) Liszt’s service contract

This is dealt with under s188 CA 2006. This provides that a director may not be employed for a period exceeding two years unless there is prior approval of the contract by the general meeting by passing an ordinary resolution.

Under s189, the civil consequences for breach are that the provisions of the contract are void to the extent that the two years is exceeded and the contract is deemed to contain a provision entitling the company to terminate it at any time by the giving of reasonable notice.
(c) **No legal proceedings**

The directors are under a duty to act in the way they consider would be most likely to promote the success of the company for the benefit of its members as a whole, s172 CA 2006. The duty is subjective and is owed to the company, reflecting the previous common law position in *Percival v Wright* [1902]. ‘Success’ is likely to mean the long-term financial success of the company. By failing to take proceedings against Chopin, they may be in breach of this duty. In reaching this decision, they ought to have weighed up, amongst other things, the likely consequences of any decision in the long-term, and the desirability of the company maintaining a reputation for high standards of business conduct. Clearly, the recovery of the money would benefit the company but the publicity of the proceedings and the facts may reduce the company’s reputation.

Williams may also be in breach of the duty to exercise independent judgment under s173 CA 2006. Instead of exercising his own decision and voting against the resolution, he voted in accordance with Brahms’ instructions, thus fettering his discretion. See *Fulham Football Club v Cabra Estates plc* [1994]. Failing to exercise independent judgment may also have a knock-on effect of breaching the no conflict duty in s175.

These breaches of duty can be ratified by the shareholders excluding the directors’ votes but this seems unlikely given the concerns of the majority shareholder. S239 CA 2006.

(d) **Grieg – the company secretary**

The last issue relates to the authority of the company secretary to bind the company to third party contracts. The modern secretary is an important official who, as the chief administrative officer, has ostensible authority to bind the company to contracts in the administrative side of the company’s business, such as the hiring of staff and transport. See *Panorama Developments v Fidelis Furnishing Fabrics Ltd* [1971]. Following this decision, it is still unclear to what extent the secretary can bind the company to a commercial contract, such as the purchase of goods or services which the company deals in, but it is likely to be very limited, if at all.

At common law, in order to decide whether Grieg can bind the company so that it has to pay for the legal advice that he has asked for, it would require the court to decide whether this is in the nature of an administrative contract or a commercial one. The company secretary is commonly the officer responsible for dealing with professional advisors and obtaining legal advice is likely to fall within the ambit of administration, thus binding the firm to pay for it.

The solicitors may seek to rely on s40 CA 2006. Under this provision in favour of a third party (the solicitors) dealing with the company in good faith, the power of the board of directors to bind the company or authorise others to do so shall be deemed free of any limitation under the company’s constitution. The section is largely untested and the problem they may face is that Grieg’s authority is not *limited under the constitution* – the articles, resolution and shareholders’ agreements.

The likely outcome is that the company will be liable to pay for the legal advice given on the basis that Grieg had ostensible authority to obtain it.

If the majority shareholder is not happy with the directors’ behaviour he can remove them by passing an ordinary resolution under s168 CA 2006.

*Examiner’s comments*

This was also a very popular question but produced the weakest set of answers. The main difficulty in answering this question was not identifying the legal issues raised by each part of the question. When an issue was identified, it was often the case that not enough detail or authority was given to attract the available marks. For example, in part (a), the weaker answers may have identified this as involving the duty to exercise reasonable skill and judgment by a director but
then did not discuss the ingredients of this particular duty. Simply saying that it is a breach of duty to exercise reasonable care is not enough but a good number of candidates did exactly this. It was disappointing that some candidates did not discuss the role and authority of a company secretary.

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.