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F4 ENG Study Text

Corporate and Business Law

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Paper F4 (ENG)

Corporate and business law (English)

Welcome to Emile Woolf's study text for Paper F4 *Corporate and business law (English)* which is:

- Written by tutors
- Comprehensive but concise
- In simple English
- Used around the world by Emile Woolf Colleges

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Syllabus and study guide

Aim

To develop knowledge and skills in the understanding of the general legal framework, and of specific legal areas relating to business, recognising the need to seek further specialist legal advice where necessary.

Main capabilities

On successful completion of this paper candidates should be able to:

A Identify the essential elements of the legal system, including the main sources of law

B Recognise and apply the appropriate legal rules relating to the law of obligations

C Explain and apply the law relating to employment relationships

D Distinguish between alternative forms and constitutions of business organisations

E Recognise and compare types of capital and the financing of companies

F Describe and explain how companies are managed, administered and regulated

G Recognise the legal implications relating to companies in difficulty or in crisis

H Demonstrate an understanding of governance and ethical issues relating to business.

Syllabus content

A Essential elements of the legal system

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2 Sources of law
3 Human rights

B The law of obligations

1 Formation of contract
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3 Breach of contract and remedies
4 The law of torts
5 Professional negligence

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1 Agency law
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3 Corporations and legal personality
4 Company formations

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2 Loan capital
3 Capital maintenance and dividend law

F Management, administration and regulation of companies

1 Company directors
2 Other company officers
3 Company meetings and resolutions

G Legal implications relating to companies in difficulty or in crisis

1 Insolvency

H Governance and ethical issues relating to business

1 Corporate governance
2 Fraudulent behaviour

Approach to examining the syllabus

The syllabus is assessed by a three hour paper-based examination.

The examination consists of seven 10 mark questions assessing knowledge of the law, and three 10 mark application questions.

Study Guide

This study guide provides more detailed guidance on the syllabus. You should use this as the basis of your studies.

A ESSENTIAL ELEMENTS OF THE LEGAL SYSTEM

1 Court structure

(a) Define law and distinguish types of law.
(b) Explain the structure and operation of the courts and tribunals systems.

2 Sources of law

(a) Explain what is meant by case law and precedent within the context of the hierarchy of the courts.
(b) Explain legislation and evaluate delegated legislation.
(c) Illustrate the rules and presumptions used by the courts in interpreting statutes.

3 Human rights

(a) Identify the concept of human rights as expressed in the Human Rights Act 1998.
(b) Explain the impact of human rights law on statutory interpretation.
(c) Explain the impact of human rights law on the common law.

B THE LAW OF OBLIGATIONS

1 Formation of contract

(a) Analyse the nature of a simple contract.
(b) Explain the meaning of offer and distinguish it from invitations to treat.
(c) Explain the meaning and consequence of acceptance.
(d) Explain the need for consideration.
(e) Analyse the doctrine of privity.
(f) Distinguish the presumptions relating to intention to create legal relations.

2 Content of contracts

(a) Distinguish terms from mere representations.
(b) Define the various contractual terms.
(c) Explain the effect of exclusion clauses and evaluate their control.

3 Breach of contract and remedies

(a) Explain the meaning and effect of breach of contract.
(b) Explain the rules relating to the award of damages.
(c) Analyse the equitable remedies for breach of contract.

4 The law of torts

(a) Explain the meaning of tort.
(b) Identify examples of torts including 'passing off' and negligence.
(c) Explain the duty of care and its breach.
(d) Explain the meaning of causality and remoteness of damage.
(e) Discuss defences to actions in negligence.

5 Professional negligence

(a) Explain and analyse the duty of care of accountants and auditors.

C EMPLOYMENT LAW

1 Contract of employment

(a) Distinguish between employees and the self-employed.
(b) Explain the nature of the contract of employment and give examples of the main duties placed on the parties to such a contract.

2 Dismissal and redundancy

(a) Distinguish between wrongful and unfair dismissal including constructive dismissal.
(b) Explain what is meant by redundancy.
(c) Discuss the remedies available to those who have been subject to unfair dismissal or redundancy.

D THE FORMATION AND CONSTITUTION OF BUSINESS ORGANISATIONS

1 Agency law

(a) Define the role of the agent and give examples of such relationships paying particular regard to partners and company directors.
(b) Explain how the agency relationship is established.
(c) Define the authority of the agent.
(d) Explain the potential liability of both principal and agent.

2 Partnerships

(a) Demonstrate a knowledge of the legislation governing the partnership, both unlimited and limited.
(b) Discuss how partnerships are established.
(c) Explain the authority of partners in relation to partnership activity.
(d) Analyse the liability of various partners for partnership debts.
(e) Explain the way in which partnerships can be brought to an end.

3 Corporations and legal personality

(a) Distinguish between sole traders, partnerships and companies.
(b) Explain the meaning and effect of limited liability.
(c) Analyse different types of companies, especially private and public companies.
(d) Illustrate the effect of separate personality.

(e) Recognise instances where separate personality will be ignored.

4 Company formations

(a) Explain the role and duties of company promoters.
(b) Describe the procedure for registering companies, both public and private.
(c) Describe the statutory books, records and returns that companies must keep or make.
(d) Describe the contents of model articles of association.
(e) Analyse the effect of a company's constitutional documents.
(f) Explain how articles of association can be changed.
(g) Explain the controls over names that companies may or may not use.

E CAPITAL AND THE FINANCING OF COMPANIES

1 Share capital

(a) Examine the different meanings of capital.
(b) Illustrate the difference between various classes of shares.
(c) Explain the procedure for altering class rights.

2 Loan capital

(a) Define companies' borrowing powers.
(b) Explain the meaning of debenture.
(c) Distinguish loan capital from share capital.
(d) Explain the concept of a company charge and distinguish between fixed and floating charges.
(e) Describe the need and the procedure for registering company charges.

3 Capital maintenance and dividend law

(a) Explain the doctrine of capital maintenance and capital reduction.
(b) Examine the effect of issuing shares at either a discount, or at a premium.
(c) Explain the rules governing the distribution of dividends in both private and public companies.

F MANAGEMENT, ADMINISTRATION AND REGULATION OF COMPANIES

1 Company directors

(a) Explain the role of directors in the operation of a company.
(b) Discuss the ways in which directors are appointed, can lose their office or be subject to a disqualification order.
(c) Distinguish between the powers of the board of directors, the managing director and individual directors to bind their company.
(d) Explain the duties that directors owe to their companies.
(e) Demonstrate an understanding of the way in which statute law has attempted to control directors.

2 Other company officers

(a) Discuss the appointment procedure relating to, and the duties and powers of, a company secretary.
(b) Discuss the appointment procedure relating to, and the duties and powers of company auditors.

3 Company meetings and resolutions

(a) Distinguish between types of meetings: ordinary and extraordinary general meetings and class meetings.
(b) Explain the procedure for calling such meetings.
(c) Detail the procedure for conducting company meetings.
(d) Distinguish between types of resolutions: ordinary, special and written.

G LEGAL IMPLICATIONS RELATING TO COMPANIES IN DIFFICULTY OR IN CRISIS

1 Insolvency

(a) Explain the meaning of and procedure involved in voluntary liquidation.
(b) Explain the meaning of and procedure involved in compulsory liquidation.
(c) Explain administration as an alternative to winding up.

H GOVERNANCE AND ETHICAL ISSUES RELATING TO BUSINESS

1 Corporate governance

(a) Explain the idea of corporate governance.
(b) Recognise the extra-legal codes of corporate governance.
(c) Identify and explain the legal regulation of corporate governance.

2 Fraudulent behaviour

(a) Recognise the nature and legal control over insider dealing.
(b) Recognise the nature and legal control over money laundering.
(c) Discuss potential criminal activity in the operation, management and winding up of companies.
(d) Distinguish between fraudulent and wrongful trading.

EXAMINABLE DOCUMENTS

Knowledge of new examinable regulations and legislation issued by 30 September will be examinable in examination sessions being held in the following calendar year.

Documents may be examinable even if the effective date is in the future. This means that all regulations and legislation issued by 30 September 2008 will be examinable in the June and December 2009 examinations.

The study guide offers more detailed guidance on the depth and level at which the examinable documents will be examined. The study guide should be read in conjunction with the examinable documents list.

Note on case law

Candidates should support their answers with analysis referring to cases or examples. There is no need to detail the facts of the case. Remember, it is the point of law that the case establishes that is important, although knowing the facts of cases can be helpful as sometimes questions include scenarios based on well-known cases.

English legal system

Knowledge of the Human Rights Act 1998 and the Constitutional Reform Act 2005 is required.

The law of obligations

Knowledge of the Unfair Contract Terms Act 1977, the Unfair Terms in Consumer Contracts Regulations 1999, and the Contracts (Rights of Third Parties) Act 1999 is required.

Employment law

Knowledge of the Employment Rights Act 1996 and the Employment Tribunals (Constitution and Rules of Procedure) Regulations 2004 is required.

Partnership law

Knowledge will be required of the Partnership Act 1890, the Limited Partnerships Act 1907, the Limited Liability Partnerships Act 2000, and the Civil Liability Act 1978.

Company law

Knowledge of the Companies Act 2006 is required. Knowledge is also required of the Business Names Act 1985, the Company Directors Disqualification Act 1986, the Insolvency Act 1986, and the Financial Services and Markets Act 2000.

Governance and ethical issues

Knowledge of the Combined Code on Corporate Governance is required.

Knowledge of the Criminal Justice Act 1993 in relation to insider dealing, and the Proceeds of Crime Act 2002, the Prevention of Terrorism Act 2005 and the Money Laundering Regulations 2007 in relation to money laundering, is required.

CHAPTER

1

The English legal system

Contents

Sources of English law

- Introduction to business and corporate law
- Where does the law come from?
- Introduction to case law (common law)
- When is case law applied?
- Introduction to legislation (statute law)
- Criminal law and civil law
- Identification of cases

1 Sources of English law

1.1 Introduction to business and corporate law

The law is the formal system of rules and regulations about how individuals and other legal persons should behave. As accountants, you need to be aware of the law relating to business. You do not need to be an expert in the law, but you need a knowledge and understanding of the main aspects of business and corporate law.

These include:

- the law relating to contracts
- the law of agency
- the law relating to companies (corporate law) and business partnerships
- employment law.

1.2 Where does the law come from?

Before going into the detail of different aspects of business and corporate law, it is important to understand where the law comes from and how it is established.

Some countries have a comprehensive set of formal laws which are contained in a number of legal codes. England, however, does not have a codified legal system.

There are three main sources of English law:

- case law, also called common law
- legislation, also called statute law
- the European Union.

The effect of the European Union on English law will be explained in more detail later.

It is possible that local custom and practice may provide a source of law, so that the law is based on the rules that have been practised for very many years. However, although custom may occasionally be the source of an existing law, it is most unlikely to provide a source of new law ('contemporary law'). New laws originate from legislation, the European Union or case law.

1.3 Introduction to case law (common law)

Case law, or common law, is law that is established by judicial decisions in the English courts. Some decisions made by a court are binding and similar subsequent legal cases should be decided on the basis of the law established in the earlier case. This is the **doctrine of precedence**: subsequent legal cases are decided by a similar case that has preceded it.

This doctrine is explained in more detail later.

Common law in England has its origins in the Middle Ages, after the Norman Conquest. A unified system of law for the whole country was established by judges who travelled the country. A decision made by a judge in one part of the country was applied across the entire country, which is how the doctrine of precedence began. Legal decisions became more predictable, because they were based on the common law. (Common law replaced differing local customs and practices.)

Decisions made in accordance with common law could sometimes be unfair. Another system of law was therefore established, called 'equity'. When a person believes that he would suffer an injustice if the common law is applied in his case, he might apply to a court for the case to be decided what is fair and reasonable (equitable).

Cases might therefore be decided on the basis of equity rather than the common law.

However, for the purpose of your examination, it is sufficient to understand that case law is one way in which the law is established.

1.4 When is case law applied?

Case law cannot be applied until there has been a legal case in the courts that establishes a precedent for subsequent cases. Once a precedent has been established, it can be applied to all subsequent legal disputes, even if these do not come to court. The parties to a dispute may be advised by their solicitors what the outcome would be if the matter did go to court, and to save time and money the case might therefore be settled out of court.

Case law might establish a precedent in two types of situation:

- when there is no legislation relating to the matter in dispute: in business law, for example, many aspects of contract law are not covered by legislation
- when the courts interpret legislation, when there is disagreement about how the legislation should be applied in the case. Decisions by a court can interpret the legislation, but cannot overrule it or overturn it.

1.5 Introduction to legislation (statute law)

Legislation in England, also known as statute law, consists of:

- **primary legislation**, which takes the form of **Acts of Parliament**, and
- **secondary legislation**, which is usually called **delegated legislation**.

New legislation may replace the common law that existed before, or may replace earlier legislation.

1.6 Criminal law and civil law

There is an important difference between criminal law and civil law. However, criminal law and civil law are both established by case law and legislation.

The **criminal law** establishes crimes against the state. A crime is behaviour that is prohibited by law, and the state takes legal action against offenders. There are thousands of criminal offences in England, from relatively minor offences such as using a mobile phone whilst driving a car to more serious offences such as murder and theft. Typically, a criminal case is brought to court after an investigation by the police. The police make a report to the Crown Prosecution Service (CPS) which then makes a decision about whether or not to prosecute.

- For criminal cases, there is trial by jury. (However, there may be an appeal and the appeal will be heard by one or more judges without a jury.)
- The courts have a range of different punishments that they might apply to any person found guilty of a crime. For business crime, punishments might be imprisonment, a fine (payable to the state) or both a fine and imprisonment.
- The 'burden of proof' is greater in a criminal case than in a civil case. In a criminal case, the accused must be found guilty 'beyond reasonable doubt'. In civil cases, decisions are reached 'on the balance of probabilities'. This means that it is more difficult to find a person guilty in a criminal court than it is to find the same person liable in a civil court for a similar or related offence.

The **civil law** applies to legal disputes between individuals who have dealings with each other. Contract law and company law are mainly civil law. In a civil dispute, one person brings a case against another person, and asks the court for a remedy or for compensation. The person bringing the case is called the plaintiff, and the person accused of wrongdoing is called the defendant.

- Civil cases are heard by a judge (there is no jury).
- If the court rules in favour of the plaintiff, it will specify a remedy that is appropriate in the circumstances. The remedy may include or consist of the payment of compensation (or 'damages') by the defendant to the plaintiff.

1.7 Identification of cases

Individual cases will be referred to in this text in three ways.

- In a criminal case, the case concerns a prosecution brought by the Crown (Regina or Rex) against the accused person. Criminal cases are therefore identified as 'Regina or Rex versus the accused person' – for example *R v Smith*.

- A civil case is identified as the plaintiff versus the defendant, possibly with the year in which the case is heard in the court. For example, *Wilkins v Peabody [2009]*.
- Sometimes a civil case might be identified using the word 'Re' which means 'concerning the affairs of' or 'relating to'. For example: *Re Brown [2009]*.

The court structure

- Hierarchy of courts: courts of first instance and courts of appeal
- The hierarchy of civil courts
- The hierarchy of criminal courts
- The Supreme Court of the United Kingdom (and the House of Lords)
- Tribunals: employment tribunals

2 The court structure

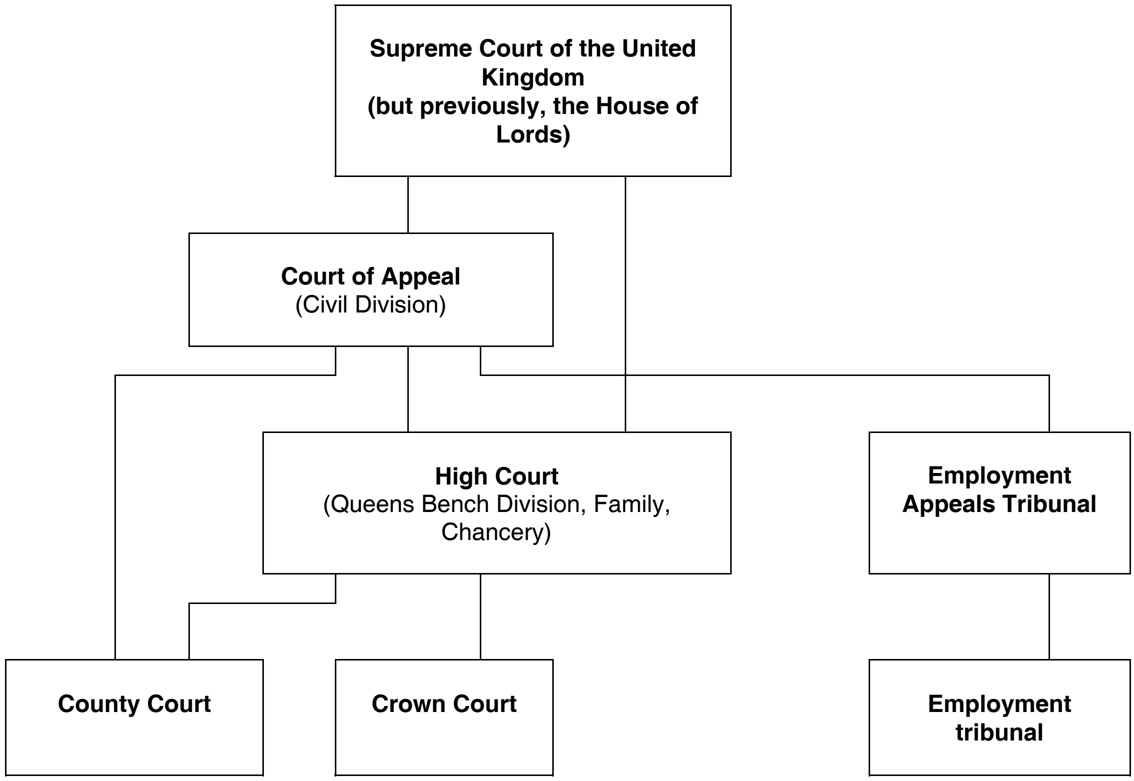
2.1 Hierarchy of courts: courts of first instance and courts of appeal

The system of courts for criminal law is different from the court system for civil law. However, both the criminal law and civil law court systems are hierarchical systems, with lower courts and higher courts.

- Court cases are heard initially ('in the first instance') in a lower court.
- A person may be able to appeal against a decision in a particular case. Appeals are made to a higher court.
- Similarly, a person may be able to appeal against a decision in an appeal court. This appeal will be heard in an even higher court.
- The highest court of appeal, for both criminal and civil cases, used to be the Appeal Court of the House of Lords. The judicial authority of the House of Lords was transferred to a new Supreme Court of the United Kingdom by the Constitutional Reform Act 2005.
- However, appeals in matters concerning European Union legislation may be referred to the European Court of Justice or the European Court of Human Rights.
- Some civil cases are dealt with in the first instance, not in a court of law, but by a tribunal. Tribunals may be used to deal with matters relating to specific areas of the law. The most significant tribunals are Employment Tribunals, which deal with many disputes relating to employment law. There is a system for appealing against decisions of a tribunal.

2.2 The hierarchy of civil courts

The hierarchy of civil courts is summarised in the following diagram. (The role of the European Court of Justice and the European Court of Human Rights will be explained in a later section.)



Most civil cases in the first instance are heard in a County Court, although magistrates' courts have some civil jurisdiction, especially for dealing with family-related matters under the Children Act 1989. County courts have a District Judge and deal mainly with small claims and 'fast track' cases

The High Court consists of three divisions, and each division deals with different types of civil case. They deal in the first instance with major cases, and they also hear appeals from County Courts and Crown Courts.

- Disputes relating to contract law and tort are dealt with by the Queens Bench Division.
- Disputes relating to company law and partnership law, and cases relating to land, mortgages, probate (wills) and bankruptcy are dealt with by Chancery.
- The Family Division hears cases relating to family- and children-related matters, including appeals against decisions by magistrates courts and County Courts

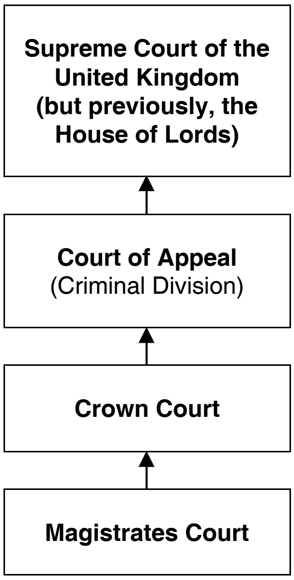
The Employment Appeals Tribunal hears appeals against decisions by an Employment Tribunal.

The Court of Appeal (Civil Division) hears appeals from the lower courts, including the Employment Appeals Tribunal. The court sually has three judges, whose decision is by majority.

There is a final court of appeal which hears appeals against decisions in the Court of Appeals and (in some cases) the High Court. The final court of appeal used to be the Appeal Court of the House of Lords, but it is now the Supreme Court of the United Kingdom, following the introduction of the Constitutional Reform Act 2005.

2.3 The hierarchy of criminal courts

The hierarchy of criminal courts is summarised in the following diagram.



Magistrates Courts try minor criminal offences, known as 'summary offences'.

Most serious criminal cases ('indictable offences') are tried in the first instance in a Crown Court with trial by jury. (For example, the Old Bailey is a Crown Court.).

There are some 'either way' offences, where the defendant has the choice of having the case dealt with in a magistrate's court or trial by jury in a Crown Court.

Appeals are to the Criminal Division of the Court of Appeal, and a further appeal may be allowed to the Supreme Court.

2.4 The Supreme Court of the United Kingdom (and the House of Lords)

The Supreme Court can be seen as a supreme court for the civil and criminal court systems in England, because it is the highest court of appeal.

However, decisions by the Supreme Court are subject to:

- decisions by the European Court of Justice, with regard to matters relating to European Union law, and
- decisions of the European Court of Human Rights, with regard to matters relating to human rights (following the introduction of the Human Rights Act 1998).

As stated earlier, the final court of appeal used to be the Appeal Court of the House of Lords, consisting in total of 12 'Lords of Appeal in Ordinary'. These were both judges and also members of the House of Lords. The judges appointed to deal with an appeal case would be drawn from these 12 Lords of Appeal.

Constitutional Reform Act 2005

The system was changed by the Constitutional Reform Act 2005. This transferred the 'appellate jurisdiction' of the House of Lords to a new Supreme Court of the United Kingdom, consisting of 12 Supreme Court Justices and led by a President and Deputy President. The Supreme Court is now the final court of appeal.

The main reason for this constitutional change were:

- to make a clear division between the legislative authority (the Houses of Parliament) and the judicial authority in the UK constitution. Previously the Lords of Appeal were both members of the House of Lords and senior members of the judiciary in England and Wales
- to change the method of appointing judges to the final court of appeal. The 2005 Act introduced a new system for the appointment of judges to the Supreme Court, although the first 12 judges appointed to the Supreme Court were the 12 existing Lords of Appeal in Ordinary. Appointments of new Supreme Court Justices are now the responsibility of a Judicial Appointments Commission.

2.5 Tribunals: employment tribunals

Because of the specialist nature of some areas of English law, and to speed up the administration of the law, a number of specialist tribunals are used to deal with specific types of legal dispute.

A tribunal is a body that is appointed to adjudicate on a matter. In England, tribunals usually consist of three individuals. One is a legally-qualified person and the other two do not have a legal background.

Tribunals deal with matters such as social security, race relations, immigration and employment. Typically, tribunals deal with disputes involving individuals and the State bureaucracy or machinery of government. However, some tribunals consider disputes between private parties – for example, employment tribunals consider disputes between employees (or former employees) and employers.

Employment tribunals

The most important type of tribunal for the purpose of your examination is the employment tribunal, which deals with disputes relating to employment law such as:

- complaints about unfair dismissal
- equal pay disputes
- claims relating to discrimination at work on the grounds of sex, race, disability and age
- health and safety issues
- disputes over trade union membership.

It can be argued that employment tribunals are a form of court, and are a part of the court system. In the UK for example:

- cases involving certain employment disputes, such as claims for unfair or wrongful dismissal, are heard by an Employment Tribunal
- appeals against a decision of an Employment Tribunal are referred to an Employment Appeal Tribunal
- appeals against a decision of the Employment Appeal Tribunal are referred to a Court of Appeal (Civil Division) which considers appeals that are referred from the lower civil courts (and which is the highest court of appeal in the civil court system below the House of Lords).

Although tribunals might be considered a part of the court system, they deal with cases differently from the normal civil courts:

- **Speed**. Cases brought before a tribunal are dealt with much more quickly than civil cases dealt with by the court system.
- **Cost**. Tribunals are much less expensive. Individuals do not require legal representation and tribunals do not need a court building to hear cases.
- **Informality and flexibility**. Proceedings in tribunal cases are much more informal than cases heard in court, and can be much more flexible.
- **Expertise**. The tribunal members together have extensive expertise in dealing with cases and knowledge of their specialist area.
- **Privacy**. Cases are heard in private, and unwelcome publicity is avoided.
- **Accessibility**. It is usually easier for individuals to obtain a hearing before a tribunal than it is to bring a case to court.

Case law and precedent

- Precedent and the doctrine of binding precedent
- How is a binding precedent established?
- Persuasive precedent
- How can binding precedents be altered or avoided?
- Situations when a court is not bound by its own previous decisions
- Advantages and disadvantages of binding precedent

3 Case law and precedent

3.1 Precedent and the doctrine of binding precedent

Case law (or common law) is the law that is created by decisions in cases that have been heard in court. Common law is applied:

- when there is no statute law dealing with this part of the law, or
- when statute law exists, but there is disagreement about what the statute law means: a court may be required to interpret the statute law.

The doctrine of binding precedent is essential to common law. The doctrine of binding precedent means that when a court has to make a decision in a case, it should base the decision on what has been decided in earlier cases. If courts follow the decisions in previous cases, the law will be applied consistently throughout the country.

Case law and precedent operate within the hierarchical structure of the court system.

- The decision of a higher court is binding on courts that are lower in the hierarchical structure.
- A precedent established in one court can be overturned at a future date, but only by a higher court.

Example

A judicial precedent might be established by the Court of Appeal. In similar cases in the future, the High Court and Crown Courts will be bound to follow this precedent and make similar decisions. However, the precedent set by the Court of Appeal might be overturned by a decision by the Supreme Court (or, previously, by the House of Lords).

Definitions: precedent and the doctrine of binding precedent

Precedent and the doctrine of binding precedent can therefore be defined as follows.

- A **precedent** is a legal principle established by one court's decision that other courts must follow in deciding on similar cases in the future. A precedent must be established by a court of sufficient seniority in the hierarchy: courts of first instance (at the lowest level in the hierarchy) are not allowed to issue binding precedents.
- The **doctrine of judicial precedent** or **doctrine of binding precedent** is that a judge presiding over a court case must apply the principles established by precedent to the facts of the case, provided that the circumstances of the case are the same. The decision in the subsequent case should therefore be the same as in the case in which the precedent was set. However, where the circumstances of a subsequent case are different, the judge in the subsequent case may reach a different decision that creates yet another precedent.

As the world changes, new legal disputes arise where the law has not yet been established by judicial precedent. In the absence of statute law, any such new dispute may require a new judicial opinion and a new precedent. In this way, case law can keep pace with progress in human affairs and social change.

3.2 How is a binding precedent established?

A precedent is established in the following circumstances.

- The judicial decision that creates a precedent must be based on a proposition of law or principle of law. A precedent cannot be based simply on a question of fact. It is not the actual decision in a particular case that creates the precedent: the **precedent is established by a principle of law** or proposition of law
- This proposition or principle of law must have been used by the judge in reaching his decision in the particular case. The reason for reaching a decision in a particular way is called the **'ratio decidendi'**. This is Latin for: 'the reasoning behind the decision'.
- A judicial decision may also include a statement of law that was not a part of the *ratio decidendi* in the case. Any such statement of the law is irrelevant to the decision and such statements are sometimes called **'obiter dicta',** which means 'said by the way'. Statements of the law that are *obiter dicta* do not form part of the binding precedent. However, they may be treated as a **persuasive authority** and taken into consideration by judges in later cases.

Applying the doctrine of precedent in practice

There are comprehensive law reports on decisions in earlier cases, and judges should refer to these and look for a similar case that sets a precedent.

- If a precedent is discovered that was set by a court of equal or higher status, the judge dealing with the current case should normally follow this precedent.
- There are rules for establishing the legal principle from the details of an earlier case, and applying the principle to the facts of the current case. The legal principle must form part of the judge's *ratio decidendi*.

- The judge will have to decide which statements by the judge in any previous case set a precedent (which legal principles are *ratio decidendi*) and whether these are relevant to the current case. If they are, the precedent is binding on the decision in the current case.
- The judge will also have to decide whether a judge in a previous case has provided *obiter dicta*, which might be persuasive in the current case, although not binding.
- The facts in the case must be materially the same as in the case that is used as the precedent. If a judge decides that the material facts in a later case are different, he or she can 'avoid' (ignore) the precedent set by the earlier case in reaching a decision.

A precedent established by a lower court does not necessarily have to be applied by a higher court, although in practice it is unusual for a higher court to overrule the precedent set by a lower court, if the precedent is long-established.

In some cases, a dispute may come to court because the lawyers for the parties involved in the dispute have found different cases which they consider relevant to the current dispute, and each of the previous cases might establish a different precedent. The court case might then be fought mainly on the issue of which of the previous cases (if any) set a binding precedent for the current dispute. It will then be for the judge to decide, having heard in court the arguments of both sides.

3.3 Persuasive precedent

Persuasive precedent, also called persuasive authority, is a precedent that is not binding but which may nevertheless be applied in a current case because the precedent has involved the application of legal principles and reasoning that the judge considers both relevant and appropriate.

There are several possible sources of persuasive precedent:

- Obiter dicta. These have already been explained.
- A previous precedent from a lower court. A precedent that has been established in a lower court is not binding on a higher court. However, the higher court may accept the precedent if the judge believes that correct legal principles and reasoning were applied by the judge in the lower court. It would be unusual for a higher court to reject a long-established precedent that was originally established in a lower court and that has since gained acceptance.
- A previous decision by a 'horizontal court' – a court at the same level in the hierarchical structure of the court system.
- In some instances, persuasive authority may be provided by a previous decision in a foreign court.

3.4 How can binding precedents be altered or avoided?

Precedents can sometimes be altered or avoided by judges. A 'binding' precedent can be altered or avoided in the following ways:

- Reversing the decision of a lower court

- Overruling a precedent
- Making a distinction between cases.

Reversing the decision of a lower court

A higher court might hear a case on appeal, and reverse the decision of the lower court **in the same case**. Its reason might be that although the higher court agrees with the *ratio decidendi* used by the lower court, it takes the view that the lower court has applied the principle incorrectly. In other words, the higher court agrees with the precedent but believes that the lower court has made a mistake in its application.

Overruling a precedent

A precedent established by a lower court can be overruled by a higher court. The higher court sets aside the decision of the lower court, and the precedent ceases to apply.

Courts at the same level are usually bound by precedents set previously by a court at the same level, and so a precedent is normally overruled only by a higher court. A notable exception, however, has been the House of Lords, when it was the final court of appeal. Since 1966 it became possible for the House of Lords to overrule its own precedents. The same now applies to the Supreme Court.

Precedents usually increase in authority with time, the longer they have been established. Courts become increasingly reluctant to overrule established precedents, even if they no longer reflect the reality of current-day practices.

Another reason why a court might be reluctant to overrule an established precedent is that the decision to overrule a precedent applies retrospectively to all previous cases. This could have implications for legal agreements that have been established, such as financial arrangements, on the basis of what was understood to be the law.

Making a distinction between cases ('distinguishing')

A judge may avoid a precedent by identifying facts in the current case that make it different from a previous case. If the facts are sufficiently different, the judge in the current case does not have to follow the precedent of the previous case. Judges who do not wish to apply a precedent in a particular case may therefore try to identify distinguishing features in the case, and use these to justify a decision that ignores the precedent.

Distinguishing is the main method used by judges to avoid precedents.

3.5 Situations when a court is not bound by its own previous decisions

A court, such as the Court of Appeal, is usually bound by precedents that it has established itself. However, there are three exceptions to this rule, which were stated in the ruling in the case of *Young v Bristol Aeroplane Co Ltd* [1944]. A court is not bound to follow previous decisions of its own in the following situations.

- When the court has made two conflicting decisions in the past, it must decide which of the two conflicting decisions it will follow. It canot follow both of them.
- The court must refuse to follow a previous decision that it has made if, in its opinion, the decision would be overturned on appeal to the House of Lords (even though a higher court has not yet overruled the precedent).
- The court is not bound to follow a previous decision it has made if it is satisfied that the previous decision was made *per incuriam*, which means 'through lack of care'. The court might have made a previous decision without its attention having been drawn to a statute or earlier legal decisions (precedents) that might have affected its decision.

As stated earlier, the Supreme Court considers itself free to depart from its own precedents when it considers that this is the proper thing to do. However, it will not do this regularly or easily, and the House of Lords did so on only a few occasions in the past, when it was the final court of appeal.

3.6 Advantages and disadvantages of binding precedent

There are several advantages in a system of law based on binding precedent.

- **Efficiency**. It can **save time and expense**. If a case goes to court, the existence of a precedent means that the legal arguments do not have to be repeated in the current case, because they are already established.
- **Certainty**. Lawyers and their clients should be able to predict what the outcome will be if their case goes to court. When a new legal dispute arises, time can be saved by considering how the court is likely to make its decision based on the relevant precedent. This may persuade one party to the dispute to reach an out-of-court settlement.
- **Consistency in the law**. Another important advantage of precedent and case law is that judicial decisions should be consistent in all cases of a similar nature, because judges are required to treat similar cases in the same way, as established by the precedent. **Consistency in judicial decisions** is an important characteristic of a good system of law, because individuals and organisations who become involved in legal disputes can often know what to expect if they take their dispute to court. (They may dispute the facts of the case, but the legal principles should be well-established.)
- **Flexibility in the law**. Judges are able to interpret the existing law, including statute law, by **creating new precedents**. This gives some flexibility to the law, because judges are able to develop new law without the need for new legislation by statute.

There are also some **disadvantages** with binding precedent and case law.

- The **large number of precedents**. There is a large number of reported legal cases that can be cited as precedents in a current case. Lawyers can therefore argue about which precedents should apply in a particular case. When there is uncertainty about which precedents should apply, there will be uncertainty about the outcome of the legal dispute. This is a weakness in the law.

- **Unjust precedents**. In some cases, a precedent might be unfair or unjust. Unless the precedent is overruled by a higher court, unfair decisions will be continued in future cases. The law is weakened when it is seen to be unfair.
- **The judiciary makes the law**. Although judges are interpreting the law when they create new precedents, they are also in effect making new law. It could be argued that the judiciary should not make new law, but should do no more than interpret the established law.

Statute law

- Statute law in England
- Primary legislation: Acts of Parliament
- Delegated legislation (secondary legislation)
- Advantages and disadvantages of delegated legislation
- The courts and delegated legislation
- The courts and interpretation of statutes

4 Statute law

4.1 Statute law in England

Statue law is law that is made by a legislative body. In England, statute law consists of:

- **primary legislation**, which takes the form of **Acts of Parliament**
- **secondary legislation** which is also called **delegated legislation**.

In England, there is a doctrine of Parliamentary sovereignty, and statute law overrides common law. In other words, when a new statute is introduced into law ('enacted') it replaces and overrides any existing case law precedent that is inconsistent with the new statute.

4.2 Primary legislation: Acts of Parliament

Statute law is created through primary legislation by means of an Act of Parliament. Both the House of Commons and the House of Lords debate and vote on proposed new statutes (Bills). However, the ultimate power rests with the House of Commons.

- New Bills are introduced into Parliament in the House of Commons.
- Bills are also referred to the House of Lords. The House of Lords has the power to 'block' a Bill and vote against it, and might suggest amendments to a Bill. However, the blocking power of the House of Lords is limited, and the House of Commons can force through new legislation in spite of opposition by the House of Lords.
  - A 'Money Bill', which is a Bill containing only financial provisions (such as a Finance Bill) can be made an Act of Parliament by the House of Commons, without the approval of the House of Lords, after a delay of one month.
  - Any other Bill can be made an Act of Parliament by the House of Commons, without the approval of the House of Lords, after a delay of one year.

If the Lords oppose a Bill, they might try to persuade members of the House of Commons to change their mind. If the government (House of Commons) is determined to enact new legislation, it should be able to succeed in doing so, although perhaps with some delay.

The House of Commons enacts a new law into being through the following process:

- *First reading*. This involves the publication and introduction of the law to the House of Commons.
- *Second reading*. This provides the opportunity for a general debate in the House of Commons on the merits of the legislation.
- *Committee stage*. The Bill is considered by a committee of MPs. They will generally represent all parties and include some MPs with a special knowledge or interest in the area.
- *Report stage*. The bill, as amended by the committee, is brought back to the House of Commons for review and a third reading.
- *Royal Assent*: following the third reading in the Commons, the Bill receives the Royal Assent.
- Once the Bill has received the Royal Assent it becomes an Act and comes into force on a predetermined day. With many Acts of Parliament, the implementation of the Act is made using one or more statutory instruments.

Reasons for Acts of Parliament

Acts of Parliament might be enacted for one or more of the following reasons.

- To create new laws, where no law had previously existed.
- To revise or replace existing statute law or common law.
- To incorporate aspects of common law into statute law. For example, the Companies Act 2006 includes statutory duties of directors of companies: these are similar to and give statutory expression to the common law rules about directors' legal duties to their company.
- To combine different statutes into a single piece of 'consolidating legislation'.

4.3 Delegated legislation (secondary legislation)

Delegated legislation is used extensively to introduce new statute law. In general terms, delegated legislation is statute law made by a person or a body to which Parliament has delegated the power to make law.

An Act of Parliament (primary legislation) might give Parliament the right to delegate law-making powers in relation to the specific aspects of the law covered by that Act. Delegated legislation therefore originates from primary legislation.

- Delegated legislation, if introduced properly, has the same force of law as primary legislation.
- However, the person or body with the delegated powers must not exceed those powers. Legislation that is introduced outside these proper delegated powers can be challenged in court and declared invalid by the court.

Why is delegated legislation necessary?

Delegated legislation can be a convenient way of introducing new statute law. Many new laws are complex and it is difficult to get all the details into an Act of Parliament without the risk of omitting something or getting something wrong.

By delegating powers to make secondary legislation, Parliament can hand over the task of specifying the law in detail to experts who know more about the issues involved than the Members of Parliament. Parliament debates and approves the broader principles, and leaves much of the detail to someone else.

Different forms of delegated legislation

Delegated legislation can take several different forms:

- Statutory instruments
- Orders in Council
- Bye-laws
- Court Rule Committees
- Professional regulations.

Bye-laws are local statute law introduced by local authorities. The power to make bye-laws for their particular area of the country is delegated to local authorities under the terms of the Local Government Act 1972.

Court Rule Committees are committees with powers to introduce laws relating to the procedures in courts of law. Powers are delegated to the Committees under the terms of the Supreme Court Act 1981, the County Courts Act 1984 and the Magistrates Courts Act 1980.

The **power to issue regulations for a professional body** might be given the status of statute law. The Law Society has the power to issue regulations to practising solicitors under the terms of the Solicitors Act.

By far the most important type of delegated legislation is statutory instruments.

Statutory instruments and Orders in Council

When a new Act of Parliament is enacted, it may include a provision to delegate to a government minister the power to introduce more detailed regulations. These detailed regulations are issued as **statutory instruments** (SIs).

- The content of a statutory instrument might then be included in the Act itself. For example, the Directors Remuneration Report Regulations 2002 were introduced by statutory instrument, and included in the Companies Act 1985.
- On the other hand, statutory instruments might simply stand on their own, and not be incorporated into the Act of Parliament itself. For example, a large number of statutory instruments were used to introduce the detailed legislation for the Financial Services and Markets Act 2000.

As statute law becomes ever more complex, we should expect the use of statutory instruments to increase as a method of introducing the detailed laws and regulations.

Orders in Council might also be used by the government (through the Privy Council) to introduce statute law without the need to go through the Parliamentary process of passing an Act of Parliament. The government might use Orders in Council for delegated legislation when using a statutory instrument is inappropriate.

4.4 Advantages and disadvantages of delegated legislation

Using delegated legislation has several advantages.

- **Ability to use experts** to help with designing the detailed regulations and inputting technical language in the wording of the regulations. Many Acts of Parliament deal with complex issues, and Members of Parliament might not have the knowledge and expertise to understand all the 'technical' aspects of the proposed new law. By delegating power to a government minister to introduce detailed regulations by statutory instrument, the advice of experts can be used. By using experts, the government should be able to make the new regulations 'better'.
- Similarly, delegating to local authorities the power to make bye-laws can be sensible, since local government representatives will know much more about conditions in their local area.
- **Efficiency**. Delegated legislation allows new regulations to be introduced quickly, and regulations to be amended quickly if they turn out to be inappropriate or ineffective, or in response to unforeseen circumstances or changes in conditions.
- **Flexibility**. A government minister who is given delegated powers is able to react quickly to any new problems (in relation to an aspect of the legislation) when it arises, without having to ask Parliament for additional powers to deal with the matter.
- **Saving time in Parliament**. Delegating powers through an Act of Parliament can save valuable legislative time in Parliament. Parliament is able to debate the broad principles and general nature of a new Bill, without getting stuck in debates about matters of excessive detail. The time required for Parliamentary 'scrutiny' of a statutory instrument is at most about two hours, and can be much less.

However, using delegated legislation also has some important disadvantages.

- **Volume of delegated legislation**. Delegated legislation has been used so much that there is now a very large amount of it in force. It is difficult – if not impossible – for individuals to keep track of all the regulations. It can therefore be argued that delegated legislation has been used excessively.
- **Accountability for the regulations**. Parliament, and the government in particular, is accountable to the voting public for the legislation that it introduces through Acts of Parliament. With delegated legislation, and statutory instruments in particular, there is no direct accountability for the government minister and the civil servants working in his or her department. It can be argued that power without accountability in a democracy is undesirable because it is undemocratic.
- There is a view that statutory instruments are now used too much and that primary legislation lacks sufficient detail, with the effect that law-making

authority is removed from Parliament and given to the government (which has the authority to introduce the delegated legislation)

4.5 The courts and delegated legislation

Delegated legislation, if it is introduced properly, has the same legal force as an Act of Parliament. The courts cannot challenge valid legislation, because statute law is superior to common law.

However, a court may challenge the validity of delegated legislation on the grounds that the person who introduced it exceeded his proper powers, or failed to follow the correct procedures when introducing the legislation. A challenge in the court to an item of delegated legislation on the grounds that it is **ultra vires** (outside the proper powers of the person making the legislation) is carried out using a process called **judicial review**.

The courts, delegated legislation and the Human Rights Act 1998

The Human Rights Act 1998 (HRA) contains a provision relating to the power of the courts to challenge statute law.

- The Human Rights Act states that the courts do not have the power to declare primary legislation (an Act of Parliament) invalid on the grounds that the Act is incompatible with the HRA.
- However, a court may issue a declaration of incompatibility, which states that a particular part of an Act of Parliament is incompatible with the Human Rights Act. It is then up to the government and Parliament to decide whether the failings of the Act of Parliament should be remedied by new legislation.
- The Human Rights Act does state, however, that the courts can declare secondary legislation invalid on the grounds that it is incompatible with the HRA.

C

Case: Wilson v First County Trust [2000]

This case involved a dispute between Ms Wilson and a pawnbroker. Ms Wilson applied to the court for a financial agreement with the pawnbroker to be declared unenforceable under the terms of the Consumer Credit Act 1974 (for reasons that we need not go into) and the court agreed. The pawnbroker challenged the court's decision on the grounds that it was an infringement of his rights under the European Convention of Human Rights and was incompatible with his rights as a creditor under the Human Rights Act.

The case went to the House of Lords, which ruled that the Human Rights Act could not be used by the courts to overrule primary legislation (the Consumer Credit Act). However, the House of Lords issued a statement of incompatibility, declaring that a part of the 1974 Act was incompatible with the HRA.

C **Case: Bellinger v Bellinger [2003]**

In 2003, the House of Lords heard a case involving a woman who was a transsexual. In 1981 the woman had been through a marriage ceremony with her husband, and she was now petitioning the court for the ceremony to be recognised as being legal. The House of Lords found that the marriage ceremony was not legal because English law did not recognise any change of gender.

However, it issued a statement of incompatibility, which stated that certain aspects of the Matrimonial Causes Act 1973 were incompatible with the Human Rights Act. The government subsequently introduced new legislation, the Gender Recognition Act 2004, but this did not apply retrospectively (so the woman failed with her petition).

4.6 The courts and interpretation of statutes

In addition to having the power to declare delegated legislation invalid, the courts are also able to interpret statue law, whenever there is some ambiguity or uncertainty about the law. For example, there may be a dispute between two parties, each arguing that a particular section in an Act of Parliament means something different. The parties may take the dispute to court, and it is then up to the court to decide what the statute actually means and how it should be interpreted.

By interpreting statutes, the courts create new case law. When they interpret legislation, the courts make use of three rules:

- the literal rule: this is the main rule that the courts use
- the golden rule
- the mischief rule.

The literal rule

The literal rule is that the court must consider what the legislation literally says, not what the law might have been intended to mean. 'The intention of Parliament is not to be judged by what is in its mind, but by the expression of that mind in the statute itself.'

When it uses the literal rule, the court should interpret words and phrases in their normal everyday meaning.

However, there are occasions when application of the literal rule produces some absurd legal decisions, and a weakness in the use of the literal rule is exposed.

C **Case: R v Maginnis [1987]**

This was a criminal case. A package of cannabis resin was found in the car of the defendant when he was arrested in connection with an assault. Maginnis claimed that the package was not his, but belonged to a friend, and he expected that the friend would soon come back to collect it. He was charged under the Misuse of

Drugs Act 1971 with the 'intention to supply' the cannabis. The legal argument centred on the meaning of 'supply'. Did holding the cannabis temporarily for a friend constitute an intention to 'supply' or not? The court applied the literal rule and decided that it did: Maginnis was found guilty.

The golden rule

The court may apply the golden rule to interpret a statute when using the literal rule would produce a legal outcome that is clearly absurd. However, the court cannot apply the golden rule simply because it thinks that its decision would be silly. There has to be a genuine reason why a literal interpretation of the legislation would produce an absurd result.

Case: Adler v George [1964]

This was actually a criminal case, in which the defendant was found guilty under the Official Secrets Act 1920 with obstruction 'in the vicinity' of a prohibited area. The defendant appealed on the grounds that she had committed the obstruction in the prohibited area itself, not in its vicinity. The court rejected the appeal by applying the golden rule. It was absurd that it should be illegal to commit an obstruction near the prohibited are but not inside it.

Case: Re Sigsworth [1935]

A son was found guilty of murdering his mother. The mother died without leaving a will and under the terms of the Administration of Justice Act 1925, her entire estate would pass to the next of kin – the son who had murdered her. The golden rule was applied, because it was absurd that the provisions of the 1925 Act should allow a murderer to benefit in this way from his crime.

The mischief rule

The courts might also use the mischief rule to interpret statute law. In doing so, the court will take into consideration the reasons why the legislation was passed and what 'mischief' it was intended to prevent. The court will then decide whether the matter under consideration constitutes such 'mischief'.

Case: Corkery v Carpenter [1964]

This was a criminal case. The defendant was charged with being drunk in charge of a carriage, under the provisions of the relevant statute, but he had actually been using a bicycle. The court found him guilty on the grounds that he was guilty of the mischief that the Act had intended to prevent.

The European Convention on Human Rights and the Human Rights Act 1998

- The European Convention on Human Rights (ECHR) and appeals to the European Court of Human Rights
- The Human Rights Act 1998
- Effect of the Human Rights Act on UK law

5 The European Convention on Human Rights and the Human Rights Act 1998

5.1 The European Convention on Human Rights (ECHR) and appeals to the European Court of Human Rights

The United Kingdom subscribes to the European Convention on Human Rights (ECHR). The original agreement on the ECHR was signed in 1951 by most European countries.

It was originally considered that UK law satisfied all of the requirements of the ECHR without the need for new legislation in the UK. Any citizen who believes that his or her felt rights under the Convention have been denied has the right to take the case to the European Court of Human Rights, which is in Strasbourg.

(**Note**: The jurisdiction of the European Court of Human Rights is not restricted to countries of the European Union. It applies to all countries that subscribe to the ECHR. The European Court of Human Rights therefore has nothing at all to do with the European Court of Justice, which is the supreme court of the European Union and which is in Luxembourg.)

However the provisions of the ECHR have now been enacted into UK law following the passing of the Human Rights Act in 1998. Under the terms of the Human Rights Act, an individual can now seek assistance from a UK court under the terms of the ECHR, rather than having to apply to the European Court of Human Rights in Strasbourg. However, individuals can still appeal to the European Court if their rights of appeal in the UK have been exhausted. The European Court remains the final court of appeal in relevant cases.

C

Case: Pretty v DPP [2002]

Mrs Pretty suffered from motor neurone disease and was terminally ill. She wished to commit suicide. However because of her incapacity, she would only be able to commit suicide with the assistance of her husband. Mr and Mrs Pretty had sought assurance from the Director of Public Prosecutions that Mr Pretty would not be subject to prosecution under the Suicide Act 1961, which makes it an offence to assist someone to commit suicide. Mrs Pretty lost her case in the UK courts, which ended in 2001 when she lost an appeal in the House of Lords.

She made a right-to-die court challenge in the European Court of Human Rights in 2002, claiming that her right to die existed under the ECHR, but was being denied. The European Court rejected her claim. It ruled that the right to dignity of life in the ECHR did not extend to dignity in death and the application was refused.

5.2 The Human Rights Act 1998

The Human Rights Act 1998 incorporates the terms of the ECHR into UK legislation.

The Act covers a wide range of human rights, including.

- Right to life
- Prohibition of torture, slavery and forced labour
- Right to liberty and security
- Right to a fair trial
- Freedom of thought, conscience and religion
- Freedom of expression
- Freedom of assembly
- Right to free elections
- Right to education.

5.3 Effect of the Human Rights Act on UK law

The full effect of the Human Rights Act on UK law has probably not yet been felt. It raises some important questions.

- What happens if a court makes a decision that conflicts with the Human Rights Act and ECHR? As we have seen, UK citizens have a right of appeal to the European Court of Human Rights, if the right of appeal fails in UK courts.
- What should be the effect on English courts if the European Court of Human Rights makes a judgement in a particular case, say a case in France or Germany?
- What should happen if a court wishes to use the doctrine of binding precedent, and follow a decision in a previous case prior to the Human Rights Act, but that precedent now conflicts with the Human Rights Act? Does this mean that the Human Rights Act should take precedence over the doctrine of binding precedent?
- What should happen if new legislation in the UK is considered contrary to the requirements of the Human Rights Act and ECHR?

It might be apparent that the Human Rights Act:

- could affect the doctrine of binding precedent in English courts, and
- could raise questions about the 'legality' of statute law.

The legal position is now as follows.

- The Human Rights Act 1998 requires the courts to take into consideration any relevant previous decision of the European Court of Human Rights. This could affect the doctrine of binding precedent, because an earlier decision in an English court might not be compatible with a subsequent decision by the European Court.
- The Human Rights Act requires the courts to interpret all legislation as far as possible to give effects to the rights under the ECHR. **The courts have the right to re-interpret statutes**, when those interpretations were made prior to the ECHR and Human Rights Act. This also affects the doctrine of binding precedent, because a court is required to interpret a law in a different way if necessary, having regard to the ECHR, when an earlier legal case (a precedent) interpreted the law differently.
- The Human Rights Act states that the courts **cannot invalidate any primary legislation** (an Act of Parliament). However, a court can make a statement of incompatibility when it finds that any aspect of primary legislation is incompatible with the ECHR. It is then for the legislature (government) to decide whether an amendment to the law is required. The Act gives any government minister the right to use a fast-track procedure to introduce changes to the legislation to remove any such incompatibility with the ECHR. This would involve introducing a change to the current statute law using delegated legislation (a statutory instrument).
- As stated earlier, the Human Rights Act gives the courts the power to **declare secondary legislation invalid** on the grounds that it is incompatible with the HRA and ECHR.

C

Case: Mendoza v Guidan [2003]

This case involved a claim by the same-sex partner of a man who had now died, and who had been a statutory tenant of a property under the Rent Act 1977. The deceased man, Mr W, was a protected tenant of a property that he had occupied since 1983. The claimant had lived in the property as a partner of Mr W throughout the period to Mr W's death.

The claimant wanted to succeed to the statutory tenancy following the death of his partner. However, in a previous case (*Fitzpatrick v Sterling Housing Association*), which was decided before the Human Rights Act came into force, the House of Lords had decided on an appeal that a same-sex partner did not have the right to succeed to a statutory tenancy, only the right to an 'assured' tenancy under the Housing Act 1988.

In the case of *Mendoza v Guidan*, which was heard after the Human Rights Act came into force, the court accepted that the previous interpretation of the statue law in the Fitzpatrick case was invalid. The Court of Appeal held that sexual orientation is not permissible as grounds for discrimination under the ECHR. The claimant had the right to succession to the statutory tenancy under the Rent Act 1977.

The European Union as a source of English law

- The institutions of the European Union
- EU law and UK law
- Sources of EU law

6 The European Union as a source of English law

The United Kingdom became a member of the European Community on 1 January 1973. As a member of the European Community/European Union, it is subject to European Community law.

6.1 The institutions of the European Union

The main institutions in the European Union are as follows.

- The *Council of Ministers*. This consists of government ministers of the countries of the EU. Relevant government ministers from each of the EU countries attend meetings of the Council of Ministers. For example, a meeting of the Council of Ministers to discuss changes to environmental law would be attended by the government ministers responsible for environmental matters in their own country
- The *European Parliament* whose members are elected in Parliamentary elections.
- The *European Commission* is the administrative body of the EU. It administers the policies of the EU and is also responsible for drafting new legislation.
- The *European Court of Justice (ECJ)*. This is the judiciary body of the European Union, and it deals with cases relating to EU law. Decisions by the European Court of Justice on matters of EU law overrule any decisions made in a national court of a member country of the EU. National courts may therefore apply to the ECJ for a preliminary ruling on a point of EU law before making a decision in a domestic case.

6.2 EU law and UK law

The UK's European Communities Act 1972 made European Union law a part of its domestic law. The effect of this is that any EU law that becomes directly effective (or was already in force on 1 January 1973) automatically becomes effective in UK law. If UK law is incompatible with EU law, EU law prevails.

C

Case: Factortame Ltd v Secretary of State for Transport [1989]

In this case, the applicants sought a declaration that the UK's Merchant Shipping Act 1988 should not apply to them, because this would be contrary to EU law (the right of non-discrimination for EU members and the right of establishment of business). The applicants were companies incorporated in England but owned by Spanish nationals, which owned a fleet of fishing vessels. Because of the non-UK ownership, the companies were denied the right under the Merchant Shipping Act to register their ships in the register of British vessels. The European Court declared the UK legislation to be invalid because it was contrary to EU law. UK law could not discriminate against citizens of other EU countries.

6.3 Sources of EU law

The sources of EU law are as follows.

- Internal treaties and protocols, such as the Treaty of Rome and the Treaty of Maastricht. At the time of reviewing this text, the EU plans a new constitutional treaty, the Lisbon Treaty
- international agreements
- decisions of the European Court of Justice
- secondary legislation.

Secondary legislation takes three forms:

- regulations, which apply directly in English law without the need for UK legislation
- decisions by the European Commission, which are also directly applicable
- EU Directives.

Regulations

Regulations are introduced either by the Council of Ministers and the EU Parliament together, or in some cases by the European Commission (where the regulations apply existing law).

When they are issued, regulations apply with immediate effect to everyone. There is no requirement for individual countries of the EU to take any further measures to introduce the new law.

EU Directives

EU Directives are normally addressed to the governments of each of the EU countries. A Directive contains legislative requirements that each of the EU countries is required to introduce into its own national law, and it specifies a date by which the new legislation should be implemented.

Each EU country then has the freedom to decide how the requirements of the Directive should be implemented. For example, some countries may need to introduce new legislation; whereas other countries may need to amend existing legislation. In some cases, a country may have already implemented into its national laws all the requirements of a new Directive, which means that no further legislative action is needed.

EU Directives have been issued on many varied matters. Directives of particular relevance to company law include the Company Law Directives (such as the 4^{th}, 7^{th} and 8^{th} Company Law Directives) and the EU Accounts Modernisation Directive.

New legislation in the EU, including regulations and Directives, is now mostly introduced by means of a 'co-decision procedure'. This is a joint decision-making procedure involving the Council of Ministers and the European Parliament. Both of them must (separately) agree to identically-worded legislation. Agreement on the wording of new legislation involves discussions and negotiation between the two bodies.

CHAPTER

2

The law of contract: offer and acceptance

Contents

The nature of a contract

1 The nature of a contract

1.1 Introduction

A contract is a legally binding agreement between two 'parties'. When a contract is made, each party is obliged to carry out his part of the agreement. If one party fails to do what was agreed in the contract, the 'injured party' can take legal action for breach of contract.

There are three key elements of a simple legal contract:

- offer and acceptance
- an intention to create a legal relationship (a binding contract)
- consideration.

A legal contract is formed and comes into existence when one party makes an offer and the other party accepts the offer. In other words, a contract is created by offer and acceptance. In the terminology of contract law:

- the person making the offer is called the '**offeror**'
- the person receiving the offer is called the '**offeree**'.

In a contract for the sale of goods, the offeror may be either the seller or the buyer. In a contract for services, the offeror may be the person providing the service or the person receiving the service.

In English law, much of contract law has been established by common law – court cases that establish a legal precedent – and the principles of contract law have been expressed through these legal judgements. You will therefore find in this chapter that many of the principles of contract law are illustrated with legal cases.

1.2 The terms of a contract agreement and the form of a contract

A general legal principle is that the parties to a contract are free to enter into an agreement without the interference of the law, and to decide the terms of the contract between themselves. This is known as the concept of **freedom of contract.**

There are however some specific areas where this freedom of contract may not apply:

- Consumer protection legislation applies to any contract involving a consumer where there is a credit arrangement (the Consumer Credit Act 1974). There is also a law to prevent one party introducing 'unfair terms' into a contract (Unfair Contract Terms Act 1977).
- Employment contracts are governed largely by employment legislation.
- 'Standard form contracts' are contracts where the terms are stated to the consumer on a take it or leave it basis. The consumer does not have an opportunity to negotiate terms. Contracts between consumers and large commercial organisations are nearly always of this kind, such as contracts for the domestic supply of water, electricity and gas.

Contracts can be either in written form or oral agreements. A written agreement, however, provides evidence that the agreement does exist. Some contracts must be in a written form.

- Deeds. A deed is a particular form of written agreement. Examples of deeds are a deed for the conveyance of land, a lease of more than three years, and a contract without consideration (such as a deed of covenant to pay a regular sum to a charity). These are known as 'specialty contracts', and all other contracts are known as 'simple contracts'. (***Note***: Consideration is explained later.)
- Some agreements are required by law to be in writing. These include a bill of exchange, a consumer credit agreement, the legal assignment of a debt, a contract for the sale of a debt and a contract for the transfer of land.
- Some legal agreements must be evidenced in writing. The agreement itself may be oral, but there must be written evidence of its existence. An example is a guarantee.

1.3 Intention to create a legal contract

A contract is a binding agreement, but not all agreements are contracts. The courts will only enforce agreements that were intended to be a contract and so have a legal effect.

The court therefore needs to decide whether an intention to create a legal relationship existed when the agreement was made. For this purposes, agreements are divided into two categories:

- domestic agreements and social agreements
- commercial agreements.

1.4 Domestic agreements and social agreements: intention to create a legal agreement

The **normal** assumption of the court is that in a domestic agreement between members of a family or a social agreement between friends or acquaintances, there is no intention to create a legally binding agreement.

A normal assumption in a case of law is called a **presumption**. So there is a presumption by the court that a domestic or social agreement is not intended to create a legally binding agreement.

C

Case: Balfour v Balfour [1919]

A man returned from Ceylon to take up employment in England, leaving his wife behind because she was too ill to make the journey. He promised that he would pay her £30 per month as maintenance. The marriage then ended in divorce and the wife sued for maintenance money that had been promised to her. The court ruled that this was a domestic agreement where the parties had not intended the promise to be legally binding, and so ruled that a legal obligation to pay the maintenance did not exist.

C

Case: Jones v Pandavatton [1969]

Mrs Jones made an offer to her daughter, Mrs Pandavatton that if the daughter came from the USA to live in England, the mother would pay for the daughter to study law. The daughter agreed to this. The mother purchased a house in London which the daughter lived in. Maintenance for the daughter was paid from rents received from other tenants in the house.

The mother and daughter then quarrelled, and the mother took legal action to reclaim possession of the house. The daughter argued that the mother could not do this, because of the nature of the agreement between the mother and daughter.

Except for the fact that a family relationship existed, the daughter would have been legally entitled to remain in the house. The court ruled, however, that in spite of the circumstances of the case, there was nothing in the agreement between mother and daughter to overrule the standard assumption that domestic agreements and domestic arrangements are not legally binding contracts.

Agreements between family members may be binding contracts

The presumption is that domestic agreements are not legal contracts. However, this presumption may be disproved or **rebutted** if there is evidence to the contrary. (A **rebuttal** in a court of law is the provision of evidence showing that a presumption does not apply in this particular case.)

An agreement between members of the same family may be legally binding contracts, but only if an intention to create a legal relationship clearly exists. This will depend on the facts and circumstances of the case.

C

Case: Merritt v Merritt [1970]

A husband left the matrimonial home. After he left, he met with his wife and promised to pay her £40 per month. She agreed to pay the outstanding mortgage on the house out of this money. At the wife's insistence, the husband signed a note in which he agreed that when the mortgage was paid off, he would transfer the legal title to the house into the wife's sole name.

The mortgage was subsequently paid off, but the husband refused to transfer the title to the house into the wife's sole name. The wife took legal action. The court held that in the circumstances of this case, the parties clearly intended the agreement to be legally enforceable. It therefore ruled that the agreement was a legal contract and so was enforceable.

Examination questions on domestic agreements and the intention to create a legal agreement

If you are required to answer a 'case study' examination question on a domestic or social agreement and the intention to create a legal relationship, the facts of the case are likely to be more straightforward than in the cases described above. In your answer to any such question, state the basic legal rule, mention a relevant legal precedent, and then state your conclusion on the case in the question.

- Suppose that a father promises his daughter that he will buy her a house if she succeeds in passing her professional accountancy examinations, but when she does pass the examinations, he says that he has changed his mind. This is a domestic agreement. The normal assumption is that domestic agreements are not contracts (*Balfour v Balfour*), and there would be nothing in this case to challenge standard assumption that domestic agreements are not legally binding contracts.
- Suppose that father promises to pay £800 to his son, a professional architect, if the son will draw plans for a proposed new extension to the parents' house. The son agrees and prepares the architect's plans, but the father then refuses to pay on the grounds that it was simply a family arrangement. Although the normal assumption is that domestic agreements are not binding contracts, the court will take a different view if the facts of the case suggest that an intention to create a legal agreement did exist (*Merritt v Merritt*). In this case, it is probably appropriate to argue that a legal contract between father and son did exist.

1.5 Commercial agreements: intention to create a legal agreement

With commercial agreements, there is a **very strong presumption** by the court that the parties did intend to create a legal agreement as a consequence of their business dealings. Commercial agreements include:

- contracts for the sale and purchase of goods
- contracts for services between a provider and receiver of the services
- employment contracts (including 'service contracts') between employer and employee.

The basic assumption that a commercial agreement is intended to be legally binding may be rebutted. However, the agreement must normally include **a specific statement** that a legal agreement is not intended before the court will reach any other conclusion and rebut the normal presumption. The burden is on the party who denies the existence of a contract to provide evidence that the intention to create a legally binding agreement did not exist.

Case: Edwards v Skyways [1964]

Mr Edwards, a pilot, was made redundant by Skyways. As part of the redundancy arrangement, he was offered the choice between (1) withdrawing his contributions from the company pension scheme and (2) continuing in the pension scheme until he reached the age of 50 when he would be entitled to claim a pension.

It was in the company's financial interests that Mr Edwards should take the money rather than remain in the pension scheme, and it offered him an 'ex gratia' payment if he would agree to do so.

Mr Edwards chose to withdraw his contributions from the scheme, but the company refused to make the ex gratia payment. It claimed that the use of the words 'ex gratia' meant that it did not intend the offer of the payment to be legally binding. The court rejected this argument. It took the view that these words were insufficient to overturn the standard assumption that in a commercial agreement there is an intention that it should be legally binding.

Case: Rose and Frank Co v Crompton Bros [1925]

In this case the two parties had made an agreement that included a statement that the agreement was **not** a 'formal or legal agreement and shall not be subject to legal jurisdiction in the Law Courts.' The court held that, given the specific wording of the agreement, it was not a contract and so was not legally binding.

Case: Jones v Vernons Pools Limited [1919]

The same approach applies to commercial agreements between a company and a consumer. In this case, the claimant claimed to have filled in a winning coupon for the football pools. The defendants claimed not to have received it. However, a clause in the football pools agreement stated that the transaction 'did not give rise to any legal relationship'. The court held that in this case, the wording of the agreement was specific, and no intention to create legal relations existed. The claim was rejected.

Offer and acceptance

- The offer
- Offer and invitation to treat
- Termination of an offer
- Revocation of an offer
- Counter-offers
- Acceptance
- Acceptance and the postal rule
- Other aspects of acceptance

2 Offer and acceptance

2.1 The offer

For a contract to come into existence, there must be an offer, and the offer must be accepted. The offer sets out the terms on which the offeror is willing to be legally bound by an agreement.

This raises the question: What is an offer? Several conditions must apply in order for an offer to exist.

- An offer must be capable of acceptance. It must therefore be sufficiently definite. It must not be so vague that the offeree does not know what the terms of the offer are.
- A statement of intention is not an offer.
- A supply of information, for example the supply of information about the price that a person might be willing to accept, is not an offer.

Several cases illustrate these principles.

C

Case: Scammel v Ouston [1941]

Ouston placed an order for a truck on hire purchase terms. However, there were a number of different hire purchase arrangements available from the truck supplier, and it was not clear in this case which terms had been offered (and which had been accepted). Since the agreement was too vague, the court held that a contract did not exist.

C

Case: Gibson v Manchester City Council [1979]

A council house tenant asked Manchester City Council how much it would cost to buy the property. The council responded, indicating that it might be prepared to sell for £2,180. The plaintiff claimed that a legal agreement existed and that the council should be required to sell the house at that price. The court held that indicating a possible willingness to sell did not constitute an offer. It was merely a statement of intention and was not an intention by Manchester City Council to be legally bound.

C

Case: Harvey v Facey [1893]

The plaintiff enquired by telegram about the price of a farm called Bumper Hall Pen. The defendant replied by telegram that the minimum price he would accept was £900. The plaintiff responded with another telegram agreeing to buy at £900, to which there was no response. The court held that the second telegram (the telegram from the defendant) was a statement of price, not an offer. The third telegram (from the plaintiff) was the offer. The defendant had not accepted this offer; therefore a binding contract for the sale and purchase of the farm did not exist.

The offeree

An offer may be made to a specific person, to a group of people, or to the world at large.

An offer is normally made to a specific person or to a specific group of people. If so, it can only be accepted by the person of any of the persons to whom the offer is specifically made.

However, it has been held by the court that an offer can be made to the whole world. When this happens, it can be accepted by anyone and made binding by the conduct of the offeree. The case of Carlill v Carbolic Smoke Ball Company is an important case that established this precedent.

C

Case: Carlill v Carbolic Smoke Ball Co [1893]

The manufacturers of a patented cure for influenza advertised that anybody using their cure would not suffer from flu and that they would pay £100 to anybody who used the medicine and still caught flu. The plaintiff, having used the medicine then caught flu, claimed the £100. The court held that the advertisement or notice constituted a general offer and that the manufacturer was bound to pay the reward. The offer in this particular case had been made binding by the conduct of the offeree.

2.2 Offer and invitation to treat

There is an important distinction between an offer and an invitation to treat.

- An offer is an offer to enter a legally binding agreement. The contract comes into existence if and when the offer is accepted.
- An invitation to treat is an invitation to someone else to make an offer. When someone responds to an invitation to treat, he is making an offer. The contract does not come into existence until and unless this offer is then accepted. The person making the invitation to treat is therefore in a position to choose whether or not to accept an offer and create a contract.

The most notable examples of an invitation to treat are:

- displays in a shop window or a store
- advertisements
- catalogues (such as a holiday tour catalogue).

C

Case: Harris v Nickerson [1873]

The plaintiff went to some effort and expense to attend an auction of furniture that was advertised by the defendant. In the event, the auction did not occur. The plaintiff sued the auctioneer for expenses. The court held that the advertisement was merely an invitation to treat. There was no legally binding agreement between the plaintiff and the auctioneer, and the court action by the plaintiff failed.

C

Case: Partridge v Crittenden [1968]

The defendant advertised wild birds for sale in a newspaper. A prosecution was brought against him by the RSPSB under the Protection of Birds Act, which makes it illegal to offer wild birds for sale. The court held that the advertisement was an invitation to treat, not an offer for sale; therefore the defendant had not broken the law.

C

Case: Fisher v Bell [1961]

A shopkeeper was prosecuted and convicted for displaying an illegal flick knife in a shop window. On appeal it was held that the display of the knife in the shop window was an invitation to treat, not an offer to sell; therefore technically the shopkeeper had not broken the law. (Following this case, the law was changed and it became an offence to 'expose for the purpose of sale' any offensive weapon.)

C

Case: Pharmaceutical Society of Great Britain v Boots Cash Chemists (Southern) [1953]

The relevant legislation required certain drugs to be sold by a qualified pharmacist. The plaintiff claimed that because the goods were sold on a self service display in Boots stores, this contravened the legislation. Boots counter-claimed by indicating that the display of the goods in store was an invitation to treat and that the qualified person was at the cash point where the goods were actually sold. The court agreed with Boots: the display of goods was an invitation to treat, not an offer of sale.

Invitations to tender

An invitation to tender may be sent out by a person who wants a particular job done or who wants to buy certain items. The invitation specifies the nature of the goods or services required. The persons receiving the tender are invited to submit offers, stating the price at which they would be willing to sell the goods or provide the service, and any other terms. Any person submitting a tender is the offeror, and a tender is the offer.

The person who sent out the invitation to tender is the offeree, and is at liberty to accept or reject each tender received.

Acceptance of a tender offer leads to one of the two following situations.

- If the tender is an offer to supply a specific quantity of goods or a specific service, at a specified price, acceptance of the offer creates a binding contract, and the offeree must buy the goods or services on the stated terms.
- The tender may be an offer to supply any quantity of an item of goods at a specified price. In accepting this type of tender offer, the offeree agrees to a **standing offer**. This means that the offeree agrees to buy the item at the agreed price from the offeror whenever he wants to buy quantities of that item. For example, a power station might agree to buy quantities of coal from a coal producer, on the terms agreed by the acceptance of a tender offer. The offeree must not deal with any other supplier, but must buy the item, whenever he wants it and in whatever quantities, from the supplier under the agreed contract terms.

2.3 Termination of an offer

An offer may be terminated in a number of different ways.

- The offeree may **reject the offer**. When an offer is rejected by the offeree, it ceases to exist. The offeree cannot then change his mind, accept the original offer and require the offeror to carry out its terms. If an offeree rejects an offer and then changes his mind, he must make a new offer to the original offeror. It is then for the original offeror, now the offeree, to decide whether or not to accept this offer and create a legally binding contract.
- The offeree may make a **counter-offer**. Counter-offers are explained later.
- The **offer may lapse**. If the offer is open for a specific period of time and is not accepted by the end of that time, it is said to lapse. If no specific period is specified in the offer, the courts will presume that an offer lapses after a reasonable time. If the offer is subject to a condition, it will lapse on failure of that condition.
- **By death**. If the offeror dies the offer cannot be accepted once the offerree knows of the death. If the offeree dies, the offer cannot be accepted by his personal representatives.
- By **revocation** or **withdrawal of the offer**.

2.4 Revocation of an offer

An offer may be withdrawn at any time before acceptance. If the offeror withdraws the offer in this way, the offer is said to have been 'revoked'.

- When an offer is revoked, the offeree is no longer able to accept it.
- An offer is not revoked (withdrawn) until the revocation has been received by the offeree.
- If the offeree knows that the offer has been withdrawn, he cannot then accept it.

C

Case: Routledge v Grant [1828]

The defendant offered to buy the plaintiff's house for a specified sum of money, and asked for a definite answer within six weeks of the date of this offer. The offer was revoked before the six week option period had ended. The plaintiff claimed that he had the right to accept the offer, even though it had been revoked, because the six-week option period had not ended.

It was held that the offeror had the right to revoke the offer and the offer ceased to exist with its revocation. It could therefore not be accepted after it had been revoked.

C

Case: Byrne v Leon van Tienhoven [1880]

An offer for the sale of goods to New York was accepted. In the meantime the offer was revoked. However, because of the time delay in postage the revocation of the offer was not received in New York until after the offer had been accepted. The court held that the revocation of an offer does not take place until the offeree has received it. In this case, a contract was therefore created with the acceptance by the offeree. Acceptance occurred when the letter of acceptance was posted. (The postal rule for acceptance is explained later.)

C

Case: Dickinson v Dodds [1876]

An offer of the sale of land was open to a particular day, when it would lapse. Before this specified day, the property was sold to a third party and the plaintiff accepted the offer even though he knew that the property had been sold. The court held that the defendant was free to revoke his offer at any time prior to acceptance. The plaintiff knew about the sale to the third party, and so was aware that the offer had been revoked. A contract did not exist between the plaintiff and the defendant.

Keeping an offer open: option contracts

An offeror may promise to keep an offer open for a minimum period of time or until a certain date. This is commonly referred to as keeping an offer open for an 'option period'. However, any such promise to keep an offer open is not legally enforceable, **unless** the promise itself is the subject of a legal contract. The offeror may withdraw a normal offer at any time before acceptance.

However, an **option contract** is a legally binding agreement to keep an offer open until a future date. It is usually in writing, and the offeror will normally receive a payment of some kind in return for the legally binding option agreement. When an option contract exists, the offeror must keep the offer open until the date specified in the option contract.

Unilateral contracts

A unilateral contract is a contract where one party promises something in return for an action on the part of the other party. Reward cases are a good example. For example, an individual might offer a reward of $300 to anyone who can find and return his missing pet dog.

A feature of a unilateral contract is that there is no compulsion on the other party to take the required action. However, once that party (the offeree) has begun the action and might be near to completing it, it would be unfair if the person giving the promise could revoke the offer before the action has been completed.

In the case of a unilateral contract, the person giving the promise (the promisor) will be bound by his promise to a person who has taken action on the basis of the promise.

C

Case: Errington v Errington [1952]

A father had some title to a property on which his son and daughter-in-law were paying a mortgage. The father promised that when they had paid off the outstanding mortgage, he would transfer his title in the property to them.

The father died and the mother tried to revoke the promise. The court held that the promise could not be withdrawn as long as the mortgage payments continued, because the offerees had already done a substantial amount to fulfil their side of the contract. (The offer or promise could only be revoked if the son and daughter-in-law failed to fulfil their side of the agreement and failed to repay the mortgage.)

2.5 Counter-offers

Acceptance must involve agreeing to all the terms of the offer. The offeree cannot try to alter some of the terms of the offer. Suggesting different terms constitutes a counter-offer. A counter-offer is a new offer, in which the original offeree becomes the new offeror. A counter-offer must be accepted before a legally binding contract is created.

C

Case: Hyde v Wrench [1840]

The defendant offered to sell property for £1,000. The plaintiff made a counter offer of £950, which was rejected. The plaintiff, having made the counter-offer of £950, decided that he wanted to accept the original offer of £1,000. The defendant now refused to sell at £1,000. The plaintiff tried to enforce his second acceptance.

The court held that the counter offer of £950 was a new offer. The counter offer superseded the original offer, which no longer existed. the vendor was not bound to accept the counter offer of £950. The subsequent offer to buy the property for £1,000 was also a new offer, which the defendant had the right to reject.

Requests for further information and counter-offers

A request for further information is not a counter-offer, and the offer remains open after the request for further information has been made. However, it may be necessary to make a distinction between a request for further information (such as: What credit terms are you offering?) and a counter-offer (such as: What would you say if I offered you £80, not £100?)

Case: Stevenson v McLean [1880]

In this case, the offeree asked the offeror for information about how long he would allow as time for payment. The court held that this was a request for information, not a counter-offer, and it did not terminate the original offer.

2.6 Acceptance

Acceptance is essential for the creation of a legal contract. The offeree must accept the offer terms in full, and the contract is created with the acceptance.

- Acceptance is normally in words, either written (including e-mail) or spoken.
- However in some cases, acceptance is implied from the conduct of the offeree.

The method of acceptance may be any method that was contemplated when the offer was made. Normally, **acceptance must be communicated** to the offeror before it is effective, but there are important **exceptions to this rule**.

- The offeror might have **waived the right to communication of acceptance**. This applies in the case of unilateral contracts to the whole world, as in the Carlill v Carbolic Smoke Ball company case. In this case, the offeree's acceptance was indicated by purchasing the medicine, even though the offeror was unaware that the offeree had made the purchase.
- When the communication of the acceptance does not reach the offeror because of an **oversight or carelessness of the offeror**. For example, acceptance by e-mail creates a contract when the e-mail reaches the offeror, and is still valid even if the offeror does not check his e-mail and does not read the message with the acceptance in it.
- The **postal rule** (described later).

Remember that if the offeree says that he will accept the offer, provided that one term or condition in the contract is changed, this is a counter-offer. The original offer lapses, and it is now for the original offeror to decide whether or not to accept the counter-offer.

- A counter-offer is not acceptance. It brings the original offer to an end: (see *Hyde v Wrench*, earlier).
- Acceptance must correspond with the terms of the offer, and the offeree cannot seek to introduce additional contract terms into the agreement.
- A conditional acceptance is not acceptance, and does not create a binding agreement.

2.7 Acceptance and the postal rule

The postal rule has several aspects.

- When acceptance is through the postal service, acceptance occurs as soon as the letter including the acceptance, properly addressed and stamped, is posted (see *Adams v Lindsell*).
- However, the postal rule only applies when it is the contemplation of both parties that the offeree will use the postal service for communicating his acceptance.
- This means that the offeror can exclude the postal rule by specifying that the post should not be used for acceptance, and specifying an alternative method of communication that must be used for acceptance.
- However, if the offeror does not **insist** that another form of acceptance must be used, then an alternative method of acceptance (different from the method contemplated) can be used, provided that this is no less advantageous to the offeror (see *Yates Building Co v J Pulleyn & Sons*).
- The offeror can also specify that the postal rule should not apply by stating that notice of acceptance must reach the offeror. This means that the offeror must receive notice of acceptance, and acceptance will not occur when the letter of acceptance is posted (see *Holwell Securities v Hughes*).
- The postal rule does not apply to faster methods of communication (see *Entores v Miles Far East Corporation*).

C

Case: Adams v Lindsell [1818]

In this case, the dispute arose because the offeree had accepted an offer by letter, but the letter was misdirected and took two days longer than it should have done to reach the offeror. It was held that the contract came into existence when the letter was posted, even though it did not reach the offeror until some time later. (Applying the postal rule, acceptance would occur when the letter of acceptance is posted, even if it never reaches the offeror.)

In many cases, the postal rule is of no practical relevance even when the letter takes some time to reach the offeror, because both parties will normally want to perform the contract. A problem arises, however, if the offeror has offered to sell an item, and because acceptance is delayed in the post, the item is sold to a third party instead. In this situation, similar to what happened in the Adams v Lindsell case, the offeror is liable to the offeree for breach of contract.

C

Case: Yates Building Co v J Pulleyn & Sons [1975]

The plaintiff had an option to purchase some land from the defendant, and it stated that notice of acceptance of the offer should be given in writing and sent by either registered post or recorded delivery mail. The plaintiff exercised the option to buy the land, but sent the acceptance by ordinary mail. The defendant argued that acceptance was not valid because the specified method of communication had not been used.

The court held that the agreement did not insist that registered post or recorded delivery should be used. This method of communication was better for the plaintiff, but gave no advantage to the defendant (the offeror) compared with ordinary mail. It was therefore held that the substance of the offer had been accepted and acceptance was valid.

C

Case: Holwell Securities v Hughes [1974]

Hughes gave Holwell Securities an option to buy some property. It was specified that the option could be exercised by giving 'notice in writing to the intending vendor' by a certain date. Holwell Securities sent a letter accepting the offer, but it was lost in the post and did not reach Hughes.

Holwell relied on the postal rule to claim that acceptance was valid and a contract existed. The court held, however, that the specific wording of the offer clearly intended that the offeror should receive notice of the acceptance. Since this had not happened, there was no acceptance and no contract.

C

Case: Entores v Miles Far East Corporation [1955]

This case occurred in the early days of telex technology. An offer was sent by telex from London to Amsterdam. The offeree returned his acceptance, also by telex. A dispute in the case centred on whether acceptance occurred as soon as the telex message indicating acceptance was sent, or whether it did not occur until the offeror actually received notification of acceptance.

There was a reluctance to allow the postal rule to extend to new technology. This could be a reason why the judge rules in the case that for telex messages, it was 'simply reasonable and obvious' that the offeror must receive the acceptance in order for the acceptance to be effective. The same rule will now apply to e-mail messages.

2.8 Other aspects of acceptance

Acceptance must be positive

Silence, or doing nothing positive, cannot be taken as acceptance of an offer.

C

Case: Felthouse v Brindley [1863]

The plaintiff wrote to the defendant offering to buy his horse. In the letter, he wrote: 'If I hear nothing, I will consider it mine.' The defendant did not respond to the letter, and the plaintiff took the matter to court, claiming that a contract for the sale of the horse existed.

The court held that the defendant's silence and lack of action could not be taken as an acceptance. Acceptance must be positive.

Negotiations 'subject to contract'

Sometimes, two parties might make offers and counter-offers without reaching agreement about the terms of a contract. When these negotiations are eventually settled, the two parties might not be completely sure what terms they have agreed. In such a situation, the terms of the contract are those that were made in the final counter-offer.

Example

Smith supplies replacement light fittings. In response to a query from Jones, Smith offers to supply light fittings at a price of £10 each. Jones replies that he will accept the terms of the supply contract, except that he will only pay £9 for each fitting. Smith e-mailed Jones saying that he would be delighted to supply the light fittings, specifying the terms of supply again, but added that he would only supply at the original stated price of £10. Jones read the e-mail, but overlooked the comment about the price of £10. He accepted the offer and ordered 5,000 light fittings.

When Jones was invoiced £10 per light fitting, he refused to pay the full price, and said that he would only pay £9.

In this situation, Jones is in the wrong. He accepted the e-mailed offer that specified a price of £10, and this is therefore in the contract.

To avoid misunderstandings when the terms of a contract are being negotiated, the parties should specify that their negotiations are **'subject to contract'**. This means that any suggestions by one party about the terms of the contract should not be taken as a formal offer. When the negotiations are finally completed, a formal contract can be prepared (and signed, if required).

The accepted meaning of 'subject to contract' was established in the case *Winn v Bull* [1877], where the court held that a contract had not come into existence because negotiations of the detail were subject to contract. When terms under discussion are subject to contract, this means that a contractual agreement is 'subject to and dependent upon a formal contract being prepared'.

Privity of contract

- Common law doctrine of privity of contract
- Exceptions to the doctrine of privity of contract
- Statutory exceptions to the doctrine of privity of contract

3 Privity of contract

3.1 Common law doctrine of privity of contract

The common law doctrine of privity of contract is the concept that it only those who are party to the contract (are 'privy' to the contract):

- have rights or liabilities under the contract, and so
- have the right to enforce the contract.

Contracts therefore do not give rights or obligations to others, known as '**third parties**', who are not a party to the contract.

The doctrine is well illustrated by the case of *Dunlop v Selfridge*.

C

Case: Dunlop v Selfridge [1915]

Dunlop supplied tyres to Dew and Co. A term of the agreement was that the tyres would not be re-sold by Dew at below a minimum specified price set (or if sold below that price then a penalty of £5 per tyre would be payable to Dunlop). It was recognised in the agreement that Dew could sell the tyres on to other retailers, but only on the same terms, that the tyres should not be sold below the minimum specified price.

Dew and Co sold the tyres to Selfridge who then sold them at a price below the minimum price set by Dunlop. Dunlop sued Selfridge to recover the £5 per tyre penalty.

The court held that Dunlop could not recover damages from Selfridge because there was no contract between them. Selfridge was a third party as regards the contract between Dunlop and Dew. The contract for the sale of tyres was between Dew and Selfridge. (Dew might have been able to take legal action against Selfridge, but chose not to do so.)

3.2 Exceptions to the doctrine of privity of contract

There are a number of exceptions to the general rule of privity of contract. Some of these are listed below.

- Formal **assignment of benefits**. A party to a contract can transfer his **benefits** (but not his obligations) under a contract agreement to another person by means of assignment. The assignment must be in writing. The **obligations** of a person under a contract agreement cannot be assigned to another person without the consent of the other party to the contract.
- Where the beneficiary (third party) sues in some other capacity (see *Beswick v Beswick*).
- Where it is foreseeable that damage caused by any breach of contract will cause loss to a third party (see *Linden Gardens Trust v Lenesta Sludge Disposals Ltd*).
- Where there is a **collateral contract**.
- The **law of agency** also provides an exception to the doctrine of privity of contract. Agency is explained in a later chapter. Briefly, however, an agent for a principal can establish a contractual relationship between the principal and a third party, even when the third party is unaware of the existence of the agency relationship when making the agreement with the agent.

C

Case: Beswick v Beswick [1968]

The plaintiff was the widow of a coal merchant who had transferred his business to a nephew in return for a weekly payment to himself and an annuity to the widow in the event that he died. Following the death of the coal merchant, all payments from the nephew ceased and the widow sued to claim the annuity.

The court held that although the plaintiff was not party to the original contract, her claim should be successful because she was acting in her capacity as the personal representative of the deceased who had been party to the contract with the nephew.

C

Case: Linden Gardens Trust v Lenesta Sludge Disposals Ltd [1994]

The owners of a property entered into a contract with Lenesta on the understanding that ownership of the property was likely to be transferred. The work by the contractor was unsatisfactory, but this only became apparent after the property was transferred. The new owners sued for breach of contract. Lenesta's defence was privity of contract, and that the new owners could not sue.

It was held that the original party to the contract could claim damages on behalf of the third party (the new owners) for breach of contract.

Collateral contract

A collateral contract is a contract where one person makes a promise to another in return for that other person entering a contract with a third person. For example, X might make a promise to Y on condition that Y enters a particular contract with Z. The contract between X and Y is a collateral contract.

- Collateral contracts are treated by the court as an exception to the doctrine of privity of contract.
- The court will infer that a contract exists even though a formal contractual agreement (a written contract document) does not exist.

C

Case: Shanklin Pier v Detel Products Ltd [1951]

A pier company (Shanklin Pier) wanted to have the pier re-painted and it contracted with a firm of painters to have the work done. Detel was a paint manufacturer. It promised the pier company that its paint was well-suited for the job because it would provide adequate protection to the pier. On the basis of this guarantee, the pier company was persuaded to specify to the painters that Detel's paint should be used for the work. The painters therefore bought the paint they needed for the work from Detel.

The Detel paint was used, but it proved unsatisfactory. The pier company sued Detel for breach of the promise that the paint was suitable for the work. Detel argued in its defence that there was no contract between the pier company and Detel. Detel's only contract was with the painters, to whom it had sold the paint.

The pier company was successful. The court held that in addition to the contract between Detel and the painters for the sale of the paint, there was also a collateral contract between Detel and the pier company. In this contract, Dtel has guaranteed the suitability of the paint in exchange for the pier company specifying that Detel's paint should be used for the work.

3.3 Statutory exceptions to the doctrine of privity of contract

Exceptions to the doctrine of privity of contract have been created by statute law.

- Motor accident insurance. The Road Traffic Act 1972 allows a person who has been injured in an accident to claim against the motorist's insurers. This is known as 'third party' insurance.
- A potentially significant exception was created by the Contract (Rights of Third Parties) Act 1999.

Contracts (Rights of Third Parties) Act 1999

The Contracts (Rights of Third Parties) Act 1999 deals with terms in a contract between two parties that confer benefits or potential benefits on a third party. It reformed a part of the doctrine of privity of contract, whereby a third party was unable to enforce any benefits granted to the third party by a contract between two other parties.

The Act allows a third party to:

- enforce the terms of a contract that benefits him in some way, provided that certain conditions are met
- obtain remedies in the event that the terms of the contract are breached by the party to the contract giving the promise of benefit (the promisor').

Specifically, the Act allows a third arty to enforce the terms of the contract in two situations:

- in cases where the third party is specifically identified in the contract as someone with the authority to enforce the contract term, or
- in cases where the contract 'purports to confer a benefit on him'. However the third party must be identified in the contract by name or as a member of a particular group or a class of persons, or as someone who answers a particular description).

Suppose that X enters into a contract with Y for Y to build a house for X. On completion of construction X then sells the house to Z. Z finds that there are structural problems with the house, which will cost a lot of money to rectify. In this situation, Z has no right of legal action against Z. This is because the contract to build the house was between X and Y. As a third party, Z has no rights because he was not specifically mentioned in the contract between X and Y. Z may be able to make a claim against X who sold him the house, but this is a different contract.

The Act also prevents the parties to a contract from modifying the terms of a contract to amend or exclude benefits for a third party that were included in the original contract:

- without the consent of the third party, and
- if the third party has previously 'assented' to the term of the contract,
- but only if the contract does not include a term that allows the parties to alter or exclude the benefits without the consent of the third party.

However the Act allows the two parties to a contract to include a term in the contract that allows them to amend or remove the benefits for a third party, without the third party's consent.

Consideration

- The need for consideration in a contract
- Consideration must be sufficient but need not be adequate
- Payment in kind
- Performance of an existing contractual agreement: can it be consideration for a new agreement?
- Past consideration is not valid consideration
- Part payment and the rule in Pinnel's case
- The doctrine of promissory estoppel

4 Consideration

4.1 The need for consideration in a contract

English law does not enforce every promise made by one person to another. It has already been explained that domestic and social agreements or promises are not legally enforceable.

An other important principle is that for a promise to be legally enforceable, there must be consideration, **unless** the promise has been given in the form of a (legal) **deed**.

Unless consideration has been given in return for a promise, the courts will not oblige the person giving the promise (the promisor) to fulfil the promise he has given.

Definition of consideration

Consideration has been defined in the past by several judges.

- A widely accepted definition was provided by a judge in the 1875 case, *Currie v Misa:* 'Some right, interest, profit or benefit accruing to one party, or some forbearance suffered by the other'.
- Another definition is: An act or forbearance of one party, or promise thereof, is the price for which the promise of the other is bought, and the promise thus given for value is enforceable.'

At its simplest, consideration involves the exchange of money for goods or a service. One party gives money (consideration) and in return the other party gives goods or a service (also consideration).

Consideration may take the form of:

- an action – doing something or giving something
- a forbearance – not doing something, and in forbearing to act, giving up some benefit or right
- a promise to act or a promise to forbear from acting in the future.

Normally giving consideration involves both:

- a benefit to the person giving the promise, and also
- a detriment to the person who is given the promise.

For example, suppose that Bill promises to pay Mick £500 if Mick will repair the roof of his house. There is consideration in this agreement because Bill will benefit from a repaired roof and the detriment for Mick is that he must do the repair work. Equally, there is benefit for Mick who will receive £500 and detriment for Bill who will pay £500.

Executed consideration and executory consideration

A distinction can be made between executed and executory consideration.

- Executed consideration. This is a promise made in return for the performance of an act **at the current time**; such as the exchange of cash in return for goods exchanged at a shop.
- Executory consideration. This involves an exchange of promises to do something in the future; for example a promise to supply goods in the future which will be paid for in the future.

Consideration must be either executed or executory. It is not possible to claim that consideration has been provided by an act in the past, before the contract was made. **Past consideration** is considered in more detail later.

4.2 Consideration must be sufficient but need not be adequate

Consideration must be sufficient, but it need not be adequate. It is for the parties to agree on the terms of their contract, and to make sure that they each get value for money in their agreement.

From a legal point of view, the consideration given by one party to a contract does not have to represent 'full value' for the benefit received in exchange. The law does not attempt to correct bad bargains. However, consideration must have some economic value however slight, sufficient for the court to recognise it as consideration.

C

Case: Thomas v Thomas [1842]

The executors of a man's will allowed the widow to live in the house of her deceased husband for a rent of £1 per year. The defendant later claimed that £1 per year was not consideration, because it was well below an economic rent for the property. He removed the widow from the house and the widow sued for breach of contract. The court held that the nominal rent of £1 was valid consideration, even though it was not adequate. The widow won the case.

C

Case: Chappell and Co v Nestle Co Ltd [1959]

The defendants (Nestle Co) ran a sales promotion that offered a vinyl record in return for a small sum of money and three wrappers of their chocolate bar. The owners of the copyright of the record challenged whether the wrappers constituted sufficient consideration in return for Nestle's promise to supply the record. (The wrappers were thrown away by Nestle and so had no value). The court held that the wrappers did constitute consideration.

C

Case: White v Bluett [1853]

A son who continually complained about being disinherited was released from a debt on condition that he stopped complaining. The court held that ceasing to complain had no value and so could not be construed as consideration.

4.3 Payment in kind

Consideration can take the form of 'money's worth' and does not have to be in the form of money. 'Money's worth' means something other than money. It could take the form of goods, or it could be in the form of a service.

For example, suppose that X owes Y £20, but does not have the money to pay the debt.

- X might offer to pay the debt by giving Y a pair of shoes. If Y agrees, the pair of shoes would be suitable consideration for the settlement of the debt. However, Y would need to agree, if the original agreement was for payment in cash.
- X might offer to settle the debt by washing Y's car. Again, if Y agrees, washing the car would be suitable consideration.

Remember that consideration need not be adequate, provided that it is sufficient. This means for example that if X owes Y £200, and offers to wash Y's car in settlement of the debt, this would be sufficient consideration provided that Y agreed to accept payment in this form – even though washing a car is not a service worth £200.

4.4 Performance of an existing contractual agreement: can it be consideration for a new agreement?

As a general rule, an agreement to continue performing an existing contractual undertaking is not sufficient consideration for a new contractual agreement. This basic principle was expressed by the court in the case Stilk v Myrick.

C

Case: Stilk v Myrick [1809]

Eleven sailors agreed to crew a ship on a voyage from London to the Baltic and back. Two sailors deserted in the Baltic, and the other nine refused to continue their work, claiming higher wages. The captain agreed to pay them more when they got back to London, but subsequently refused to make the extra payment. The sailors sued him for the extra wages, but lost.

The court held that they had agreed to crew the ship for the two-way voyage, and their agreement in the Baltic to fulfil their existing contractual obligation was not sufficient consideration in return for the promise of higher pay.

It was held that there was no new consideration for the higher wages and therefore a contract had never been created. The sailors were already bound by their existing contract to do the work.

The long-established rule in Stilk v Myrick has been brought into question in some situations by the case of Williams v Roffey Bros.

C

Case: Williams v Roffey Brothers [1990]

In this case, due to the particular circumstances of the case, a promise to perform an existing contractual obligation was held to be sufficient consideration for a new agreement.

Roffey Bros were a firm of building contractors who took on a contract to renovate a block of flats. There was a penalty clause in the contract, and Roffey Bros would have to make a penalty payment if the work was completed later than the final date specified by the contract.

Roffey Bros sub-contracted part of the work to Williams. Williams fell behind schedule, and claimed that this was because he had not been given enough money to do the work. Roffey Bros and Williams therefore negotiated a new deal in which extra amounts would be paid to Williams on completion of each stage of the contract work, if the work was completed on schedule. However, when the next stage of the contract work was completed on time, Roffey Bros refused to pay the extra money.

Their argument was that the agreement by Williams to fulfil his existing contractual obligations was not sufficient consideration for the new agreement.

In this case, the court decided that the rule in Stilk v Myrick did not apply. The agreement by Williams did represent consideration, because completing the work on time meant that Roffey Bros were able to avoid a penalty payment under the terms of their building contract. This was a benefit under the new agreement that did not exist before.

The decision in Williams v Roffey, although providing some challenge to the basic rule in Stilk v Myrick, has not been widely followed by the courts in subsequent cases.

Duties imposed by statute do not represent consideration

If one person promises to do something that he is legally obliged to do anyway, the promise is not sufficient consideration for a legally enforceable contract.

Case: Collins v Godefroy [1831]

Collins was subpoenaed to appear as a witness in a legal action where the defendant was involved. The defendant promised Collins six guineas if he would appear as a witness, but subsequently refused to pay the promised money.

The court held that Collins was legally obliged to appear as a witness in the case. Since he had a statutory obligation to act as a witness, his promise did not constitute sufficient consideration for a legally enforceable contract.

4.5 Past consideration is not valid consideration

Past consideration is not valid consideration. This means that something done in the past, before an agreement is made, cannot be consideration for that agreement. The consideration must be provided either at the time of the agreement or at a later date.

Case: Re McArdle [1951]

A widow was left the life interest in a house. This gave her the right to live in the house for her lifetime, and the children would receive it on their mother's death. One of the children carried out renovations to the house and subsequently signed an agreement with the other children that the cost would be repaid when they all inherited the house.

On the death of the mother the estate refused to refund the cost of the repairs, on the grounds that the work was done before any agreement was signed. Since the work had been done before the agreement was made, it could not be consideration for the agreement to refund the costs. The court agreed. It was held that because the improvements were carried out before the agreement was made, the consideration was past and the promise could not be enforced.

4.6 Part payment and the rule in Pinnel's case

A disagreement may arise when one party makes a part payment on a larger debt, and the other party initially accepts the part payment as full payment and then changes his mind.

The long-established rule in Pinnel's case is that the payment of a lesser sum in satisfaction of a greater sum is generally **not binding** as satisfaction for the whole sum. This is because there has generally been no consideration in the contract to accept a lesser sum.

In other words, suppose X owes Y £500 and then offers to pay £400 if Y will accept this as full payment of the debt. Y might agree and take the £400, but then change his mind and demand the remaining £100. In law, X is required to pay the remaining £100. This is because the promise by Y to take £400 as final payment of the debt from Y was given without any consideration in return. The agreement to take the part payment as full payment cannot therefore have any legal standing.

This basic rule was first expressed in Pinnel's case, and has been reinforced by subsequent decisions in *Foakes v Beer* and *Re Selectmove*.

C

Case: Pinnel's case [1602]

Cole owed Pinnel a sum of money (£8 10s) but at Pinnel's request paid a part of this amount (£5 2s 6d) one month before the full sum was due for payment. Cole claimed that there was an agreement by Pinnel that the part-payment would discharge the full debt. The court disagreed, and held that the part-payment did not constitute full payment, regardless of what Pinnel might have promised.

C

Case: Foakes v Beer [1884]

Mrs Beer received judgement on a debt of £2,090 and costs from Foakes. She agreed to allow Foakes to pay the debt by instalments and not to take any further action. Foakes paid the capital amount of the debt, but not the interest. Mrs Beer claimed the interest as her right on a judgement debt.

The court held in favour of Mrs Beer. There had been no consideration for the promise not to take any further action. Consequently, there was no contract and Mrs Beer was entitled to the interest.

C

Case: Re Selectmove [1994]

The Inland Revenue applied for the business of Selectmove to be wound up for non-payment of tax (debts). In the past, the Inland Revenue had agreed to take payments by instalment, but now argued in court that it could not be held to this agreement because Selectmove had given no consideration in return. The court agreed with the Inland Revenue.

Exceptions to the rule on part payment

There are some exceptions to the general rule that part payment is not sufficient to settle a debt in full.

- **Composition with the creditors**. This occurs when the creditors of an individual or a company agree between themselves and the debtor how the debtor's available money should be shared between them. All the creditors agree to accept a lower amount, which the debtor agrees to pay. The consideration is given in the form of the agreement between the creditors themselves and the debtor
- **Part payment by a third party**. If a third party agrees to make a reduced payment with a creditor, on behalf of the debtor, the creditor cannot then pursue the original debtor for the remaining payment. For example suppose that Ben owes £500 to Tom, and since Ben cannot pay the debt his father offers £300 to Tom in full settlement of the debt. If Tome accepts the £300 in settlement of the debt, he cannot then continue to ask Ben for the remaining £200.

4.7 The doctrine of promissory estoppel

The doctrine of promissory estoppel is based on the law of equity (fairness). Basically, it states that although a promise might not be enforceable in common law, the person who gave the promise may in fairness be 'estopped' (prevented) from enforcing his strict legal rights.

When the doctrine is applied, this usually means that the person who gave the promise should be required to carry out the promise, at least for a while.

- In fairness, this might protect the person who was given the promise (the promisee) where he has relied on the promise.
- Normally, the doctrine of promissory estoppel only suspends the rights of the person who made the promise. By giving reasonable notice, the promisor can normally retract his promise and revert to the original contractual agreement with the promise.
- The doctrine of promissory estoppel is based on the concept of equity. It is intended to give some protection to the promisee, and should only be used in such cases. It should not be used by the promisee as a 'weapon' to extract additional concessions from the promisor.

C

Case: Central London Property Trust Ltd v High Trees House Ltd [1947]

This case is commonly referred to as the 'High Trees' case.

In 1937, CLP granted a lease on the property (a new block of flats) at a rent of £2,500 per year. Due to the impact of the war that soon followed, it was impossible to find tenants for the flats except at lower rents. In 1940 CLP and High Trees therefore agreed a lower annual rent for the property. By 1945 the property was fully let and a claim was made by CLP to revert to the old rent.

The court held that agreement for reduced rent between 1940 and 1945 was not supported by consideration from High Trees; therefore the agreement was in principle not a contract. However under the doctrine of estoppel, the landlords would be estopped from denying that they had made a promise to accept the lower rent and so would not have been able to claim for this higher rent.

A controversial aspect of the judge's opinion in this case appeared to be that the promisor would never be able to retract the promise. It is generally accepted, as stated earlier, that a promise given for no consideration can be retracted if sufficient notice is given to the promise.

C

Case: D & C Builders v Rees [1966]

D & C carried out some building work on the business premises of Rees. The bill was for £482, but Rees (who was ill) did not pay. Mrs Rees offered £300 in full settlement of the bill, arguing that Rees would never be able to pay the full amount and £300 was better than nothing. She gave D & C a cheque, but insisted that they should write 'in completion of the account' on the receipt.

D & C subsequently claimed for the remaining £182. Rees argued that they were estopped from insisting on the full amount of £482.

The court held that the principle of estoppel should only apply when it would be inequitable to hold the promisee to the original promise. In this case, Mrs Rees had known that D & C were in financial difficulties and had held them to ransom with her offer of £300 – take it or leave it. It was not inequitable in the circumstances to find that no consideration had been given for the promise to accept a lower payment, and Rees was therefore required to pay the additional money.

C

Case: Combe v Combe [1951]

Before their divorce, Mr Combe had promised to pay an annual amount to his wife for maintenance. After their divorce, he refused to make any payments, and Mrs Combe applied for a court order to enforce the promise.

She argued estoppel. Mr Combe had made a promise and Mrs Combe had acted on it (by not seeking a maintenance order from the courts). Mr Combe should therefore be estopped from denying that he had made the promise, and the promise should be enforced.

The court eventually decided against Mrs Combe. It held that estoppel is a shield to protect the promisee, not a weapon against the promisor. The original promise by Mr Combe to make the maintenance payments was not a legally binding agreement (since it was a domestic agreement and there was no consideration from Mrs Combe). Estoppel could not be used to create a legal obligation on Mr Combe and legal rights for Mrs Combe when none had existed before.

CHAPTER

3

The law of contract: contract terms and breach of contract

Contents

Contract terms

- The nature of contract terms
- Contract terms and representations
- Conditions and warranties
- Innominate terms
- Express terms and implied terms
- Exemption clauses (exclusion clauses)
- Unfair contract terms: statutory regulations

1 Contract terms

1.1 The nature of contract terms

The terms of a contract are the statements within a contract that form part of the agreement between the parties.

- The parties to a contract are legally bound to perform any promise that they have agreed to within the terms of the contract.
- If either party fails to keep to his promises, he is in breach of contract. The other party may then bring a legal action for breach of contract.
- When a case for breach of contract comes to court, and the court decides that a breach has occurred, it will decide the remedy that should be applied.
- The nature of the remedy that is available to the 'injured party' will depend on the nature of the promise that has been broken.

1.2 Contract terms and representations

Representations

A representation is something said in the run-up to a contract to encourage someone to enter into the contract. An example of a representation might be comments made by a sales representative who is trying to persuade a customer to make a purchase.

Representations might well succeed in persuading someone to agree to enter a contract. Even so, **representations are not contract terms**, and **do not form a part of the contract**.

Someone might subsequently find that representations made to him, to persuade him to agree to a contract, were incorrect and misleading. If so, there is no breach of contract because the representations are not a part of the contract. Instead, there may be a legal action for **misrepresentation** (rather than an action for breach of contract) and the remedies available for misrepresentation are different to those for breach of contract.

It is therefore important to understand what the actual terms of a contract are and what representations that do not form a part of the contract are. As a general guide, when there is a written contract, the contract terms are written into the contract whereas representations are not.

Representations and warranties

It is common to associate 'representations' with 'warranties'.

- A representation is a statement by one person to another about current facts, which is intended to induce another person to enter into a contract.
- A warranty is a form of assurance about the future. Warranties may be included as terms in a contract, and so may be included in a written contract (as specific terms of the contract).
- The written contract may be said to include 'representations and warranties'.

An example may help to explain the connection between representations and warranties.

- A retailer may sell washing machines, and in doing so may give certain representations about the washing machine – such as its speed of operation, its capacity and various other operational features. The representation to a potential buyer is: 'This is a washing machine and these are the things that it can do.'
- The retailer may include in the selling agreement a warranty that if anything goes wrong with the washing machine in the next two years – so that if it fails to do the things it is said to be able to do within that time – the washing machine will be repaired or replaced free of charge. The warranty would be a term of the contract (usually in writing).

1.3 Conditions and warranties

A contract contains a number of different terms. These can be categorised as:

- conditions
- warranties, and
- innominate terms.

Most terms are either conditions or warranties.

A **condition** is a fundamental part of a contract agreement. It is an essential term of the contract. If one party is in breach of a condition, the injured party has the right **either** to:

- terminate the contract and refuse to carry out his obligations under the terms of the contract, or
- continue with the agreement and sue for breach of contract (sue for damages).

A **warranty** is a term in a contract that is not fundamental to the contract and not essential to the overall agreement. If one party is in breach of a warranty, the overall purpose of the contract is not destroyed, and the injured party does not have the right to terminate the agreement. The injured party must complete his part of the agreement and sue the other party for damages for breach of contract.

The difference between conditions and warranties is well explained in section 11 of the Sale of Goods Act 1979, which also states that the court will decide on the facts of each case whether a particular term in a contract for the sale of goods is a condition or a warranty.
"Whether a stipulation in a contract of sale is a condition to be fulfilled by the seller, the breach of which may give rise to a right to treat the contract as repudiated, or a warranty, the breach of which may give rise to a claim for damages but not to a right to reject the goods and treat the contract as repudiated, depends in each case on the construction of the contract; and a stipulation may be a condition though called a warranty in the contract."

Some cases also help to illustrate the difference between conditions and warranties.

C

Case: Poussard v Spiers & Pond [1876]

An opera singer contracted to sing throughout a season in an opera that the defendants were producing. Due to illness she was unable to perform on the opening night and on the next few nights. In consequence the promoters hired a replacement singer. When the original singer had recovered from her illness, the promoters refused to employ her for the remainder of the season.

The court held in this case that failure to perform on the opening night was a breach of a condition, and the promoters had the right to repudiate the contract and treat it as terminated.

C

Case: Bettini v Gye [1876]

This was another case in the same year involving another opera singer. An opera singer was contracted for a season including attendance at rehearsals for six days prior to the opening. The singer did not attend the rehearsals for the first three days due to illness. The promoter treated the contract as discharged. The court held, however, that the rehearsal clause was a warranty. The opera singer was in breach of a warranty, and the contract could not be repudiated.

1.4 Innominate terms

In the past, all terms in a contract were treated as either conditions or warranties. However, the courts now recognise another type of contract term, known as an innominate term.

With an innominate term, the rights of the injured party in the event of a breach of contract depend on the circumstances of the breach.

- If the breach of contract deprives the injured party of 'substantially the whole benefit of the contract', the injured party has a right to repudiate the contract and treat it as terminated. This is the same as if the term in the contract were a condition.

- If, however, the injured party does not lose 'substantially the whole benefit of the contract' as a consequence of the breach, he does not have a right to repudiate the contract, and may therefore only take legal action for damages. This is the same as if the term in the contract were a warranty.

C

Case: The Hansa Nord [1976]

A buyer and seller agreed a contract for the sale of a cargo of goods (citrus pulp pellets, for use as animal feed). A term of the contract was that the goods should be delivered in good condition.

The goods were shipped but about one third arrived in poor condition. The buyers rejected the entire shipment. A middle man bought the goods for £33,720 and immediately sold them to the original buyer for the same price. The effect was that the buyer acquired all of the original goods for £33,720 rather than £100,000, and used them for their original intended purpose as animal feed.

The court held that the term in the contract was an innominate term. A breach of this term, in other circumstances, might well have given the injured party the right to repudiate the contract. In this situation, however, the breach of the contract did not make the injured party lose substantially the whole benefit of the contract. This was evidenced by the fact that the buyers bought and used exactly the same goods. The breach of contract gave the injured party (the buyer) the right to sue for damages. The buyer had the right to a price reduction, but not to repudiation of the contract. The sellers were within their contractual rights to retain the money that they had been paid.

General: during the process of negotiating a contract and in the contents of a contract, a number of issues will have been raised and discussed and actually included in the contract. Some will be explicitly stated, others will be implied, and some will be statements to encourage the sale. Understanding these and being able to distinguish them is important when deciding whether the parties have complied with what was actually agreed.

1.5 Express terms and implied terms

The terms in a contract are either express or implied.

- Express terms: these are contract terms that are very clearly inserted in the contract (oral or written).
- Implied terms: these are terms that are not expressly stated in the contract, but they are nevertheless part of the contract because there is an implication that they are terms in the contract.

Implied terms can be grouped into three main categories:

- Terms implied by custom or usage
- Terms implied by the courts
- Terms implied by statute.

Terms implied by custom or usage

A contract may include a term that is implied from common usage or custom with regard to contracts of that type, even though the term is not specified in the contract. However, when there is an express term in a contract that differs from custom or usage, the express term will apply.

C

Case: Hutton v Warren [1836]

A tenant farmer reached the last year of his tenancy. It was custom in the locality for tenant farming agreements to allow the tenant farmer in the last year of a tenancy to claim for the cost of seed and labour (on the grounds that the next tenant would benefit). However, the contract between Hutton and Warren did not expressly include this term. The landowner refused to pay for the seed and labour.

The court held that the right of the tenant farmer to claim for the cost of seed and labour was an implied term in the contract, because it was customary in the locality for such agreements to include this term and there was nothing in the actual contract indicating that the term should not apply. (In other words there was no express term in the contract indicating that the customary term should not be implied.)

Terms implied by the courts

As a general rule, it is for the parties to a contract to decide what the terms of the contract should be. However, the courts will sometimes decide that a contract term should be implied, in order to give the contract 'business efficacy'.

In deciding whether a contract term should be applied, the courts will apply the 'officious bystander test'. Suppose that two parties X and Y are negotiating the terms of a contract, and Z is standing nearby listening to them. Z then interrupts the negotiations of X and Y to suggest that a particular term should be added to the contract. X and Y might then turn to Z and tell him that this term was understood and accepted by them, even though they had not discussed it.

This is the type of term that a court will imply in a contract, when it is not expressly stated.

C

Case: The Moorcock [1889]

A ship owner entered into a contract with the operators of a wharf to moor a ship (The Moorcock) and unload it. Both parties knew that at low tide the ship would rest on the harbour floor. At a low tide the ship grounded on a rock, with the result that its back was broken. The wharf operators claimed that the contract with the ship owners did not contain an express provision that the ship would not be damaged.

The court held that although there was no express term in the contract, in order to give the agreement 'business efficacy' there must be an implied provision that the ship would not be damaged and that it would be safe for the ship to rest on the harbour floor.

Terms implied by statute

In some cases, a statute (Act of Parliament) might include a requirement that certain types of contractual agreement must include particular terms, and if they do not include the terms expressly, they should be included by implication.

For example, the Sale of Goods Act 1979 states that in a contract for the sale of goods, terms relating to the description of the goods and their quality and fitness for purpose must be included in the contract by implication, and these terms cannot be removed even if both parties to the contract agreed to their removal.

1.6 Exemption clauses (exclusion clauses)

An exemption clause, also called an exclusion clause, is a clause in a contract that tries to exempt or limit the liability of a party who is in breach of contract.

The legal problems relating to exclusion clauses apply mainly to 'standard' terms that a supplier tries to include in a contract, exempting him from liability for any loss that the other party may suffer, for example due to damage to property or personal injury.

When one party to a contract attempts to make use of an exclusion clause, two issues need to be considered.

- First, is the exclusion actually a part of the contract, or is it not a contract term at all? Obviously, when an exclusion clause is written into a contract, it is a term of the contract. However, there are cases where disputes arise about whether an exclusion clause is actually in the contract.
- Second, if the exclusion clause is part of the contract, is it enforceable? Or can the other party claim that the clause is unreasonable and so not binding on him?

The first issue is resolved by common law tests. The second issue is decided by statute law and regulations, although the courts may be asked to apply the statute law to specific cases where there is disagreement about the legal position.

As a general rule, the courts are hostile to exclusion clauses.

Is an exclusion term actually a part of the contract?

A principle of law applying to exclusion clauses is that an exclusion clause cannot form part of a contract unless the party affected by it:

- actually knew of it, or
- was given sufficient notice of it.

However, for notice to be 'sufficient':

- the document containing the exclusion clause must be an integral part of the contract, and
- the notice must be given at the time the contract was made (and not later).

C

Case: Chapelton v Barry UDC [1940]

The plaintiff hired a deck chair and was given a ticket for the chair hire. The terms of hire were printed on the back of the ticket, and these included a clause excluding Barry Urban District Council from any liability for injury to users of the chairs arising as a fault of the chairs. The plaintiff's chair broke and he was injured.

Barry UDC argued that the terms printed on the ticket were a contractual document, therefore the exclusion clause was a part of the contract between the council and users of its deck chairs. The court disagreed, and held that the ticket was a receipt, not a contractual document.

The exclusion printed on the ticket was therefore not an exclusion clause in the contract for the hire of the deck chair.

This same rule applies to similar tickets, such as cloakroom tickets.

C

Case: Thornton v Shoe Lane Parking Ltd [1971]

The wages of a maintenance and repairs engineer might be a direct cost of the department in which he works. However, his wages are an indirect cost of each individual cost unit produced by the department. This is because the job of the engineer is to fix machines and other equipment when they break down, and he is not involved directly in producing the output of the department.
direct cost of all the units of production made in the factory.

Thornton went to park his car in a multi-storey car park owned by the defendants. A notice at the entry to the car park stated that parking was at the owner's risk, but this was not visible until the cars were already on the ramp leading to the entry to the car park. At the entry to the car park was a ticket dispensing machine that issued car park tickets. The tickets contained the words: 'This ticket is issued subject to the conditions of issue as displayed on the premises.'

Inside the premises were several large notices displaying the terms for customers using the car park. These terms included an exclusion exempting the car park company from any liability to customers for damage to their cars or for personal injury. On returning to collect his car, Thornton was injured and the cause of the accident was partly his fault but partly the defendants' fault.

The defendants claimed that the exclusion in the conditions of use exempted them from any liability. The court disagreed. It held that the ticket was received too late, since the plaintiff's car was already on the ramp to the car park when he received it. In attention, the exclusion was not fairly brought to the defendant's attention. The defendants were therefore unable to claim that the exclusion clause was a part of the contract between the car park company and users of the car park.

A person who is affected by an exclusion clause cannot claim that the exclusion clause is invalid because he did not see it, possibly because he did not have time to read the contract, before the contract was made. Similarly, a person cannot seek to avoid an exclusion clause by claiming that he read it but didn't understand it.

If the exclusion is included in the contract, or if sufficient notice is given, it is an actual contract term. (The courts would then have to decide whether the exclusion clause is reasonable, or unfair, as explained later.)

C

Case: L'Estrange v Graucob [1934]

Mrs L'Estrange owned a café. She bought a cigarette machine from the manufacturers, but when the machine was installed, it did not work properly. An implied term in a contract for the sale of goods is that the goods should be suitable for their intended purpose, which this machine was not (since it did not work). However, the contract for the sale of the cigarette machine, which was signed by Mrs L'Estrange, included an exclusion clause in which the manufacturers disclaimed all liability for any malfunction of the machine. Mrs L'Estrange claimed that she had not read the clause when she signed the contract.

The court held, however, that she could not claim damages from the manufacturers since the manufacturer had not been guilty of any fraud or misrepresentation when they got her to sign the contract.

(Note: This case was decided before the Unfair Contract Terms Act 1977 came into force. If the same case re-occurred today, it might be possible to claim that the exclusion clause was not binding on Mrs L'Estrange because it was unreasonable and unfair.)

Another principle applied in cases dealing with exclusion clauses is that if the two parties have previously had dealings on the basis of an exclusion clause, the same exclusion clause may be included in subsequent contracts between the same two parties. However, the party subject to the exclusion clause must be **actually aware** of the existence of the exclusion clause in the new contract. The fact that the exclusion clause was in a previous contract is not sufficient to demonstrate 'actual knowledge' by that party of its inclusion in the new contract.

This principle might seem unusual. It may be applied, however, to cases where an individual deals with a supplier occasionally. Each time the individual deals with the supplier, there is a new contract. If there is an exclusion clause in a previous contract, the supplier might wish to assume that the customer is well aware that the same exclusion clause applies to the current contract.

1.7 Unfair contract terms: statutory regulations

Although much of the law relating to contracts is based on common law (case law), there are some important statutory rules about contracts containing unfair contract terms. The main statutory rules and regulations are:

- The Unfair Contract Terms Act 1977
- The Unfair Terms in Consumer Contracts Regulations 1999.

In addition, the **Sale of Goods Act 1979** states that traders must sell goods as they are described and the goods must be of satisfactory quality. If **consumers** find that goods they have purchased do not meet these requirements, they can reject the goods and ask for their money back (provided they do so quickly). Alternatively they can ask for the goods to be repaired or replaced, or (in some situations) claim compensation.

Unfair Contract Terms Act 1977 (UCTA)

The Unfair Contract Terms Act 1977 (UCTA) seeks to prevent contracts from including terms that are unfair or unreasonable in trying to exclude one party (usually the seller) from liability.

- Any exclusion clause that is unreasonable is void and unenforceable.
- Only a court can decide, whenever a disagreement arises between the parties to a contract, whether an exclusion clause is unreasonable.

The UCTA uses the term 'negligence', so it is useful to understand what exactly this means in terms of contract law. Negligence occurs when a party to a contract fails to exercise reasonable care or exercise reasonable skill.

Section 2 of UCTA specifies the key provisions of the Act.

- A contract term, or notice given to a person or to persons generally, cannot exclude a person from liability for death or personal injury that arises as a result of that person's negligence.
- In the case of any other loss or damage to the other party, a person cannot use a contract term to exclude or restrict his liability for negligence, except insofar as the exclusion term satisfies the requirement of 'reasonableness'.

This means that a contract cannot contain a clause excluding a person from liability for death or personal injury, where the death or injury is caused by that person's negligence. In addition, exclusion clauses cannot exclude a person from liability for loss to the other party, unless the exclusions are reasonable.

Section 11 UCTA defines the requirement for reasonableness by stating that a contract term excluding one party from liability 'shall be a fair and reasonable one … having regard to the circumstances.' If a dispute about the reasonableness of an exclusion clause in a contract is taken to court it is for the person claiming that the term satisfies the requirement for reasonableness to demonstrate to the court that it does. In other words, the 'burden of proof' is on the party seeking to benefit from the exclusion clause.

Unfair Terms in Consumer Contracts Regulations 1999

The Unfair Terms in Consumer Contracts Regulations 1999 (UTCCR) are intended to protect consumers from unfair terms in 'standard contracts', such as contracts for gas supply, electricity supply and water supply. These are contracts where the standard terms are imposed by the supplier on a 'take it or leave it' basis, and the consumer is not able to negotiate terms and agree negotiated terms with the supplier. When a supplier imposes standard terms on consumers, the contracts might include some terms that are unfair to the consumer. All suppliers who apply standard contract terms must comply with the Regulations.

The Regulations define a consumer as any **natural person** who in contracts covered by the Regulations is acting for purposes that are outside his trade, business or profession. This provides a fairly broad definition of 'consumer'.

Regulation 5 defines an unfair term in a consumer contract. 'A contractual term which has not been individually negotiated shall be regarded as unfair if … it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.'

Regulation 8 specifies the consequence of an unfair contract term in a consumer contract. 'An unfair term in a contract concluded with a customer by a seller or supplier shall not be binding on the consumer. The contract shall continue to bind the parties if it is capable of continuing in existence without the unfair terms.' In other words, an unfair term in a standard contract cannot be enforced against the consumer.

This means for example that if there is an unfair term in a standard contract to supply electricity to a householder, the unfair term is not binding on the householder, but the rest of the contract is unaffected. This means that the householder is not at risk of having the electricity supply withdrawn as a result of the any dispute over the unfair contract term.

The **Office of Fair Trading** may investigate any complaints of unfair contract terms. It has also issued guidelines on what it would consider to be an 'unfair' contract term. These include terms in a standard contract that:

- protect the supplier from certain claims in law that the customer may wish to make
- exclude the supplier from liability for selling faulty or incorrectly-described goods
- set unreasonable time limits on the right of customers to make claims.

Disclaimers that seek to exclude the supplier from liability or limit the liability of the supplier are also unfair terms.

Contracts: discharge and breach

- Discharge of a contract
- Partial performance of contract obligations
- The doctrine of partial performance: quantum meruit
- Breach of contract
- Anticipatory breach
- Remedies for breach of contract

2 Contracts: discharge and breach

2.1 Discharge of a contract

Discharge is the way that a contract comes to an end. **Most contracts are discharged by performance**, with both parties doing what they agreed to do.

The parties may also agree between themselves to bring a contract to an end. For example, an agreement for the rental of a property might be terminated by one party giving an agreed amount of notice (to terminate the contract) to the other party.

In some cases, performance of a contract may be frustrated by factors outside the control of the parties, such as a war or natural disaster. In such cases, the contract is void.

When a contract is not discharged by performance or agreement between the parties (or ended by factors outside the control of the parties) there is a breach of contract.

2.2 Partial performance of contract obligations

As a normal rule, a contract is not discharged by partial completion of the contract obligations. The contract is only discharged when everything agreed in the contract has been done and completed.

At one time, the legal rule on discharge of contractual obligations was very harsh.

C

Case: Cutter v Powell [1795]

An individual was employed as the second mate on a ship. His contract stated that he would be paid an agreed sum on completion of the voyage. He died part way through the voyage and the owner refused to pay the widow on the grounds that the contract had not been discharged.

The court upheld the owner's view as the contract was not discharged until the voyage had been completed, and that the individual (his estate) was not entitled to any payment. Effectively, this ruling meant that by dying, the individual was in breach of contract.

This very harsh rule has now been developed, to provide a number of exceptions to the basic rule:

- Where a contract of employment is for a specific term, but fulfilment of the contract requirements is divisible. The employee is therefore entitled to a monthly salary or weekly wage for work done as the term of the contract progresses. If the individual leaves the job before completing the agreed term, the employer is not entitled to claim back all the wages or salaries paid to date.
- Where the major part of the contract obligations have been fulfilled, a person who is then in breach of contract should be entitled to some payment for the work done up to the time of the breach.
- Where partial performance is accepted by the other party. In effect, when there is an agreement between two parties that a contract should be ended when it is only partially completed, the parties are released from their original contract.
- When completion of the contract is frustrated by the other party, the other party is required to make some payment even though the contract has not been completed.

Two of these exceptions are illustrated by the following cases.

C

Case: Hoenig v Isaacs [1956]

A contract was agreed for the decoration of a flat for £750. The defendant claimed the work was not fully completed and the unfinished work cost £56 to remedy. The defendant claimed that since the work had not been finished, there was a breach of contract and the decorator was not entitled to any payment.

The court held that the plaintiff had completed the substantial part of his contract obligations, and the defendant was required to pay him the £750 less the £56 cost of completion. This ruling is consistent with the more general rules on the measure of damages, which are explained later.

C

Case: Planche v Colburn [1831]

The plaintiff agreed a contract with the defendant to write a book on armour, with £100 payable on completion. The plaintiff carried out some research into the subject before the defendant decided to abandon the project. The court held that the plaintiff was entitled to a proportion of the fee because the completion of the contract had been frustrated by the defendant.

2.3 The doctrine of partial performance: quantum meruit

The **doctrine of partial performance** is that if one party to a contract accepts partial performance by the other party, both parties are by implication released from their obligations under the original contract and they agree to a new contract in which there is an agreement to pay for the work done so far or the goods supplied so far.

The doctrine of partial performance only applies, however:

- if neither party has committed a breach of the contract up to the time that it is terminated, and
- the party who is receiving goods or services under the terms of the contract has a choice of accepting or rejecting partial performance, and there is no necessity to terminate the contract.

This restricted application is intended to prevent a party to a contract from breaching the terms of the contract, or indicating his intention to breach the contract, and using the doctrine of partial performance to claim some of the agreed payment.

Quantum meruit

When a contract is discharged when it has only been partly performed, there is a question about how much should be paid to the party who has fulfilled some but not all of the contract obligations, and is entitled to some but not all of the payment specified in the contract.

The courts apply the principle of 'quantum meruit' in deciding how much a party should be paid for partial completion of a contract, in situations where the doctrine of partial performance applies. 'Quantum meruit' is also applied by the court to decide the amount that should be paid for services:

- when a formal contract for providing the services does not exist (for example, when the contract has been agreed verbally, without any discussion of price), or
- when there is doubt as to the amount that should be paid for the work that has been performed under any other circumstances where payment could be expected by one party to the contract.

'Quantum meruit' means 'as much as he deserves'. The court will decide the amount of the payment due on the basis of the amount that is merited for the amount and the quality of the work actually done.

C

Case: Sumpter v Hedges [1898]

Sumpter agreed to erect some buildings on Hedges' land for £565. He did a part of the work, but then abandoned the job before any of the buildings were complete. Hedges completed the construction work himself, using materials left on site by Sumpter. Sumpter sued Hedges to recover the value of the work done on the partially-finished contract.

The court held that in this case the doctrine of partial performance did not apply. This was because Hedges had no choice but to accept that Sumpter would not finish the work. Since Hedges had no choice, the doctrine did not apply, and Sumper could not claim any payment for the work he had done. However the court also held that Hedges did not have to use the materials that Sumpter left on site: he had the choice of buying other materials to finish the work. Hedges should therefore be liable to Sumpter for the cost of the materials he had used.

2.4 Breach of contract

Breach of contract: this occurs when the contract is not discharged, because one party (but not the other) fails to fulfil his obligations under the terms of the contract, either:

- completely, as specified in the terms of the contract, or
- to a satisfactory standard.

When one party is in breach of contract, the other party (the 'injured party') has a right to take legal action to obtain a remedy.

A breach of contract may be either:

- a repudiatory breach, or
- an anticipatory breach.

Repudiatory breach

A repudiatory breach occurs in either of the following situations:

- When one party indicates, either by words or actions when the time to fulfil the contract terms has started, that he will not complete his side of the contract.
- When one party fails to satisfy one of the conditions of the contract, and this failure impacts on the other party.

2.5 Anticipatory breach

A repudiatory breach only occurs after the time to fulfil the terms of the contract has begun. An **anticipatory breach** of contract occurs where it is apparent **before** the time to fulfil the contract has started that one party will breach the terms of the contract.

- One party to the contract might indicate, before the date for performance of the contract, that he has no intention of fulfilling his contractual obligations.
- Alternatively, it becomes apparent to one party, before the date for performance of the contract, that the other party will not be in a position to fulfil his contractual obligations.

Anticipatory breach of contract is either:

- express, or
- implied. These terms are explained later.

The significance of anticipatory breach is that the injured party has a choice of when to take legal action for breach of contract.

- The injured party can sue for damages as soon as it is apparent that the contract will not be completed.
- Alternatively the injured party can continue with his side of the contract until the breach actually occurs.

C

Case: White and Carter (Councils) v McGregor [1961]

McGregor agreed a contract with the plaintiffs for the plaintiffs to put advertisements on public litter bins that were supplied to local authorities. He then wrote to the plaintiffs asking them to cancel the contract. The plaintiffs refused, but McGregor's request to cancel the contract and indication that he would not pay was an anticipatory breach of contract.

The plaintiffs decided to continue with their side of the contract obligations and produced the litter bins with the display advertisements. They then sued McGregor for payment.

The court held that the plaintiffs were under no obligation to accept McGregor's repudiation of the contract, and they were entitled to carry out their side of the contract obligations before suing for breach of contract by the other party. Having carried out their side of the contract, the plaintiffs were entitled to claim payment of the agreed price.

C

Case: Vitol SA v Norelf Ltd [1996]

The parties agreed a contract for the sale of a cargo of propane. While the cargo was being loaded, the buyers sent a telex to the sellers repudiating the contract on the grounds that the loading would not be completed on time. The sellers did not reply to the telex. The loading was completed and the vessel sailed with its cargo on board.

The sellers brought a claim (in arbitration) for the difference between the contract price for the propane that had been agreed with the buyers and the price at which they had been obliged to sell the propane in the market.

In this case, the arbitration court found that the anticipatory breach of the contract by the buyers gave the sellers the right to repudiate the contract. Their decision to sell the propane for what they could get in the market was sufficient notification to the buyers of their intention to elect to treat the contract as being at an end.

Express anticipatory breach of contract

Express anticipatory breach of contract occurs when one party announces before the date for performance of the contract that he has no intention of complying with his contractual obligations. In other words, one party openly admits in advance that he will breach the contract.

C

Case: Hochster v De La Tour [1853]

In April, Hochster was engaged by De La Tour to act as a courier on a European tour starting on 1 June. De La Tour then wrote to Hochster on 11 May saying that his services on the tour would no longer be needed.

On 22 May, Hochster started proceedings for breach of contract by De La Tour, but De La Tour argued that proceedings could not be started before 1 June, when the services of Hochster were contracted to begin.

It was held, however, that there had been an express anticipatory breach of contract, and Hochster was entitled to take legal action as soon as the anticipatory breach occurred.

Implied anticipatory breach

With implied anticipatory breach of contract, the party that will be in breach of the contract does not openly state that he will not carry out his contractual obligations. However, he does something that makes a breach of contract inevitable, because he puts himself in a position where it will be impossible for him to carry out his contractual obligations.

C

Case: Omnium Enterprises v Sutherland [1919]

The defendant agreed to lease a ship to the plaintiff with the lease period to start from a future date. Before the actual date arrived for the start of the lease, the defendant sold the ship to a third party.

The court held that by selling the ship, the defendant had made it clear that he would not be in a position to carry out his obligations under the terms of the contract with the plaintiff. An implied anticipatory breach of contract had occurred, and the plaintiffs were entitled to take legal action for breach as soon as the anticipatory breach occurred, without having to wait for the start date for performance of the contract.

2.6 Remedies for breach of contract

When a breach occurs the court has to decide what the appropriate remedy should be. There are a number of possible remedies. The main remedies are:

- Damages
- Specific performance
- An injunction
- Rescission of the contract.

Damages are a common law remedy. The party to the contract who has committed the breach of contract is required to make a payment to the injured party, for the loss that the injured party has suffered.

Damages are the most common remedy in cases of breach of contract. The rules on the award of damages are explained in more detail later.

There are situations where damages might not be the most appropriate solution, and another remedy might be more fair. The court therefore has the power to apply an equitable remedy – specific performance, an injunction or rescission.

Specific performance

Specific performance is an equitable remedy where the court requires the person who committed the breach of contract to carry out his obligations under the contract. This remedy is granted at the court's discretion and there is no automatic right of the injured party to specific performance. As a remedy, it is most commonly applied in cases of breach of contract relating to the sale and purchase of land (or other valuable assets).

The remedy of specific performance is **never** used in cases where the contract involves:

- the provision of **personal services** by the party who is in breach of the contract, or
- contracts of **employment**.

C

Case: Beswick v Beswick [1968]

The plaintiff was the widow of a coal merchant who had transferred his business to a nephew in return for a weekly payment and an annuity to the widow if he died. Following the death of the coal merchant, the nephew did not make the promised payments to the widow, and the widow sued to claim the annuity.

The court held in this case that damages were not an adequate remedy and the courts ordered the nephew to make the payments (i.e. specific performance of the contract).

Injunction

An injunction is another equitable remedy. It is a court order that directs a person not to break their contract. An injunction will only be used as a remedy to enforce a negative promise or undertaking (negative 'covenant' in a contract). An injunction is not used to oblige a person to do something positive.

However, the effect of an injunction in the case of contracts for personal service might be to enforce the contract and oblige a party to the contract to continue providing the service.

C

Case: Warner Bros v Nelson [1937]

Nelson was an actress under contract to Warner Bros. Her contract stated that she could only perform for Warner Bros during the period of her contract. Warner Bros took her to court when she decided to break this agreement, and the court's remedy was an injunction requiring her to comply with her promise not to work for any other studio.

In effect, the injunction obliged her to comply with the (negative) promise in her contract.

Rescission

Rescission is a remedy for breach of contract where the contract is void as a result of the breach and the injured party can treat the contract as if it had never been made. As a result, the injured party can demand that all money and other assets that have been exchanged under the terms of the contract, up to the time of the breach, should be recovered.

Rules relating to the award of damages

- Damages as a common law remedy
- Deciding the amount of damages: guiding principles and rules
- Rules relating to the 'remoteness' of damage
- Rules relating to the 'measure' of damages
- Duty to mitigate losses
- Damages for anxiety, vexation or aggravation
- Liquidated damages and penalty clauses

3 Rules relating to the award of damages

3.1 Damages as a common law remedy

Damages are a common law remedy for breach of contract. Whereas 'equitable' remedies for breach of contract are discretionary and for the court to decide, damages are available as a **right** to any injured party who has suffered a money loss (pecuniary loss) as a consequence of a breach of contract.

When a breach of contract occurs, the court has to decide what the amount of damages should be. The main problem relates to '**unliquidated damages**': this term relates to damages where the contract itself makes no reference to the amount of damages in the event of a breach of contract; therefore the court has to decide the amount of the loss and the amount of damages payable.

A basic principle is that damages are not intended to be punitive. They are intended to be 'restorative'. In other words, the amount of the damages is not decided so that the party who commits the breach of contract is punished. The purpose of damages is to put the injured party back into the financial position that he would have been if the contract had been completed and no breach had occurred.

3.2 Deciding the amount of damages: guiding principles and rules

The main rules relating to the award of unliquidated damages can be divided into two categories:

- rules relating to the 'remoteness' of the damage
- rules relating to the 'measure' of the damage.

3.3 Rules relating to the 'remoteness' of damage

'Remoteness of damage' is concerned with the **consequences** of a breach of contract. Damages are awarded for the loss that the injured party suffers when a breach of contract occurs. However, a breach of contract might have some 'knock-on' effects that were possibly not foreseen when the contract was originally agreed.

For example, suppose that a well-known actor has agreed to appear in a new stage play at a theatre, but then announces soon before the play is about to open that he has changed his mind. The theatre company will have to find and pay for a different actor to play the part. If it has to pay more for the new actor than it had arranged to pay the actor in breach of contract, the theatre company would suffer a direct loss.

However, the theatre company might also claim that the new actor they have found for the play is not as good as the actor who is in breach of contract, and as a consequence the audiences for the play were much smaller than expected. Should the theatre company be allowed to claim loss of sales income from theatre audiences as part of the damages? Or is the loss of theatre audiences too 'remote' so that it would be unreasonable to expect the actor to pay for the theatre company's loss of income?

The rule in Hadley v Baxendale

The rule on the remoteness of damage were stated for the first time in the case *Hadley v Baxendale*. The rule was stated as follows: 'Where two parties have made a contract which one of them has broken, the damages in respect of breach should be such as may fairly and reasonably be considered either (1) arising naturally, according to the usual course of things from such breach of contract itself or (2) such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of breach of it.'

There are two parts to this rule. The rule is that the effect of damages (the loss to the injured party) will only be awarded in respect of:

- losses that arise naturally, in the normal course of events (first part of the rule); and/or
- losses that do not arise normally, but that both parties may reasonably be supposed to have contemplated, when the contract was made, would be the probable consequences of a breach of contract (second part of the rule).

The **first part of the rule** means that damages should be awarded for direct losses suffered by the injured party, if the losses occurred naturally as a consequence of the breach of contract. It does not matter whether the parties **expected** the loss to occur as a consequence of a breach of contract. It is sufficient that the loss would occur naturally as a consequence of the breach.

The **second part of the rule** means that damages will also be awarded by the court for indirect losses (consequential losses) arising as an unusual or abnormal consequence of the breach, but **only if** both parties knew that these unusual consequences (and losses) would probably occur.

C

Case: Hadley v Baxendale [1854]

The plaintiff was a mill owner, who contracted with a carrier to deliver a broken iron mill shaft to a manufacturer. The manufacturer would then use the broken shaft as a template for making a new one. The carrier was late in delivering the broken shaft. The mill owner had told the carrier that delivery was urgent, and the carrier knew that the mill was out of operation and idle.

As a result of the late delivery of the mill shaft, the mill could not operate for longer than the mill owner had expected, and the mill owner suffered losses (due to lost business) as a result. The mill owner claimed for loss of profits while the mill lay idle.

The court decided that although the carrier knew that delivery was urgent and the mill was currently idle, he could not know that the resumption of operations at the mill depended on the timing of the delivery. The resulting loss from late delivery was not in the contemplation of the carrier when the contract with the mill owner was agreed. Due to the remoteness of the damage, the court decided that the plaintiff should not be awarded damages for loss of profits.

C

Case: Victoria Laundry Ltd v Newman Industries Ltd [1949]

In this case, the plaintiff claimed damages for delay in completion of a contract by the defendant, which amounted to a breach of contract. The plaintiffs claimed damages for loss of normal profits as a result of the delay. In addition, they claimed damages for the loss of abnormal profits that had occurred: this was because a highly profitable contract had been lost as a consequence of the delay. The defendants knew nothing about this contract.

Applying the rule in *Hadley v Baxendale*, the court decided that damages should be awarded for the loss of normal profits (first part of the rule), but damages should not be awarded for the loss of abnormal profits, because this loss was not in the contemplation of the parties (as a probable consequence of the breach of contract) when the contract was made.

C

Case: The Heron II [1969]

A contract for the shipping of sugar was agreed between two parties. It was generally known that the sugar would be sold on arrival at the destination. The ship arrived nine days late, during which time the price of sugar had fallen. The injured party claimed for the loss suffered over the nine days.

The court (House of Lords) upheld the claim on the grounds that the market price of sugar value is variable, and the consequence of the delay in shipment should have been 'within the reasonable contemplation of the parties' at the time they agreed their contract. In this case, the loss was therefore a normal loss, falling within the first part of the rule in *Hadley v Baxendale*.

3.4 Rules relating to the 'measure' of damages

As stated earlier, the basic rule about the amount of damages (or '**quantum'** of damages) is that the amount of damages should be sufficient to compensate the injured party for the losses suffered as a consequence of the breach of contract. They are not intended to punish the party that committed the breach.

The market rule

In some cases, deciding the amount of damages is fairly straightforward and can be decided by application of the 'market rule'. This means that when there is a breach of contract between a buyer and seller, the injured party is entitled to go into the market to buy or sell.

- If the buyer is the injured party because the seller is in breach of contract, the buyer is entitled to go into the market to buy similar goods and pay the market price for those goods. The loss is the difference between this market price and the price for the goods in the contract that has been breached.
- If the seller is the injured party, the seller is entitled to go into the market and sell the goods that the buyer has refused to accept, and sell them for as much as possible. The loss is the difference between this market price and the price for the goods in the contract that has been breached.

For example, suppose that X and Y agree a contract for the supply by Y to X of 100 tonnes of Material M at a price of £5,000.

- Suppose that Y fails to supply the materials as promised. A breach of contract has occurred, and X is forced to buy the materials from another supplier for £6,000, which is the best alternative price available. In this case the amount of damages payable by Y to X should be £1,000, which is the extra amount that X has been obliged to pay for the materials as a consequence of the breach by Y.
- Suppose that instead of Y being in breach of the contract, Y delivers the 100 tonnes of Material M to X, but X refuses to accept the delivery and is in breach of contract. As a consequence, Y is forced to sell the materials elsewhere, and the best price obtainable is £1,500. In this case the amount of damages payable by X to Y should be £3,500, which is the loss of revenue that Y has suffered as a result of the breach of contract by X.

In many cases of breach of contract, however, it is not so easy to establish the amount of the pecuniary loss suffered by the injured party. The courts follow certain rules and guidelines in deciding how the amount of the loss and therefore the amount of damages payable should be established.

The measure of damages if there is no monetary loss

Since the amount of damages will be based on the amount needed to remedy the loss and put the injured party back in the position he would have been if the contract had been completed, it follows that if the injured party does not actually suffer any loss, damages will not be awarded or will be nominal (very small).

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Case: Surrey County Council v Bredero Homes [1993]

The Council sold some land to the defendant on condition that he would built a specified number of homes on the property. The defendant deliberately built more homes in breach of this condition and the Council claimed as damages for breach of contract the additional profit that the developer had made.

The court held that the Council had not suffered any loss and therefore had no right to claim the excess profits made by the defendant.

Measure of damages with construction contracts

Problems often arise with measuring the damages when there has been a breach of a construction or building contract. The builders might have breached the contract by:

- failing to do any construction work at all, or
- doing the work, but to an unsatisfactory standard.

If a contractor fails to do the agreed work, the injured party will have to go into the market and find another contractor who will do the work instead. The direct loss to the injured party is then the difference between the price agreed in the original contract and the price that must be paid to the new contractor, if this is higher.

The situation is more complicated when the contractor does the work to an unsatisfactory standard. In some cases, the loss to the injured party may simply be the cost of getting rectification work done. In some situations, however, the cost of getting someone else to rectify the bad work might be out of all proportion to the value of the original construction contract.

When the cost of carrying out rectification work is out of all proportion to the benefits that are obtained from the rectification, the measure of damages should be only the difference in value between:

- the benefits actually obtained from the faulty construction, and
- the benefits that would have been obtained if the construction had been completed in accordance with the contract specification.

The following case illustrates this rule.

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Case: Ruxley Electronics and Construction Ltd v Forsyth [1995]

A construction company contracted with a householder to build a swimming pool in the householder's garden. The contract specified that the pool should have a maximum depth of seven feet six inches. The construction company built the pool to a maximum depth of six feet nine inches. A breach of contract had occurred, but the dispute was about the amount of the damages.

The original contract price for building the pool was £70,000 and the cost of reconstructing the pool to its specified maximum depth would have been an extra £21,000. The court decided that this was much too high in relation to the extra benefit that would be obtained from having a deeper pool. The pool was safe to dive into, and the loss of depth did not affect the value of the pool. The court decided, however, that there was some 'loss of amenity' for the householder, which it valued at £2,500. Damages were therefore decided at £2,500 rather than the £21,000 cost of reconstruction.

3.5 Duty to mitigate losses

A basic legal rule on damages is that when there is a breach of contract, the injured party is under a duty to take all reasonable steps to mitigate his loss. ('Mitigate' means reduce or make less severe.)

- Suppose that a supplier and a customer agree a contract for the sale and purchase of goods, but the supplier fails to deliver the goods as promised. The buyer can claim damages for breach of contract, but is under a duty to mitigate his loss. He should do this by trying to purchase similar goods from another supplier at the lowest price available.
- Suppose that the buyer refuses to take delivery of the goods that he has agreed to buy. The seller can claim damages for breach of contract, but is under a duty to mitigate his loss. If he still has possession of the goods, he should sell the goods to an alternative customer for the highest price available.

In each case, the amount of the loss is calculated as the difference between the price in the contract agreement between the buyer and the seller, and the price at which the injured party is able to deal with someone else for buying/selling the goods.

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Case: Payzu v Saunders [1919]

Payzu made a contract with the defendant for the purchase of quantities of fabric. The fabric would be delivered in instalments and it was agreed that payment should be made in instalments, after each delivery. The buyer (Payzu) failed to pay the first instalment on time and the defendant refused to supply any more fabric unless Payzu paid for each delivery in advance. Payzu refused and sued for breach of contract.

The court held that the defendant was in breach of contract. However, it also decided that the injured party has a duty to mitigate his losses. In this case, Payzu could have mitigated the losses by paying for the deliveries in advance. The losses would then be the cost of interest for the difference between paying in advance and paying after delivery.

Ability to mitigate a loss for breach of contract

The ability of an injured party to mitigate the loss for breach of contract depends on the circumstances of the case, which the court will take into consideration.

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Case: Western Web Offset Printers Ltd v Independent Media Ltd [1995]

The parties entered into a contract for the plaintiff to print 48 issues of a weekly newspaper. The defendants then repudiated the contract and the plaintiff took action for breach of contract. There had clearly been a breach of contract, but the question was how much should the damages be?

The plaintiff argued that the losses amounted to the loss of gross profit as a result of losing the work. This would be about £177,000. The defendants argued that the losses should be only the net profit, after deducting labour costs and overhead costs from the gross profit. This would make the loss about £38,000.

The argument of the defendant was that the plaintiff had a duty to take reasonable steps to mitigate the loss. By finding other work from other customers, the plaintiff should be able to cover the labour and overhead costs, and so the loss should only be the net profit of £38,000 from the contract.

The court (Court of Appeal) disagreed. It took the view that in view of the recession in the economy at the time, the plaintiffs were unable to mitigate their losses by finding alternative work. The plaintiffs were therefore entitled to claim the full gross profit on the contract as the loss they had suffered from the breach of contract.

3.6 Damages for anxiety, vexation or aggravation

A general rule applied by the courts is that when there is a breach of contract, damages cannot be awarded for the anxiety, vexation, aggravation or similar mental disturbance that is caused to the injured party by the breach. This principle has been stated by the judge in several cases.

- 'Contract-breaking is treated as an incident of commercial life which players in the game are expected to meet with mental fortitude' (the judge in *Johnson v Gore Wood & Co* [2001]).
- 'A contract-breaker is not in general liable for any distress, frustration, anxiety, displeasure, vexation, tension or aggravation which his breach of contract may cause to an innocent party. This rule is not, I think, founded on the assumption that such reactions are not foreseeable, which they surely are or may be, but on consideration of policy' (the judge in *Watts v Morrow* [1991]).

There is an exception to this general rule. When a contract is intended to provide relaxation, pleasure or peace of mind, damages will be awarded for the mental distress, displeasure or disappointment suffered by the injured party as a result of a breach of contract. For example, an individual might buy a holiday from a travel company which then cancels the holiday at a late stage, which means that the holiday maker cannot make alternative holiday arrangements. In this situation, the courts would award damages to the individual for the distress caused by the cancellation of the holiday.

3.7 Liquidated damages and penalty clauses

The parties to a business contract may discuss what should happen if there is a breach of contract by one of them, and include in the terms of the contract a provision for the payment of damages in the event that a breach occurs stating what the **amount of the damages** should be.

Damages payable under such a contract provision are called **liquidated damages**.

A party to a contract may challenge the validity of a liquidated damages clause. The court will recognise a liquidated damages clause as valid:

- only if it represents a genuine estimate (at the time the contract is made) of the losses that would arise in the event of a breach of contract, and
- only if the amount of the damages is not intended as a penalty against the party who breaches the contract terms.

A **penalty clause** is one in which the amount payable in the event of a breach of contract is excessive in view of the losses suffered by the injured party. If a court decides that a clause in a contract is a penalty clause, it will not enforce the clause. Instead, it will apply the normal rules for establishing the amount of damages payable.

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Case: Dunlop v New Garage and Motor Co [1915]

Dunlop supplied the defendants with tyres. The contract between them included a clause that provided for a minimum resale price for the tyres (at a time when minimum resale price agreements were legal). It also stated that if the defendants re-sold the tyres for less than the minimum agreed amount, a payment of £5 per tyre should be made to Dunlop.

The defendants did sell tyres below the agreed minimum price but refused to pay the £5 per tyre. In court, they argued that the £5 per tyre was a penalty payment and so invalid. On considering the particular facts of the case, the court decided that the payment of £5 per tyre was a genuine attempt to estimate the losses to Dunlop from a breach of the agreement, and the payment therefore represented liquidated damages. The liquidated damages clause was enforceable.

CHAPTER

4

The law of tort

Contents

The meaning of tort

- Tort and tortious liability
- Vicarious liability
- Examples of torts
- The tort of deceit
- The tort of private nuisance
- Remedies for tort

1 The meaning of tort

1.1 Tort and tortious liability

Tort is a wrongful act that causes damage or injury to a person. The wrongful act might be deliberate, but might also be unintentional and due for example to negligence and carelessness.

Tort is a civil offence, not a criminal offence. A person who suffers loss or damage as a result of a tort can therefore bring a civil action as a 'claimant', in most cases seeking 'unliquidated damages'. Unliquidated damages are damages where the court decides on the amount of damages payable.

Tortious liability

Tortious liability is the liability that a person has arising from the law of tort. It is usually based on the principle of fault and the liable person is to blame in some way for the damage or injury to the other person.

Tortious liability also usually occurs when a person is in breach of a duty that is fixed primarily by law and is a duty towards other people generally.

An example is injury caused to another individual in a road accident. A person driving a car has a legal duty to drive with due care, but might injure another person. If the injury is caused by careless driving, the driver has a tortuous liability to the injured person, who can bring a legal action for damages for the loss or injury suffered.

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Case: Ward v Tesco Stores Ltd [1976]

Duties in the law of tort normally arise from a general statutory duty, such as a duty to drive on the roads with care. However, a tortuous liability can sometimes arise because the claimant and the defendant have entered a voluntary relationship, even though this relationship is not a contractual one.

In the case Ward v Tesco Stores, the claimant was injured in a supermarket when she slipped on some spilled yoghurt. The court held that the supermarket company had a duty of care (a 'tortious obligation') to the woman as soon as she entered the store, and was therefore liable for the injuries she had suffered because it had not shown sufficient care in allowing the yoghurt to remain on the floor and not clearing it up.

The law of tort and contract law

In the law of contract, a contract exists between two parties, and if one party breaks the terms of the contract, the injured party can bring a civil action for breach of contract.

In the law of tort, there is no contract between the person causing the injury or damage and the person who suffers it.

Definitions

Tort can therefore be defined as 'damage, injury or a wrongful act done wilfully, negligently or in circumstances involving strict liability but not involving breach of contract for which a civil suit can be brought.'

Tortious liability can be defined as a liability that 'arises from the breach of a duty primarily fixed by law; this duty is towards persons generally and its breach is redressible by an action for unliquidated damages' (Winfield and Jolowicz).

1.2 Vicarious liability

The principle of vicarious liability is that one person can be held responsible and liable for the tort of another person. The person held liable might be entirely innocent of any wrongdoing, but is nevertheless held liable because in some way he authorised the wrongful act of the person who did commit the tort (the 'tortfeasor').

In business, vicarious liability is an important concept.

- Vicarious liability exists in a 'master-servant' relationship, and employers are liable for the wrongful acts of their employees that are committed in the course of their work. This means for example that if an employee accidentally but negligently causes physical injury to a member of the public in the course of doing his work, the injured person can sue the employer for the injury caused and the employer will be liable.
- Vicarious liability exists in a principal-agent relationship, so that a company might be liable for the torts committed by an agent in the course of the agent's work for the principal.
- Business partners are liable for the torts of the other partners committed in the course of the partnership business.

1.3 Examples of torts

There are several types of tort. The most common is the tort of **negligence**, and most of this chapter will deal with negligence, including professional negligence. Other types of tort include:

- passing off
- malice
- deceit
- trespass to land
- private nuisance.

Passing off is described in more detail later.

1.4 The tort of deceit

Deceit occurs when one person makes a statement or representation that is false at the time that it is made. For a tort to occur:

- the statement or representation must be made intentionally
- there must be some element of dishonesty in the statement
- a person to whom the representation is made (the claimant in the case) must have been deceived, and
- the claimant must consequently have suffered loss or damage.

Case: Clef Acquitaine v Laporte [2001]

A claimant successfully sued the defendant in the tort of deceit in a case where the defendant had made fraudulent misrepresentations to the claimant about price lists. The defendant had persuaded the claimant, on the basis of the deceit, to invest a large sum of money in a particular way. The investment was not a good one, and the claimant sued for the losses he incurred as a consequence of taking the defendant's advice.

1.5 The tort of private nuisance

The tort of private nuisance is an act that wrongfully interferes with a person's right to the peaceful enjoyment of his land and the rights over his land. ('Public nuisance' is a criminal offence where action is brought by a public body against the offender. Private nuisance is a tort where the legal action is initiated by a private person.)

To succeed in a claim for private nuisance, the claimant must show that significant damage has occurred to his enjoyment of the rights in his land.

- The nuisance might cause physical damage. For example in *St Helens Smelters v Tipping* [1865] the claimant successfully brought an action in the tort of nuisance for damage caused to the trees on his land by fumes from an industrial plant.
- Damage can be to the claimant's enjoyment of the amenity of the land and, rather than its physical damage. In the case *Tetley v Chitty* [1986], a claimant successfully brought a claim for damage caused to his land by noise from a neighbouring go-kart track. In the case *Bone v Seal* [1975], there was a successful claim for damage caused by the odours from a nearby pig farm.

Actions in the tort of nuisance might therefore be brought by the landowner in cases involving noise, odours and soil contamination, as well as physical damage.

1.6 Remedies for tort

The claimant usually seeks damages for the damage or injury caused, although other remedies may be available. The most usual remedy for claimants in tort is **unliquidated damages**, where the court decides on the amount of damages payable. Other possible remedies include:

- **Injunction**. The court may issue an injunction ordering the defendant to stop committing the wrongful act. Injunction is a common remedy in cases involving 'passing off'.
- **Abatement**. In cases involving the tort of nuisance, the court may order the defendant to reduce the amount of noise or odour that has been causing the nuisance.

Negligence: duty of care

2 Negligence: duty of care

2.1 Establishing a liability for negligence

Negligence is the most important tort. It arises when one person suffers damage or injury through the negligent act (or omission to act) of another person. The aim is to provide compensation for those who suffer loss or injury through the negligence of another person.

An individual is not automatically liable for the consequences of a negligent act. For a person to be held liable for the tort of negligence, three elements of liability must be proved:

- The person accused of negligence must owe a duty of care to one or more other persons (the claimant or claimants).
- This person must be in breach of this duty of care (usually due to negligence, although the breach of duty might be prompted by malice).
- The breach of the duty of care must have caused damage or injury to a person to whom the duty was owed.

This section of the chapter considers what a duty of care means and when it exists. The next section considers breach of a duty of care, causality and damage.

2.2 A duty of care

A person is not automatically liable for every negligent or wrongful act that he commits. A duty of care must exist.

A duty of care usually exists, for example, in the following situations.

- A manufacturer has a duty of care to consumers who use its products.
- An employer has a duty of care to employees, for example to provide a safe working environment.

- A professional person or skilled workman owes a duty of care to the clients or customers using their services: this is in addition to any contractual duties that he might have.
- A driver of a car on the road owes a duty of care to other road users.

2.3 The need to establish a duty of care

A duty of care does not exist in all situations where one person suffers damage or injury through the action of someone else. As stated earlier, to make a successful claim in the tort of negligence, the claimant must demonstrate three things:

- that the defendant owed him a duty of care existed
- that the defendant was in breach of this duty of care, and
- as a result of this breach of duty, the claimant suffered loss through damage or injury.

The existence of a duty of care

A duty of care of the defendant to the claimant must exist.

- Unless it can be demonstrated that a duty of care exists, a person cannot be held liable for his negligent action and the effect of this action on the other person.
- The onus is on the claimant to prove or demonstrate that a duty of care exists.

The law on negligence has developed over time, and there are still some uncertainties about when a duty of care exists.

2.4 The neighbour test

The initial test for establishing whether a duty of care exists was set out by Lord Atkin in the case *Donoghue v Stevens* [1932]. The case established that a manufacturer owes a duty of care to the ultimate consumers of its products. Even though there is no contractual relationship between the manufacturer and the ultimate consumer, a manufacturer must exercise reasonable care to prevent injury to the consumer.

Lord Atkin explained the neighbour test as follows.

- 'The rule that you are to love your neighbour becomes, in law, you must not injure your neighbour. And the lawyer's question: 'Who is my neighbour?' receives a restricted reply.
- 'You must take reasonable care to avoid acts or omissions which you could reasonably foresee would be likely to injure your neighbour. Who, then, is my neighbour?... any person so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question.'

The neighbour test established the following principles.

- The existence of a duty of care is an **objective test** that can be decided rationally. It is not a subjective test based on opinion. This objective test is that the consequences of a negligent act should be 'reasonably foreseeable'.

- A duty of care can be owed to a class or group of persons who might be injured as a consequence of the negligent act or omission. The injured person does not have to be a specific individual.

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Case: Donoghue v Stevens [1932]

This case is sometimes called the snail in the beer bottle case. Mrs D went with a friend to a café where the friend bought her a bottle of ginger beer. She poured out some of the ginger beer and drank it. When she later poured out the rest of the beer from the bottle, the remains of a decomposed snail fell out.

Mrs D subsequently became ill and her illness could be attributed to the ginger beer that she drank. However, because she had not purchased the drink herself, she could not sue the café that had sold the drink under the law of contract. Instead she sued the manufacturer of the ginger beer.

The court found that the manufacturer was liable to the end consumer in the tort of negligence. At the time it was a new basis for establishing liability. It was an important case not only because it established a duty of care for a manufacturer to the end consumers of its products: it also established that a more general duty of care exists in the form of the 'neighbour principle'.

2.5 Reasonable foreseeability and proximity

Court cases since *Donoghue v Stevens* have developed the principles of whether a duty of care exists. Two key factors in establishing a duty of care are:

- reasonable foreseeability, and
- proximity.

Reasonable foreseeability

The neighbour principle relies on the concept of reasonable foreseeability. Reasonable foreseeability is the principle that for a duty of care to exist, the harm that might be caused through a negligent act or omission should be reasonably foreseeable. The claimant must demonstrate that the defendant should reasonably have been expected to foresee the damage that would occur to the claimant as the consequence of his negligent act.

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Case: Fardon v Harcourt-Rivington [1932]

The defendant's car was parked in a street with a dog inside. The car windows were closed. As the claimant walked by the car the dog jumped up and broke a window. A splinter of glass went into the claimant's eye, and the claimant sued the defendant in the tort of negligence for the injury he had sustained.

The case went to the House of Lords, where the claim was dismissed. It was held that a reasonable person could not have foreseen that the accident would happen from leaving the dog in the car, and the defendant was therefore not liable.

Proximity

In order for damage or injury to be reasonably foreseeable, there must be a reasonable closeness or 'proximity' between the claimant and the defendant. There must be sufficient proximity in:

- time (the time between the negligent act and the injury or damage)
- space (physical distance), and
- the relationship between the claimant and the defendant.

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Case: Home Office v Dorset Yacht Co [1970]

Some boys escaped from a Borstal on an island after some of the guards had negligently left them unsupervised. The boys attempted to leave the island and in their attempt they damaged a yacht belonging to the claimant. The claimant brought an action against the employer of the guards, claiming that the employer should be held liable for the negligence of the guards.

The court upheld the claim, on the grounds that there was sufficient proximity in the relationship between the guards and the yacht owner. A reasonable person should have been able to foresee that if the boys escaped to due negligent supervision, they would try to leave the island, and that in trying to leave the island they might cause damage to a yacht (since a yacht or boat was the obvious means of escape).

2.6 Justness and fairness of imposing a duty of care

Another test applied by the courts in deciding whether a duty of care should be applied in a negligence case is whether, in the circumstances of the case, it is just and fair that a duty of care should be imposed. For example, suppose that a bank robber escaping from the scene of his crime is injured in a car accident due to negligent driving by getaway driver. It would not be just or fair to impose on the driver a duty of care towards the bank robber.

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Case: Hill v Chief Constable of West Yorkshire [1988]

Deciding whether it is just and fair to impose a duty of care is sometimes a matter of public policy. In the so-called Yorkshire Ripper negligence case, the House of Lords considered a claim against the police for their failure to arrest the Yorkshire Ripper earlier, despite the existence of strong evidence pointing to his guilt. The claimant argued that because of the police negligence, the Yorkshire Ripper had gone on to murder more victims.

The court rejected the claim partly on the grounds of lack of proximity between the claimant and the police. It also held that it would not be just or fair to impose such a duty of care on the police in carrying out their investigations.

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Case: White v Jones [1995]

A solicitor carelessly failed to amend a will of a client, and the client died before the mistake could be rectified. As a result, individuals who would have become beneficiaries in the will were excluded from the will altogether. The intended beneficiaries brought an action for negligence against the solicitor, to recover the money they would have received in the will.

The lower courts dismissed the claim on the grounds that a solicitor does not owe a duty of care to anyone except the client. However, the House of Lords ruled (by a 3 – 2 majority) that in this particular case it was just and fair that the solicitor should be liable. In the circumstances, he did have a duty of care to the intended beneficiaries, even though he had never met them and had no professional dealings with them.

2.7 Establishing reasonable foreseeability and proximity

In each case involving a claim for negligence, the existence of a duty of care depends on the facts and circumstances of the case, and in particular whether there is reasonable foreseeability of the consequences of a negligent action and whether there is sufficient proximity between the defendant and the claimant.

Some cases have been fairly complex, especially where the relationship between the defendant and the claimant is indirect. For example there might be a contractual relationship between two parties A and B, and as a result of negligence by B in performance of the contract, another person C suffers a loss. C cannot sue B for breach of contract, because no contractual relationship exists. However, can C sue B for negligence in the law of tort?

Negligent misrepresentation

Cases of this type have often involved 'negligent misrepresentation'. This is a negligent statement or representation made by one person, as a result of which another person might act on the false information and suffer a loss.

- Suppose that A and B have a contractual relationship, in which B provides professional advice or information to A. If the advice or information given by B is provided negligently, and is incorrect or misleading (a misrepresentation), it is quite likely that A can sue B for damages for breach of contract. Alternatively, A might sue B for negligent misrepresentation in the law of tort.
- Suppose that A and B have a contractual relationship, in which B provides professional advice or information to A, which A then passes on to C. If the advice or information given by B is provided negligently, and is incorrect or misleading (a misrepresentation), can C sue B for negligence on the grounds that B owed him a duty of care? To establish a duty of care, C would need to demonstrate that the loss to C (or someone similar) as a consequence of the negligence of B was reasonably foreseeable by B. In addition, there must be reasonable proximity between B and C.

Some cases will help to show how the courts might reach a decision on the basis of the differing circumstances of the case.

C **Case: Hedley Byrne v Heller [1963]**

This case established the principle that a person can be held liable for a negligent misstatement, where it is reasonably foreseeable that the information will be acted on by its recipient.

In this case the claimant was an advertising agency that sought to recover losses it had incurred in its business with a client. Its claim was made on the grounds that in its dealings with the client, the agency's decisions had been based on the information given in a reference from the bank in which the bank had negligently over-stated the client's financial resources.

A key factor in the decision in this case was that in providing the reference, the bank was assuming responsibility for the information, and it was reasonably foreseeable that the advertising agency would rely on the professional or skilled opinion provided by the bank.

C **Case: Smith v Eric S Bush [1990]**

The claimant was buying a small house and applied for a mortgage. The mortgage provider used a professional surveyor and valuer to carry out a survey of the house for the purpose of mortgage valuation, and the surveyor/valuer performed this task quickly and carelessly. He informed the mortgage provider that there was no problem with the valuation for the purpose of the mortgage. The claimant did not arrange for a survey of his own and instead relied on the mortgage provider's survey and valuation, and he went ahead and bought the property. It was subsequently discovered that there was serious subsidence of the property. (The cost of repair was about the same as the original cost of the house.)

The claimant sued the surveyor for negligence. The defendant valuer claimed it was not reasonable to expect that the defendant would rely on his valuation and that the claimant should have arranged an independent survey. The case went to the House of Lords where the decision was given in favour of the claimant. The Lords held that whether it was reasonable for the claimant to rely on the valuation had to be decided on the facts of the case. In the purchase of an inexpensive house, as in this case, the buyer might reasonably be expected to rely on the valuation of the lender's surveyor. However, if the property had been much more expensive, it would probably not be a reasonable expectation.

The case established that a person might have a duty of care for negligence when information given to one person is passed on to a second person and used by that second person, who suffers loss as a consequence.

C **Case: Caparo Industries plc v Dickman [1990]**

There are situations where it might be reasonably foreseeable that information given to one person might be passed on to another person, and the other person might act on it.

In the Caparo case, the defendant was an auditor who had made an error in the work on the statutory report and accounts for a client company. The claimant, who was already a shareholder in the company, bought additional shares on the basis of the information provided in the accounts. As a result of acting on the misleading information the claimant suffered a loss and sued the auditor for negligent misrepresentation.

The House of Lords eventually ruled that an auditor has a duty of care to the shareholders of the company, but not to potential investors in the company. In this case, although the claimant was already a shareholder and had bought additional shares, the House of Lords decided that in this case the issue was whether the auditor had a duty of care to the claimant as a potential investor, not as an existing shareholder.

It should have been reasonably foreseeable by the auditor that if the accounts contained misleading information, the claimant might have acted on it and suffered a loss as a consequence. However, there is not sufficient proximity between an auditor and potential investors in the company whose accounts they prepare or audit. The negligence claim therefore passed the reasonable foreseeability test but failed the test of proximity.

2.8 The standard of care

Where a duty of care exists, there is a need to establish what the standard of care ought to be. When is a person sufficiently careful and when is he negligent and failing to provide the expected standard of care?

The basic rule is that negligence occurs when a person who owes a duty of care fails to do something that a reasonable man would do or would not do. The legal standard of care is not the standard that the defendant personally is capable of, but the standard expected from a man of 'ordinary prudence', using an ordinary amount of care and skill in the circumstances.

Although this is the basic rule, the court has to decide what might be expected from an ordinary person 'in the circumstances'. Several different factors may affect the standard of care that is expected, as the following cases illustrate.

C

Case: Haley v London Electricity Board [1965]

The defendant had been carrying out some works that involved digging a hole in a pavement. The claimant was a blind person who was unable to see the hole and as a result suffered some injury. The defendant claimed that any ordinary person would have been able to see the condition of the pavement and would not have suffered any injury. The court decided in favour of the claimant, on the grounds that the electricity company should have foreseen that blind people may walk along the pavement and should therefore have taken better measures to warn them of the potential risk.

C

Case: Carmarthenshire County Council v Lewis [1955]

The defendant county council operated a nursery school. One of the young children wandered out of the school on to the nearby road, causing an accident in which the claimant's husband was killed. The court decided that the council had failed to provide the required standard of care, and should have ensured that the school premises were designed so that young children could not wander off into places where they might cause injury to themselves or to other people.

C

Case: Latimer v AEC Ltd [1952]

AEC owned a factory that was flooded during an usually heavy rainstorm. The rain mixed with deposits of oil on the factory floor, which therefore became very slippy. Although sawdust was spread over the factory floor, it was inefficient to cover all the slippy areas. The claimant slipped on a part of the floor not covered with sawdust and was injured.

The court decided that the factory had applied a suitable standard of care. The only way of avoiding the risk of injury to anyone would have been to close the entire factory, and in the circumstances a reasonable person would not have closed the factory. The plaintiff's claim was therefore rejected.

Factors that may affect the decision of a court about the standard of care required include:

- **The probability of injury and degree of risk involved**: this factor applied in the case of *Haley v London Electricity Board* (see above).
- **The cost and practicability of the measures needed to eliminate the risk**: this factor applied in the case of *Latimer v AEC Ltd* (see above).
- **Common practice**. Measures that conform to normal practice will usually be considered a sufficient standard of care.
- **Skilled persons**. A killed person should be judged in terms of the standard of care expected of a reasonable person with the same professional skill, not a reasonable person who does not posses that skill.

2.9 Summary: three-stage test for establishing a duty of care

The current position of the courts towards establishing a duty of care is a three-stage incremental approach, with the onus on the claimant to demonstrate that a duty of care exists. This point was summarised by Lord Hoffman in the case *Stovin v Wise* [1996] as follows: 'The trend of authorities has been to discourage the assumption that anyone who suffers a loss is *prima facie* entitled to compensation from a person … whose act or omission can be said to have caused it. The default position is that he is not.'

A claimant needs to prove three things, one after the other.

- That the harm caused was reasonably foreseeable.

- That there is a relationship of proximity between the claimant and the defendant.
- That in all the circumstances, it is just and fair that a duty of care should be imposed on the defendant.

Negligence: causality and the remoteness of damage

- Causality
- Contributory negligence
- Volenti non fit injuria
- Remoteness of damage
- Exclusion clauses or statements denying liability
- The nature of loss: pure economic loss

3 Negligence: causality and the remoteness of damage

3.1 Causality

Having established that the defendant owes a duty of care, the claimant in a negligence case must then prove, on the balance of probability, that the injury or damage would not have occurred but for the negligent act or omission of the defendant. In other words, the claimant must show that the defendant committed a negligent or wrongful act and that this act (on the balance of probability) caused him injury or damage.

There must be an unbroken link connecting the negligence of wrongful conduct of the defendant with the damage or injury to the claimant. The normal test of causality is the 'but for' test, which is to ask the question: 'Would the claimant have suffered the damage but for the tort of the defendant?'

- If the answer to this question is 'No', there is probably a causal link between the tort and the damage.
- If the answer is 'Yes' and the damage would have been sustained anyway, causality does not exist and the defendant cannot be liable.

The legal burden is on the claimant to prove causation **on the balance of probability**, that the tort of the defendant was **substantially and materially** responsible for the damage or injury he suffered.

As with the duty of care, the claimant must demonstrate that it should have been reasonably foreseeable that the cause of the defendant's tort would cause damage or injury to the claimant. The test of reasonable foreseeability in establishing a causal link is illustrated by the Wagon Mound case from the Australian courts. The court's decision in this case was 'adopted' by the Privy Council in England, although this has only persuasive authority over the English courts and is not legally binding.

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Case: Wagon Mound case [1961]

The defendant carelessly discharged oil from one if its ships into Sydney Harbour. The oil floated on the surface of the water towards a wharf operated by the claimant.

The claimant's employees were doing welding work on the wharf, and they continued working after they were advised (non-negligently) that it was safe to do so.
Sparks from the welding equipment set fire to cotton wool waste that was mixed up with the oil on the water, and then the oil caught fire. The wharf was destroyed by the fire and the claimant sued the defendant.

Although the oil negligently discharged from the defendant's ship had been the cause of the destruction, the court held that it was not reasonable to foresee that the oil would catch fire. Pollution damage caused by the oil would have been reasonably foreseeable, but fire damage was not. The claim was therefore rejected.

The Wagon Mound case was decided on the basis of 'reasonable foresight' of the events that might lead to an accident. This does not mean that causality occurs only if it should have been possible to foresee the exact sequence of events leading to the injury or loss. Lord Denning commented in the case *Stewart v West African Air Terminals* (1964) that: 'It is not necessary that the precise concatenation of circumstances should be envisaged. If the consequence was one within a general range which any reasonable person might foresee …, then it is within the rule that a person who has been found guilty of negligence is liable for the consequences.'

The application of this principle is illustrated by the following case.

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Case: Hughes v Lord Advocate [1963]

Employees of the Post Office were working down a manhole. The manhole cover had been removed, but there was a tent around the hole, and lamps surrounding the tent. A child picked up a lamp and went into the tent. It then tripped over the lamp which then fell into the hole, causing an explosion in which the child was burned.

The defendant argued that is was not foreseeable that the vapour from the paraffin in the lamp would cause the explosion and the degree of injury actually sustained by the child.

The court decided, however, that it was reasonably foreseeable that a child might be burned, even though the exact sequence of events leading to the injury (an explosion) might not have been predicted. The defendant was therefore liable for the injury caused to the child.

3.2 Contributory negligence

Although it is not a defence against a claim of negligence, the concept of contributory negligence may be applied in certain cases, to reduce the amount of damages awarded. Contributory negligence occurs when the claimant is found to have contributed in some way to the damage or loss that he or she has suffered as a consequence of the other person's (the defendant's) negligence.

(It is for the defendant to demonstrate that the claimant contributed to the damage or loss, not for the claimant to demonstrate that he or she did not contribute to the loss.)

The Law Reform (Contributory Negligence) Act 1945 states that if a claimant is partly at fault for damage or injury suffered as a consequence of negligence by the defendant, the judge may reduce the amount of damages in proportion to the defendant's own negligence.

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Case: Sayers v Harlow Urban District Council [1961]

The claimant was trapped in a public lavatory due to a faulty lock on the door. After spending ten to fifteen minutes trying to attract attention by banging on the door and shouting, she thought she might be able to climb out. She put her foot on a toilet roll holder and held on to a pipe, but then decided that climbing out was not possible.

In trying to get back down again, she put her weight on to the toilet roll holder, which revolved. She fell and suffered injury to her leg. Her claim for damages for negligence against the local council was successful; however, it was held that she had contributed to her injury by using a revolving toilet roll holder in her attempt to climb out. Damages were therefore reduced by 25% for contributory negligence.

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Case: Jones v Livox Quarries Council [1952]

The claimant was riding on the back of a dumper truck of the defendant down a slope into a quarry, contrary to orders, when another vehicle owned by the defendant was driven into the back of the truck as a consequence of negligence by the vehicle driver. The defendant was injured in the crash. A claim for negligence succeeded, but the amount of damages was reduced because of contributory negligence by the defendant, exposing himself to the risk of injury by riding on the back of the dumper truck.

3.3 Volenti not fit injuria

This is a Latin term meaning 'injury cannot be done to a person who voluntarily accepts the risk'. A defence against a claim for negligence is that the claimant willingly exposed himself to the risk that led to his injury. If a defence of 'volenti' succeeds, the defendant is not negligent and no damages at all are awarded.

The consent to accepting the risk may be either express or implied from the defendant's conduct.

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Case: ICI Ltd v Shatwell [1965]

The claimant and his brother were employed by the defendant. They chose to ignore the employer's orders and statutory safety regulations, by testing detonators without taking shelter. There was an explosion and the claimant was injured. He brought a claim against the company on the grounds that it was vicariously responsible for the negligence of the claimant's brother.

On appeal, the House of Lords held that the claimant had willingly exposed himself to the risk, and the defendant's claim of 'volenti not fit injuria' was upheld.

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Case: Morris v Murray [1990]

The claimant had taken a ride in a private plane, when the pilot was clearly drunk. The plane crashed and the claimant was injured. He brought an action against the pilot for negligence. The court held that since the pilot had been so obviously drunk, the claimant had willingly accepted the risk of injury in agreeing to go on the flight. The defendant's claim of 'volenti not fit injuria' was upheld.

(Note: Similar incidents involving injury caused to passengers in motor vehicles are covered by the Road Traffic Act 1988.)

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Case: Wooldridge v Sumner [1963]

The claimant was a professional photographer who suffered injury at a horse show from a horse that was out of control. He made a claim for damages due to negligence of the horse rider. The rider argued 'volenti non fit injuria'. The court decided, however, that contestants in a game or competition are not negligent if they make an error of judgement or display some lack of skill, provided they are not reckless in their disregard for the safety of others. The claim therefore failed since the defendant had not been negligent and a defence of 'volenti' was unnecessary.

3.4 Remoteness of damage

When a claimant has demonstrated that the defendant has been in breach of a duty of care and that a breach of duty has been the cause of injury or damage to the claimant, the claimant must then establish the nature of the damage that has occurred. The court will decide how much damages should be awarded, but the claimant needs to demonstrate the nature of the damage so that the court can reach its decision.

A problem with causality is that once a negligent or wrongful act causes damage, there is potentially no limit to the amount of losses that might be recovered, even though the loss to the claimant might be a fairly remote consequence of the defendant's tort.

The law takes the view that a person cannot be held liable for damage arising from a breach of a duty of care if the damages are too remote from the breach.

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Example

Suppose that a taxi driver is driving his taxi at an excessive speed when a tree falls on the taxi, injuring the passenger. The injury to the passenger was not caused by the driving at speed; it was caused by the falling tree. The passenger might argue that if the taxi driver had not been speeding, the taxi would not have been in the place where the tree fell at the time that it fell, and injury would have been avoided.

The court would reject this argument, on the grounds that the damage is coincidental and too remote.

Establishing liability for damage

The principle of remoteness of damage is that a person can only be held liable for negligence in tort for damages that were a direct consequence of the negligence. The position was summarised by Lord Denning in the case *Roe v Minister of Health* [1954] as follows:

'Duty, causation and remoteness run continually into one another… they are simply three different ways of looking at one and the same problem. Starting with the proposition that a negligent person should be liable, within reason, for the consequences of his conduct, the extent of his liability is to be found by asking the one question: Is the consequence fairly to be regarded as within the risk created by the negligence? If so, the negligent person is liable for it.'

3.5 Exclusion clauses or statements denying liability

A person might try to avoid liability for negligence. For example:

- A manufacturer might try to avoid liability for injury or damage caused by its products to their users. (For example, a product might contain the wording on its packaging: The company accepts no liability for….')
- A professional firm might try to restrict its liability for negligent misrepresentation to its contractual clients, and deny liability to any other person.

The ability of a manufacturer to exclude itself from liability to users of its products or services is restricted by the Unfair Contract Terms Act 1977. The Act deals with clauses or statements that attempt to limit a person's liability for negligence or breach of contract. The Act includes the following provisions.

- A clause attempting to limit negligent liability for personal injury or death to another person is void.
- A clause attempting to limit negligent liability for loss or damage is void **unless** it is shown to be 'reasonable'.
- The law does not attempt to define 'reasonable', and the burden of proof is on a claimant to demonstrate that the limitation of liability is not reasonable. The judgement of what is reasonable depends on the circumstances of each case, and the court will generally lean towards favouring any person in the dispute who had a relatively weak bargaining position.

A professional person or firm can avoid liability to any person other than its client for negligent misrepresentation by making a clear statement within the information provided that it accepts no such liability. This is an important factor in the consideration of professional negligence.

3.6 The nature of loss: pure economic loss

The loss suffered by a claimant in a negligence case might be:

- loss arising as a result of personal injury to the claimant
- loss resulting from damage to the claimant's property

- economic loss suffered by the claimant: this is financial loss that is not directly connected to the losses arising from personal injury or damage to property.

The courts do not have a problem with awarding damages for loss due to injury or damage to property. However a court might have difficulty in deciding whether pure economic loss is recoverable from a defendant by a claimant. The general rule appears to be that:

- where an individual has assumed responsibility information that he provides, as in the case *Hedley Byrne v Heller*, the defendant is liable for economic loss caused to the claimant, but
- in other cases, the defendant is not liable (in tort law) for economic loss to the defendant.

For example, the court will usually issue an injunction to settle cases involving 'passing off' and will not award damages to the claimant for economic loss.

Murphy v Brentwood DC is a notable case where the court decided, in a case involving negligence, against awarding damages for economic loss to a claimant even though a duty of care existed and had been breached by the defendant.

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Case: Murphy v Brentwood DC [1990]

The defendant was a local authority that had failed to inspect properly the foundations of a building. The building subsequently became dangerously unstable. The claimant did not have the money to pay for the necessary repairs to the building, and he therefore had to sell another house at a considerable loss in order to obtain the money he needed. He sued the local authority for the loss he had incurred on the sale of the house.

The court held that the local authority did have a duty of care to avoid damage to a building that would endanger the health and safety of its occupants, and this duty arose out of its power to require compliance with building regulations. In this case the local authority had been negligent and in breach of its duty. However, because the damage suffered by the claimant was economic loss, rather than loss due to personal injury or damage to property, the court ruled that the loss was irrecoverable.

Professional negligence

- Professional duties to a client
- Professional negligence and the law of tort
- Companies Act 2006: limiting the liability of auditors for negligence

4 Professional negligence

4.1 Professional duties to a client

Professional duties are owed to a client in several ways:

- In some cases, a professional owes duties in statute law. For example the directors of a company owe certain general duties to their company under the provisions of the Companies Act 2006.
- There are contractual obligations of a professional to a client in the terms of their contract agreement.
- A professional has obligations to a client in the tort of negligence.

In the law of tort, the term 'professional' can be applied to any person who holds himself out as having a particular knowledge, expertise or skill. This includes anyone in the 'professions' such as solicitors, accountants and chartered surveyors. It also covers other situations, such as the knowledge that banks have about the financial affairs of their customers.

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Case: Chaudhry v Prabhakar [1987]

Although 'professional negligence' is mainly associated with the business professions, the principle that anyone claiming to have specialist knowledge or expertise is potentially liable for misrepresentation or poor advice.

In this case, the claimant sued the defendant for negligence in giving incompetent advice to buy a particular second-hand car.

The court upheld the claim. Its decision was based on the general principle in tort law that if a person holds himself out to have a particular skill, he should work to a standard that is compatible with that level of skill. It was reasonable for the claimant to rely on the defendant's claim to be competent, even though the claim might be not be justified.

4.2 Professional negligence and the law of tort

Professional negligence has been a particular problem for firms of accountants. When a client company becomes insolvent and goes into liquidation, the company's shareholders or creditors might try to recover their losses by blaming someone for negligence in allowing the company to fail or not warning creditors and investors sooner. They might therefore think of suing someone for the tort of negligence. Audit firms are a good target for legal action, largely because they are assumed to have large financial resources and are in a strong position to pay any damages that a court might award.

This concern of professional auditors led to legislation on auditors' liability in the Companies Act 2006. This is described briefly later.

General principles of professional negligence and the law of tort

The principles of professional negligence and the law of tort are mainly the same as the principles applying to the tort of negligence generally.

- A professional person has concurrent liabilities to a client both in contract and in tort. In many situations, there is sufficient proximity between a professional and a client to find a duty of care in tort to go with the contractual obligations in the contract between the professional and client.
- The courts normally apply the concept of a duty of care quite narrowly, and restrict its application to cases where there is a special relationship between the professional and the client or customer.
- Professional liability for a negligent misstatement is therefore normally limited to a situation where there is negligence in the provision of information to a known recipient for a specific purpose, where the provider of the information (the professional) should be able to foresee reasonably that the information in the statement will be relied on. This is the situation that occurred in the case *Hedley Byrne v Heller*, which was described earlier.
- The claimant must be able to demonstrate that the professional has been in breach of a duty of care and that there was causality between the negligent breach of duty and the claimant's loss.
- The law is not so clear in cases where there is a contractual relationship between a professional and another person, but another person outside the contractual relationship relies on information provided negligently to the client. The Caparo case has already been described: in this case the court held that an auditor did not have a duty of care to a potential investor in the company, even though the potential investor (in additional shares) was already a shareholder of the company.
- It should be possible to avoid liability for a negligent misstatement which is acted on by a person outside the contractual relationship between professional and client. The liability can be avoided by stating clearly on the document containing the information that the professional is not liable for the content of the information to any person other than the client.

Some more cases might help to illustrate these general rules.

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Case: Henderson v Merrett Syndicates Ltd [1995]

This case involved a claim of professional negligence in the Lloyds insurance market. The plaintiffs were 'Names' in the Lloyds market whose interests were managed by the defendants as underwriting agent (managing agent) for the

business. The relationship between the Names and the managing agent were regulated by contractual agency agreements that gave the agent absolute discretion over the type of insurance business they would arrange on behalf of the Names.
The Names suffered large losses on their business, and they alleged that the managing agent had been negligent. The court upheld the claim, on the grounds that there was an implied term in the agreements between the Names and the agent, to the effect that the agent would exercise due care and skill in carrying out business for the Names.

The tort law principle upheld by the court in the Henderson case is that where a defendant voluntarily assumes responsibility for the economic interests of a claimant, and where they know or ought to have known that their expertise would be relied on by the claimant, a duty of care exists.

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Case: Royal Bank of Scotland v Bannerman [2002]

This case in the Scottish courts only has persuasive authority in the English courts.

It involved the question about whether an auditor owes a professional duty of care to a third party in respect of the content of a company's report and accounts. In this case, the bank alleged that it had relied on the audited accounts of a company to make a decision about lending to the company.

The bank also alleged that the audit firm should have been aware from a facility letter to the company that the bank would receive a copy of the audited accounts and would rely on them to make its lending decision.

The defendants alleged that the audited accounts were not produced for the purpose of helping the bank to make a lending decision, and the auditors were not aware that the bank intended to use the accounts for this purpose.

The court decided, however, that in becoming aware of the existence of the facility letter from the bank, the auditors should reasonably have expected that the bank would rely on the report and accounts and that it had therefore assumed responsibility to the bank for the information in the report and accounts.

Significantly, the court ruling added that the auditors could have avoided any responsibility to the bank by disclaiming responsibility to anyone except the company, its contractual client. As the auditors had not disclaimed responsibility, they had assumed responsibility.

C

Case: The Equitable Life case

In 2002 the life assurance firm Equitable Life brought a claim for negligence, alleging damages of £2.6 billion. In 2003 the Court of Appeal allowed Equitable Life to bring a claim of £2 million against auditors Ernst & Young, alleging that the audit firm had signed off the Equitable Life accounts without giving any warning of the problems that brought it close to financial collapse in 2000.

The case argued by Equitable Life was that Ernst & Young had been negligent by failing to warn the directors of the problems that the business faced and the financial mess that Equitable Life was in.

Equitable Life eventually dropped its case against Ernst & Young when it became apparent that the former directors of the firm (who had all been forced to resign when the business nearly collapsed in 2000) would not have acted any differently, regardless of any advice given to them by the audit firm, and that the firm would have suffered near-collapse anyway.

This case illustrates the need for the claimant to demonstrate causality in order to succeed in a case of alleged negligence.

The financial threat to Ernst & Young had been severe, and it is questionable whether the firm would have survived financially if the claim against it by Equitable Life had been successful. This case (and several others) helped to demonstrate the problem for the audit profession and business in general if another major audit firm were to collapse (following the collapse of Andersens in 2002 in the wake of the Enron scandal in the US).

Concerns about unlimited professional liability for audit firms led to changes in the law on auditors' liability in the Companies Act 2006.

4.3 Companies Act 2006: limiting the liability of auditors for negligence

Cases such as the Equitable Life case led to changes in company law that enable companies to place a cap on the potential liability of their auditors. The shareholders of a company can agree to limit the liability of their auditors in respect of any negligence, default, breach of duty or breach of trust occurring in the course of the audit. The limit to the auditors' liability should be written into a **liability limitation agreement** (LLA).

This is an important new development in company law (in force from 6 April 2008), and the key features of the legislation are as follows.

- Both public and private companies may agree an LLA for their auditors.
- An LLA can set a cap on the auditors' liability, but cannot reduce this maximum liability to 'less than such amount as is fair and reasonable in all the circumstances' having regard to the auditors' responsibilities, their contractual obligations to the company and the professional standards that should be expected from them.
- An LLA with the auditors must be disclosed in the company's annual report and accounts.
- An LLA can apply to the acts or omissions of the company's auditors in carrying out the audit for one financial year only. This means that if a cap on the auditors' liability is to continue, it must be renewed each year by shareholder approval.
- The cap on the auditors' liability in an LLA can be expressed as a fixed amount of money or as a formula. However, it can also be expressed as a proportion of any loss suffered by the company. This is likely to be the form of LLA cap preferred by audit firms, which have sought to restrict their liability to a 'proportional loss' – a proportion of the total losses arising.

The tort of 'passing off'

- The nature of 'passing off'
- Claims relating to 'passing off': the three elements of 'passing off'
- Remedies for 'passing off'
- Domain names

5 The tort of 'passing off'

5.1 The nature of 'passing off'

'Passing off' occurs when one business pretends to its customers that it is someone else, in order to benefit from the goodwill of the business that it is pretending to be. The tort of 'passing off' is linked closely to the law on trade marks, trade names and brand names.

- Trade marks can be registered. Registered trade marks are protected by statute law, the Trade Marks Act 1994, and other businesses cannot use the registered trade marks of any other company. (There are also laws in the European Community for the protection of the designation of the geographical origin of products: for example a wine made by the champagne method cannot call itself 'champagne' unless it has been made in the champagne region of France.)
- A business might use a trade mark that has not been registered. Owners of non-registered trade marks are protected by the law of tort against 'passing off' by another business.

Essentially, 'passing off' therefore involves some form of misrepresentation by one business to profit from the goodwill of another business, causing damage or the probability of damage to the other business.

5.2 Claims relating to 'passing off': the three elements of 'passing off'

In most cases of passing off, the claimant has to demonstrate the following, in order to succeed with the claim.

- There has been a misrepresentation by the defendant.
- This misrepresentation was made by the defendant to its customers or potential customers in the course of its trade.
- The misrepresentation was calculated to cause damage to the claimant's business or goodwill.
- The misrepresentation did actually cause damage to the claimant's business or goodwill, or is likely to do so.

The claimant must be able to demonstrate that the defendant was using the claimant's goodwill as if it were its own. The claimant must therefore establish three things, which have been called the 'classic trinity' of elements in 'passing off' and the 'trinity of confusion leading to deception and damage'.

(1) There is a goodwill attached to his products or services in the mind of the purchasing public.

(2) There has been a misrepresentation by the defendant (deliberate or otherwise) that has led customers to believe that the defendant's goods or services are actually supplied by the claimant.

(3) The claimant has (or is likely to) suffer loss as a consequence.

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Case: Reckitt & Colman v Borden [1990]

The claimant had since 1954 produced and sold a lemon juice under the brand name Jif that it sold in yellow plastic containers that were shaped like and looked like a lemon. The defendant began selling a lemon juice in a similar packaging, although with different labelling.

The House of Lords upheld the claim that the defendants had been 'passing off' their product as though it were Reckitt & Colman's Jif product. (The court rejected the claim of the defendants that there were clear differences between the two products and customers were 'stupid' if they mixed up the two.)

5.3 Remedies for 'passing off'

The normal remedy for 'passing off' is an injunction by the court to stop the defendant from continuing to 'pass off' its products or services as those of the claimant. The award of damages is rare, since the court does not usually award damages for economic loss in such cases, and the claimant has to prove that actual loss has occurred.

In practice, cases often come to an end when the court awards a temporary injunction, before the case comes to trial. A temporary injunction forces the defendant to change the packaging of its products, and the cost of the changes are so high that there is no financial advantage in continuing the business.

5.4 Domain names

A variation of the tort of 'passing off' is the registration of domain names for well-known companies by another person where that person has registered the domain name for the sole purpose of selling it to someone else for a high price to enable that person to use it dishonestly.

When internet use was developing rapidly, there was extensive wrongful registration of domain names. The courts decided that the tort of passing off had occurred as soon as a domain name was registered with the intention of selling it on to someone else for dishonest use, even though no dishonest use of the domain name had yet occurred.

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Case: British Telecommunications and others v One in a Million and others [1998]

Some businesses had registered a number of domain names relating to company names such as British Telecommunications, Marks and Spencer, Sainsburys, Cellnet and Burger King. The companies whose names were being used brought an action against the registrants alleging 'passing off'.

During the case, the court heard how the defendants had tried to profit from their ownership of the domain names. One of the defendants had written to the owners of the restaurant chain Burger King after obtaining the domain name 'burgerking.co.uk.' Burger King had already registered its own domain name 'burger-king.co.uk' which was identical except for the hyphen.

The defendant had written: 'Further to our telephone conversation early this evening, I confirm that I own the domain name burgerking.co.uk. I would be willing to sell the domain name for the sum of £25,000 plus VAT. In answer to your question regarding as to what we would do with the domain name should you decide not to purchase it - the domain name would be available for sale to any other interested party. As I am sure you are aware the Internet is an extremely fast growing medium, and the standard convention for Domain name for company name of more than a single word is to have no hyphens in the domain name. Although you currently have burger-king.co.uk this would not be the most obvious first choice for any individual to use, should they be speculatively looking for your UK website.'

The same defendant had also tried to sell the domain name 'bt.org' to British Telecommunications for £4,700.

The court upheld the claim.

CHAPTER

5

Employment law

Contents

Contract of service and contract for services

- The difference between a contract of service and a contract for services
- Making a distinction between a contract of service and a contract for services
- Control test
- Integration test
- Economic reality test (multiple test)

1 Contract of service and contract for services

Employment law is a large area of law. It affects all employers: sole traders with employees, partnerships, companies and other organisations that employ people. For your examination, you are required to know some of the basic aspects of employment law, without having to learn large amounts of detail. This chapter covers those aspects of employment law that are in the syllabus.

1.1 The difference between a contract of service and a contract for services

There is an important difference between:

- a contract of service, and
- a contract for services.

A contract of service is a contract between an employer and an employee, in which the employee agrees to work in the service of the employer, in return for benefits such as a wage or salary. A worker with a contract of service is therefore an employee.

A contract for services is a contract between two independent parties, in which one party agrees to provide services in return for payment for those services. A contract for services is therefore provided to another party by an independent contractor – a self-employed person.

The importance of the difference

It is important to distinguish between a contract of service and a contract for services. Key differences between an employee and a self-employed person are the employment rights of employees, the duties of the employer towards employees and its liabilities for the actions of employees.

- Employees have much more protection under the law – both statute law and common law – than a self-employed person. The law protects employees against unfair and unreasonable actions by the employer, by establishing employees' rights. The only rights that a self-employed person has, in relation to the person to whom he provides a service, are his rights within the terms of the contract of service. This is a normal contract, subject to the normal rules of contract law.

- A customer of a business who deals with an employee of the business has a contract with the employer, not the individual employee. In contrast, a customer of a self-employed person has a contract with that individual only.
- An employer is liable for any wrongs ('torts') committed by an employee. For example, if an employee driving a company van on company business injures a pedestrian due to careless driving, the pedestrian has a right to claim compensation form the employer.
- Income tax rules and rules on National Insurance contributions differ for employees and self-employed persons.

1.2 Making a distinction between a contract of service and a contract for services

Occasionally, there are disagreements about whether an individual has a contract of service, and so is an employee of an employer, or whether he has a contract for services. For example, an individual might claim to be an employee with employment rights, whereas the other party claims that there is only a contract for services from a self-employed person. The government might disagree with a company about whether an individual should be treated as an employee or a self-employed person for tax or pension reasons.

The courts have developed a number of tests for deciding whether an individual has a contract of service or a contract for services. These tests are:

- a control test
- an integration test
- an economic reality test (also called a multiple test).

The courts will look at all of the above tests before making a decision.

1.3 Control test

The original test applied by the courts was the control test. The test in this case was the amount of control that one person had over the other. A high degree of control indicates a master-servant type of relationship, and the court would assume that a contract of service existed between an employer and an employee.

When the amount of control is small, the relationship is based on a contract for services between a self-employed person and a customer or client.

C

Case: Walker v Crystal Palace Football Club [1910]

The court held in this case that a professional footballer was an employee of the football club. The reason the court reached this decision was that the football club had a large amount of control over the footballer, in relation to his training, discipline and the way in which he was paid.

1.4 Integration test

The control test on its own proved inadequate for deciding whether or not a contract of service existed. The concept of control is that an employer can tell an employee what to do, but business methods and technology are so complex that employers do not have the same knowledge in specialist areas as their employees in order to give them instructions. In many cases, an employer has to allow the employee to use his discretion and judgement in deciding what to do in his work. An employee may therefore have a large amount of control over what he does, without 'interference' from the employer.

A notable example is the position of a medical consultant. In the absence of a formal contract of employment, how would the court decide whether a medical consultant or surgeon was an employee of the health authority or hospital, of whether he was a self-employed person?

The courts therefore developed another test for a contract of service, the integration test.

The test of integration is a test of the extent to which the individual is integrated into the business of his actual/alleged employer.

- If the work done by the individual is an integral part of the business, the individual is an employee with a contract of service.
- If the work is not integral to the business, the individual is self-employed with a contract for services.

C

Case: Cassidy v Ministry of Health [1951]

A full-time assistant medical officer at a hospital performed a surgical operation on a patient, and did so negligently. The patient sued the ministry of Health, as employer of the medical officer. The Ministry of Health argued that the medical officer was not an employee because it had no control over the way that he did his work.

The court held that in the circumstances, the proper test of employment was not a test of control, but a test of whether the Ministry had appointed the individual and integrated him into the hospital organisation. If the patient had made the choice of surgeon, the ministry would not be liable as an employer. However, the Ministry had made the choice that the medical officer should perform the operation; therefore it was an employer and as such was liable to the patient.

C

Case: Whittaker v Minister of Pensions & National Insurance [1967]

This case concerned a circus trapeze artist and whether she was an employee of the circus. The court applied the integration test, and held that because she was required to do general tasks around the circus, in addition to performing as a trapeze artist, she was an employee, not a self-employed person.

As a consequence, she was able to claim compensation for injuries that she sustained during the course of her employment.

1.5 Economic reality test (multiple test)

The court might also apply an economic reality test or multiple test. In applying this test, it does not rely on a single factor, such as control or integration, to decide whether an individual is an employee. Instead, it uses a more general test of several factors on order to reach a general assessment of the 'economic reality'.

The factors that the court might consider, in addition to the degree of control or integration, include:

- The regularity and method of payment: employees are paid regularly, directly into their bank account
- The ownership of tools and equipment: a self-employed person (such as a builder, electrician or carpenter) will own his own tools and equipment, whereas an employee normally uses the equipment of the employer.
- The regularity of hours of work.
- Whether there are **mutual obligations** between the individual and the actual/alleged employer. If the provider of work has an obligation to provide work and if the worker is under an obligation to accept it, this indicates an employer-employee relationship.
- The ability to delegate all the work. If an individual is able to delegate all the work to a subordinate, this would be an indication of self-employment. An employee has to do the work that he has been employed to do, and cannot pass it over to someone else.

C

Case: Ready Mixed Concrete v Ministry of Pensions [1968]

The plaintiff employed a lorry driver who provided his own lorry (that had been bought on hire purchase from the plaintiff). He was paid on a basis of mileage and deliveries, and the payment was made 'gross', without deduction of income tax or National Insurance Contributions.

He could employ a substitute driver but he wore company uniforms and the lorry was painted in the company's colours. He was 'managed' by a foreman and was only allowed to use the lorry on company business.

The dispute was about whether the individual was an employee, which meant that the employer would be liable for employer National Insurance Contributions.

Held: The court applied an economic reality test and decided that the driver was a self-employed individual. The key issue was that he took financial risk.

This case was the first to establish the economic reality test, and the court held that there were three conditions that indicate the existence of a contract of employment:

- The employee agrees to provide his own work and skill in return for a wage.
- The employee agrees that he will be subject to a degree of control by the employer. This agreement can be implied; it does not have to be expressly stated.
- Other provisions of the contract are consistent with it being a contract of employment (which means that multiple tests may be applied).

C

Case: O'Kelly v Trusthouse Forte plc [1983]

In this case, the issue of mutual obligations between the worker and the provider of work was a key issue.

A casual worker did work for the company on a regular basis as a waiter, whenever he was required. There was an understanding that he would accept work whenever it was offered, and that the company would give him preference over other casual workers in offering him work.

A tribunal held that this was not sufficient to create a mutual obligation. The company was not obliged to offer work and the individual was not obliged to accept it. The individual was therefore self-employed and there was no contract of employment.

C

Case: Nethermere (St Neots) Ltd v Gardiner and Taverna [1984]

Two home workers were engaged by a company that manufactured trousers. It employed full-time staff in its factory but also used a number of home workers, and relied on their output. The home workers worked part-time, sewing trouser flaps and pockets using machines that were provided by the company. There were no fixed hours of work and the workers were paid according to the work that they did and were not obliged to accept any particular quantity of work.

Mrs Gardiner had worked in the factory as an employee until 1976 and in 1979 she began to do home work. Work was delivered to her and collected daily. In a period of over two years, she worked for all but five weeks.

The industrial tribunal found that Mrs Gardiner was engaged under a single contract of service. There had been a course of dealing over several years and **mutual obligation** had built up. The company had built up an obligation to provide a quantity of work and the home workers had built up an obligation to do the when it was offered.

This minimum obligation to work, which could not be reduced, was the key factor in deciding the existence of contracts of employment.

C

Case: Market Investigations Ltd v Ministry of Social Security [1969]

This case is notable for the fact that an individual who called herself a self-employed person was held by the court to be an employee. The label 'self-employed' does not necessarily mean that a person is self-employed in law.

The individual was a market researcher, who carried out market research interviews for the company. Each market research task was treated as a separate contract for services, and the individual carried out the market research as instructed.

There were no specified hours of work, and no holiday or sick pay entitlement. The only requirement was that each research contract should be completed by a specified date. She could also work for others whilst she worked for this company.

The court applied an economic reality test, and found that the individual was an employee, not a self-employed contractor. The company had some control over the way that she did her work, and there were other features of the work that made it consistent with a contract of employment. She did not provide her own tools and equipment, and she took no business risk. She could not therefore be considered to act 'in business on her own account'.

Contract of employment

- Employment Rights Act 1996
- Definition of employee
- Particulars of employment
- Duties of an employer
- Duties of an employee

2 Contract of employment

2.1 Employment Rights Act 1996

The statute law relating to employment rights of employees is contained mainly in the Employment Rights Act 1996 (ERA 1996). This Act:

- defines 'employee'
- states the right of an employee to a written statement of particulars of employment
- specifies a variety of rights of the employee
- deals with dismissal of employees, and considers when dismissal is unfair or for reasons of redundancy.

2.2 Definition of employee

Section 230 ERA 1996 defines an employee as 'an individual who has entered into or works under … a contract of employment'.

The Act uses the term 'contract of employment' rather than 'contract of service'. It also states that a contract of employment means a contract of service or apprenticeship that may be:

- an express agreement or implied, and
- if it is an express agreement, it may be oral or in writing.

2.3 Particulars of employment

Section 1 ERA 1996 states that when an employee begins employment, the employer must give the employee a written statement of particulars of employment.

This statement must contain particulars of the following:

- the names of the employer and the employee
- the date that the employment began
- the rate of pay

- the intervals at which remuneration will be paid (weekly, monthly or at other specified intervals)
- hours of work
- entitlements to holiday and holiday pay
- conditions relating to incapacity due to sickness or injury, and sick pay
- pensions arrangements
- length of notice that must be given by the employer and by the employee to terminate the contract of employment
- where the contract of employment is for a fixed term, the date when it is to end
- the employee's place of work
- the employer's address.

Implied and express terms: statutory terms

These particulars of employment contain a number of terms in the contract of employment. However, there may be other terms in the employment contract. These include implied terms as well as express terms.

- Express terms are terms that are specifically stated, and agreed between the employer and the employee. They may be included in a written contract of employment.
- Implied terms are terms that are not specifically stated in the contract, but are implied by custom and common law. Sometimes terms are implied in a contract when the employer has an agreement with a trade union or staff association representing a grade or type of employee.
- Some terms in a contract of employment are specified by statute law. For example, the ERA 1996 includes a number of employee rights, including:
  - the right of employees to maternity leave
  - the right of employees to receive an itemised statement of pay
  - the right of an employee to receive a minimum period of notice of termination of his employment, as follows:

Continuous employment of employee	**Minimum notice of termination of employment from the employer**
1 month to 2 years	1 week
2 years to 12 years	1 week for each year of employment
12 or more years	12 weeks

2.4 Duties of an employer

The duties of the employer are as follows:

- To **pay reasonable remuneration**. This aspect of employment is now largely covered by the minimum wages legislation, but in the absence of an express clause in the contract of employment this duty would be implied.

- To **provide a safe system of work**. This is covered by the common law duty to take reasonable care of employees, but is also covered by the health and safety at work legislation.
- Duty to **give reasonable notice** (see above)
- Duty of **mutual co-operation**. Both employers and employees are expected to establish reasonable working relations so that both parties behave with a view to achieving a mutually acceptable working relationship.
- Duty to **provide work**. There is no common law duty for an employer to provide work to the employee. However, such a duty may be implied when a failure to provide work would deprive the employee of benefits expected from the employment. In particular, this implied duty is likely to apply where the pay rate is based on piece work. There is an assumption that the employer will provide a reasonable level of work activity, so that the employee can earn a reasonable wage.

Providing a reference

There is no common law duty on an employer to provide a reference. An employer who does provide a reference for a (current or former) could be liable to the employee for the tort of defamation if a reference is derogatory and untrue. The new employee who receives the reference may also have an action in the tort of negligence if the reference is made carelessly and is incorrect.

As a matter of practice many employers will now only provide a reference stating the role and the period worked and the reason for leaving, rather than a full and informative reference, in order to avoid the risk of legal action.

2.5 Duties of an employee

An employee has certain duties, as follows:

- Duty of **mutual co-operation with the employer** (see above).
- Duty to **obey reasonable and lawful orders**.
- Duty of **reasonable skill and care**. Employees have a common law duty to exercise reasonable skill and care in any activity that they carry out in their role as an employee.
- Fiduciary duty of ‘good faith’, which is a duty to **give honest and faithful service**. Employees have a duty of honesty to their employer and must account for all moneys and property that they receive in the course of their employment.
- **Cannot delegate**. An employee cannot delegate the responsibilities as an employee to a third party.

C

Case: Pepper v Webb [1968]

A gardener was rude and impolite to his employer and refused to carry out reasonable instructions in relation to plantings. The employer dismissed him immediately.

Held: The gardener was in breach of his duty to carry out lawfully-given and reasonable instructions (and therefore the summary dismissal was reasonable).

C

Case: Sinclair v Neighbour [1967]

An employee borrowed money from the till without telling anyone, and repaid the money the next day. This secret borrowing was discovered, and the employee dismissed him immediately.

Held: The employee's secret act was a serious breach of good faith (fiduciary duty) and the employer was justified in dismissing him summarily.

Unfair dismissal

3 Unfair dismissal

3.1 Unfair dismissal and the Employment Rights Act 1996

The Employment Rights Act states that an employee has a right not to be dismissed unfairly by his employer.

When an employee is dismissed unfairly by his employer, he has a right to appeal to a tribunal.

Statute law (the ERA 1986) therefore covers **unfair dismissal**. An employee might choose instead to take action against the employer in **common law** for **wrongful dismissal**. Wrongful dismissal is explained later.

3.2 Definition of dismissal

Section 95 ERA 96 specifies the circumstances in which an employee is dismissed by his employer. Dismissal occurs in any of the following situations.

- The employer terminates the contract of employment, with or without notice. (For example, an employer might give an employee notice, possibly in writing, that he is being dismissed. Alternatively, an employer might dismiss an employee summarily by saying: "You're fired. Get out!")
- The employee's fixed term of employment comes to an end and the employer does not renew it.
- The employee terminates the contract of employment, with or without notice, in circumstances where the employee is justified in terminating the conduct because of the conduct of the employer. This is **constructive dismissal**.

It may be necessary to decide in a given situation whether:

- the employer has dismissed the employee, or

- the employee has walked out on his job without being dismissed.

Disputes about dismissal, and whether the employee has a right to redundancy pay or to compensation for unfair dismissal, usually concern dismissals for **redundancy** or dismissals for a **disciplinary 'offence'** or misbehaviour at work. Sometimes, there might be cases of constructive dismissal arising from a **grievance of the employee** that has not been resolved by the employer.

It can be difficult to decide what exactly has happened, especially in cases of constructive dismissal.

3.3 Constructive dismissal

Constructive dismissal occurs when the employer does not formally dismiss the employee by terminating his contract of employment, but acts in such a way that the employee is justified in terminating the employment due to the 'fault' of the employer.

Conditions for constructive dismissal

The grounds for claiming constructive dismissal (which is unfair or wrongful) were stated by the judge in the case *Western Excavating Ltd v Sharp* [1978]:

- There must be a fundamental breach of the contract of employment by the employer.
- This breach of contract must have caused the employee to leave the job.
- The employee should not delay his resignation for too long; otherwise remaining in the job will be an affirmation of the contract of employment. The employee then loses the right to claim constructive dismissal. (In many cases of constructive dismissal, the action of an employer might cause the employee to walk out of the job immediately.)

Whether or not constructive dismissal has occurred depends on the circumstances of each case. Here are some examples.

Case: Donovan v Invicta Airways [1970]

Donovan was employed as a pilot and on three occasions was asked to take unreasonable risks in flying the plane. On each occasion Donovan refused and eventually resigned. He claimed that there had been constructive dismissal and the dismissal was wrongful (in common law).

Held: The behaviour of the employer was unreasonable and the claimant had effectively been constructively dismissed and could therefore claim wrongful dismissal.

Case: Simmonds v Dowty Seals Ltd [1978]

Simmonds was employed to work on the night shift. The employer changed his shift, and put him on the day shift (where the rate of pay was lower).
Held: The action by the employer was a unilateral attempt to change the terms of the

contract of employment. Simmonds was therefore entitled to claim constructive dismissal (and wrongful dismissal)

For the court to decide that there has been constructive dismissal (rather than simply resignation of the employee from his job), there must be a serious breach of the terms of the employment contract. The complexity of this issue is illustrated by the following cases.

C

Case: Western Excavating Ltd v Sharp [1978]

Sharp was dismissed from his job for taking time off work without permission. He appealed to an internal disciplinary hearing, which decided that he should be re-instated into his job but should first be suspended for five days without pay. Sharp agreed to this decision, but as he was short of money he asked the employer for an advance on his holiday pay. When this was refused, he asked for a loan of £40 from the employer, which was also refused. Sharp therefore resigned, claiming constructive dismissal. His argument was that he had been forced to resign by the employer's unreasonable conduct.

An employment tribunal found in Sharp's favour, but the employer took the case to the Court of Appeal. The Court decided that for constructive dismissal to occur, the employer must be in serious breach of the employment contract, such that the employee is entitled to resign. In the case of Sharp the Court decided that no such breach of contract had occurred; therefore the claim of constructive dismissal was rejected.

C

Case: British Aircraft Corporation v Austin [1978]

Austin made a claim for constructive dismissal when he left his job following a refusal by the employer to investigate a health and safety complaint. The court agreed, taking the view that failure to investigate the matter amounted to a breach of the employment contract with the employee.

3.4 Summary dismissal

Summary dismissal occurs when an employer dismisses an employee on the spot, without notice. Summary dismissal is often unfair; however, in some cases an employer might be entirely within his rights to sack the employee without notice.

Summary dismissal might be justified and so 'fair' when there has been a breakdown in the relationship between employer and employee, such that the continued employment of the employee is no longer possible. The employee is likely to be in serious breach of a duty to the employer. This may occur, for example, in the following situations.

- The employee refuses to comply with a reasonable and lawfully-given order.
- There is a one-off incident of a very serious nature such as violence or theft.
- The employee is guilty of an act of extreme carelessness or incompetence.

However, the ability of an employer to dismiss an employee summarily and in a fair manner are restricted by the **Dispute Resolution Regulations 2004**, which are described later.

3.5 Deciding whether dismissal is fair or unfair

If the employee can establish that he has been dismissed, and has not simply walked out of his job, the onus is on the employer to demonstrate that the dismissal was fair. The Employment Rights Act 1996 sets out the circumstances in which dismissal is fair and when it is unfair.

- When it is fair, the employee has no legal claim against the employer.
- When dismissal is unfair, the employee is given statutory protection by the Act.

An employee alleging unfair dismissal makes the claim to an employment tribunal. Appeals are to the Court of Appeal and then the House of Lords.

When dismissal is fair

Section 98 ERA96 states that when an employee alleges unfair dismissal, **it is for the employer to show** the reason for the dismissal and to demonstrate that the dismissal was fair.

Section 95 specifies five situations where a dismissal will be considered 'fair', provided that the employer has 'acted reasonably':

(1) The employee did not have the **capability or the qualifications to do the work** for which he was employed. 'Capability' could refer to skill, aptitude, health or any other mental or physical quality (such as height or strength). 'Qualifications' refers to an academic, technical or professional qualification.

(2) The **conduct of the employee** justified dismissal. In general, any breach of an employee's contractual duties or any act of gross misconduct will be covered by this 'fair' cause for dismissal. (See the earlier notes on summary dismissal.)

(3) The employee was **made redundant**. When an employee is made redundant, he has different rights under the law on redundancy. This is explained later.

(4) **Illegality**. The employee could not remain in the current position without breaking the law.

(5) **Some other substantial reason**, where in the circumstances the employer acted reasonably, and his reasons were sufficient to justify dismissal. This is very general, and the court will decide each case on its merits, applying the principle of equity or fairness in reaching a judgement.

If the reason for dismissing the employee is fair, but the employer did not act reasonably, the dismissal will be regarded as unfair by an employment tribunal.

When dismissal will be judged unfair

Whether or not a dismissal is unfair will often depend on circumstances. However, the Employment Rights Act 1996 specifies a number of situations where the court will decide that a dismissal is unfair.

An employee will be regarded as having been **unfairly dismissed**:

- because he has raised issues concerning health and safety at work
- because the employee is pregnant, or for a reason connected with the pregnancy of the employee
- because the employee is involved in trade union activities or because he is a member of a trade union: however, when individuals are engaged in a strike it is not unfair to dismiss them provided that the employer dismisses them all and does not pick on selected individuals to dismiss (for example, dismissing the leaders of the strike)
- because the employee has made a '**protected disclosure**': the employee has been a 'whistleblower', and has reported the employer for engaging in certain activity, such as;
  - criminal activity
  - a breach of legal obligations
  - a breach of health and safety regulations
  - activity that is damaging to the environment.
- because the employee has brought proceedings against the employer to assert a statutory right, or has alleged that the employer has infringed a statutory right of the employee. Statutory rights include statutory rights under the Working Time Regulations 1998 and the National minimum Wage Act 1998.
- because the employee was made redundant, but other employees working in a similar position and doing the same type of work were not made redundant, and the employer has victimised the employee in selecting him for redundancy. For example the employee might have been selected for redundancy because he was involved in trade union activities and so was considered a 'trouble-maker'.

Age as a reason for dismissal: Employment Equality (Age) Regulations 2006

With the introduction of the Employment Equality (Age) Regulations 2006, all employees have a right to ask the employer to work beyond the default retirement age of 65. However, refusal by the employer is not necessarily unfair dismissal. The Employment Rights Act 1996 has been amended so that in specified circumstances, if the employer dismisses an employee at or after a justified retirement age, the dismissal might in some circumstances be regarded as fair.

The need for the employer to act reasonably: ACAS Code on internal procedures

With the complexity of case law on unfair dismissal, it might be difficult to predict how an employment tribunal might decide a case. The employer will have to demonstrate that is the circumstances he acted reasonably. Employers should therefore establish 'fair' procedure for dealing with the dismissal of employees, whether for redundancy or other reasons. ACAS, the Advisory, Conciliation and Arbitration Service (ACAS) has produced a Code of Practice on Disciplinary Practice and Procedures in Employment. Compliance with such a Code or something similar is usually a precondition for the employment tribunal to decide that a dismissal was fair.

3.6 Dispute Resolution Regulations 2004

In order to reduce the number of workplace disputes being taken to an employment tribunal, the Employment Act 2002 provided that employers and employees should use a compulsory internal dispute resolution procedure. A dismissal that seems justified on the bass of the reasons explained above, it may be an unfair dismissal if the employer does not follow the correct procedures for dismissal.

The procedures that an employer must follow so that a dismissal is not unfair are now set out in the Dispute Resolution Regulations 2004, which were introduced following the Employment Act 2002. These apply to the resolution of grievances and disciplinary matters in the workplace, including cases of alleged unfair dismissal.

These regulations set out a standard and a modified dismissal and disciplinary procedure, which employers must follow in nearly all cases. There is a standard internal grievance procedure and a modified procedure. The standard procedure is in three steps, as follows:

- Step 1. The employee must **set out in writing the nature of his or her alleged** grievance. A copy of this document must be sent to the employer. The employee's letter is called a Step 1 letter.
- Step 2. The employee must respond to the employee. If the employee wishes to have a meeting, the **meeting** is held to discuss the dismissal. The employee is entitled to be accompanied, by a colleague for example or by a trade union representative.
- Step 3. The employee must be allowed a right of appeal, which means that the employer must have an **appeals procedure**. An appeal against dismissal should be to an independent person or to a more senior person who was not at all involved in the original decision to dismiss the employee.

Dismissal without complying with the above procedure will be **automatically** unfair dismissal, with minimum compensation of four weeks' pay (provided the employee has served the minimum one year to qualify for a claim for unfair dismissal). However, simply following the three-step process is not in itself enough, as the employer must act reasonably at all times.

The modified procedure may be used in certain cases. This consists of two steps: (1) the employee submits a Step 1 letter and (2) the employer responds in writing to the employee.

The Dispute Resolution Regulations do not cover oral warnings or written warnings to the employee, nor do they cover suspension on full pay. These might be included within the internal disciplinary procedures. Most employers will have a process involving written warnings prior to dismissal, in order to show that the process is reasonable and fair and transparent.

In a limited number of cases, an employment tribunal might decide that summary dismissal has been fair, without the employer going through the statutory dismissal process. However, the Regulations came into force in October 2004, and case law may eventually determine the principles to apply when judging a summary dismissal to be fair.

3.7 Employment Tribunals (Constitution and Rules of Procedure) Regulations 2004

There are regulations about the way in which an employment tribunal should consider claims from employees or former employees. These are the Employment Tribunals (Constitution and Rules of Procedure) Regulations, which were amended in 2004 to provide consistency with the Dispute Resolution Regulations 2004.

The Regulations are detailed, but the essential features are as follows.

- A person wishing to make a claim against an employer or former employer (the 'claimant') must submit the claim on a standard form. The form asks for sufficient information to enable the tribunal will accept the claim for consideration.
- An important condition is (usually) that the claimant must have submitted a Step 1 letter to the employer under the Dispute Resolutions Regulations. If he or she has not done so, the tribunal will not consider the claim.
- If the claim is accepted, the employer (known as the 'respondent') is invited to respond to the claim, also using a standard form.
- If the employer fails to respond, the tribunal may reach a default judgement in the case, although a default judgement may be revoked if the claimant and respondent reach a compromise agreement.
- When the employer has responded, there is a fixed time period (usually 13 weeks) during which the two parties are encouraged to use ACAS to reach a settlement. (In complex cases involving discrimination or an equal pay or whistle-blowing dispute, ACAS has a continuing duty to encourage the parties to reach a settlement throughout the time until the employment tribunal makes a judgement.)
- If no settlement is reached during the conciliation period, the employment tribunal will call a hearing to take evidence. Witnesses may be called and questioned under oath. The tribunal then reaches a judgement, which it must issue in writing.

3.8 Remedies for unfair dismissal

After one year's employment, an employee can make a claim for unfair dismissal to an employment tribunal. The claim must be made **within three months** of the dismissal.

If the employee wins his or her case, the tribunal can choose from three remedies. These are:

- reinstatement
- re-engagement
- compensation.

Reinstatement

Reinstatement means that the employee should be treated as if he had not been dismissed (s 114 ERA 96). It means restoring the employee to the same job and the same conditions as before, and assuming that the employee had never been dismissed. When it makes an order for reinstatement, the tribunal will specify:

- the amount of arrears of pay and other benefits that the employer must pay to the employee
- any other rights and privileges that must be restored to the employee, such as seniority rights and pension rights
- the date by which the employer must comply with the tribunal's reinstatement order.

Re-engagement

Re-engagement means that the employee should be given another job by the employer (or an associated employer, such as another company in the group). The new job offered to the employee must be either:

- comparable to the job from which the employee was dismissed, or
- 'other suitable employment' (s115 ERA 96).

In making an order for re-engagement, the employment tribunal will specify the nature of the employment for which the employee will be re-engaged, and the remuneration. The tribunal may also specify that other benefits should be paid to the employee that would have been earned if the employee had not been dismissed, such as arrears of pay.

Compensation

The employment tribunal might order compensation to be paid to an employee in addition to reinstatement or re-engagement.

The tribunal might decide that the employer must pay compensation to the dismissed employee, without reinstatement or re-engagement.

The ERA 96 (section 118) provides for three component elements to compensation:

- a basic award
- a compensatory award
- a special award.

Basic award

The basic award is an amount of compensation that depends on the age, length of employment and the wage or salary of the employee. It is subject to a specified maximum amount of compensation (a maximum of 20 years' service and a maximum weekly wage, which from 1 February 2007 went up from £290 to £310).

The basic award may be adjusted by the tribunal, so that the 'formula' for calculating the award is not necessarily strictly applied. However, the maximum basic award from 1 February 2007 is £9,300, the same as for redundancy payments.

The amount of the award is not dependent on the loss suffered by the dismissed employee.

Compensatory award

The compensatory award is an amount payable by the employer to the former employee to take account of the losses suffered by the employee as a consequence of the dismissal.

Section 123 ERA 96 states: 'The amount of the compensatory award shall be such amount as the tribunal considers just and equitable in all the circumstances, having regard to the loss sustained by the complainant in consequence of the dismissal, in so far as that loss is attributable to actions taken by the employer.'

The tribunal will therefore take into consideration factors such as the loss of earnings and loss of pension rights. It will deduct any amounts of money already paid by the employer. The employee ('complainant') also has a duty to mitigate his losses, for example by trying to find alternative employment.

The Act specifies a maximum amount of compensatory payment, but this can be altered at any time by the Secretary of State. From February 2007, the maximum compensatory award payable is £60,600.

Special award

The tribunal may also make an award, in cases where:

- the employer ignores an order for reinstatement or re-engagement, or
- the dismissal was unlawful because it was for reasons of sex discrimination or racial discrimination, or
- the dismissal is for an inadmissible reason.

There is a maximum amount of special award, which differs according to the reason for the award.

3.9 Wrongful dismissal as an alternative to a claim for unfair dismissal

Instead of making a claim against an employer for unfair dismissal under the Employment Rights Act 1996, an employee can bring a claim for wrongful dismissal at common law.

The choice between a claim for wrongful dismissal and a claim for unfair dismissal will depend on the remedy that the employee expects to obtain from either option.

- With a successful claim for wrongful dismissal, the tribunal will normally award damages as a remedy, and will not order the reinstatement or re-engagement of the employee. In rare cases, the tribunal might issue an injunction forbidding the employer from dismissing the employee.

- The amount of damages awarded should represent the loss of earnings sustained by the dismissed employee. However, the dismissed employee should seek to mitigate his losses, for example by finding alternative employment of a similar nature.

Redundancy

- The purpose of legislation on redundancy
- The meaning of redundancy
- The right to claim a redundancy payment
- The amount of the redundancy payment
- The redundancy process

4 Redundancy

4.1 The purpose of legislation on redundancy

Redundancy is a form of dismissal of employees. Dismissal through redundancy is not unfair, but employees who are made redundant have certain rights.

The statute law on redundancy is contained in the Employment Rights Act 1996. The purpose of the legislation is two-fold:

- to encourage employers to consider alternative ways of dealing with employees other than dismissing them, when the work that they do is no longer required
- to give employees who are dismissed for reasons of redundancy the right to a minimum payment, to help them until they can hopefully find another job.

4.2 The meaning of redundancy

Redundancy is defined in section 139 ERA 1996. This states that an employee who is dismissed shall be taken to be dismissed because he is redundant when the reason (or the main reason) is because:

- the employer has ceased (or intends to cease) carrying on the business for the purpose of which the employee was employed
- the employer has ceased (or intends to cease) carrying on the business in the place where the employee was (or is) employed, or
- the requirements of the business for employees to carry out work of the kind performed by the employee have ceased, or have diminished (or are expected to cease or diminish).

Relocation of place of business

Disagreements may arise between an employer and an employee when the employer proposes to move to another place of business, and the employee refuses to move. The employee might claim that this amounts to redundancy, whereas the employer might argue that the re-location is not a significant distance.

- If the employer offers the employee identical or very similar work in the new location, and the re-location causes no added inconvenience to the employee, the employee cannot claim dismissal for redundancy.

- If the re-location will cause added inconvenience to the employee, the employee can claim dismissal for redundancy, provided that there is no 'mobility clause' in his contract of employment. A mobility clause is a clause stating that the employee may be expected to move if required by the employer. For example:
  - in the case *O'Brien v Associated Fire Alarms* [1969], an employee without a mobility clause in his contract successfully claimed that he had been made redundant when he refused to move with his employer from Liverpool to Barrow-in-Furness
  - in the case *Rank Xerox Ltd v Churchill* [1988] a clam for redundancy was dismissed because the employee, who was required to move location of employment, had a mobility clause in his contract of employment.

Resignation or redundancy?

There should generally be no dispute about the fact that an employee is made redundant if the employer closes down his business, or closes down the part of his business in which the employee is employed.

The situation is not so clear when an employee resigns because the employer has made an unreasonable demand, and the employee refuses, claiming that the employer as put him out of a job. This type of dispute can arise in cases where:

- the employer is re-locating his business to another area (another town), or
- there is a reorganisation of the employer's work, resulting in the disappearance of the employee's job, but the employee is offered alternative employment.

In these cases, the onus is on the employee to demonstrate that he did not resign voluntarily, but was dismissed (constructive dismissal). Once dismissal has been demonstrated to the tribunal, it is up to the employer to show that the dismissal was not for reasons of redundancy (or was not unfair).

Offer of alternative employment

An employee loses the right to claim redundancy payments if, before the end of his employment:

- the employer offers suitable alternative employment, and
- the employee unreasonably refuses the offer.

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Case: Taylor v Kent County Council [1969]

Taylor was employed by the County Council as the headmaster of a school that was combined with another school. Another person was made the headmaster of the combined school.

The County Council offered alternative employment, on his current salary, acting as a temporary stand-in at schools that were temporarily under-staffed. He rejected the offer as unreasonable and claimed redundancy.

The tribunal found that as the new offer of employment was substantially different, and in particular was a job with lower status, Taylor was entitled to reject the offer of alternative employment and claim for redundancy.

4.3 The right to claim a redundancy payment

In order to be able to claim a redundancy payment, an employee must comply with certain requirements. The most important of these is that the employee must have been in the employment of the employer (or an associated company) for a **continuous period of at least two years.**

This differs from the right to make a claim for unfair dismissal, where an employee must have a minimum period of continuous employment of **one year** in order to claim for unfair dismissal.

There is a time limit on the right to make a claim for redundancy. An employee loses the right to claim a redundancy payment from the employer unless, **within six months** of receiving a redundancy notice (or within six months of the date of termination of the employment, if no notice was given);

- the redundancy payment has been agreed between the employer and the employee, and the payment has been made
- the employee has submitted a written claim to the employer, asking for payment of redundancy money
- a dispute about the right to a redundancy payment or the amount of the payment has been referred to an employment tribunal
- a claim for unfair dismissal has been referred to an employment tribunal.

4.4 The amount of the redundancy payment

An employee who is made redundant is entitled to a minimum amount of redundancy payment from the employer. The amount of this minimum payment is specified in the Employment Rights Act 1996 (section 162). The rules were amended slightly for redundancies after 1 October 2006.

- For each year of employment when the employee was aged 41 or over, the employee is entitled to 1½ weeks' pay for each year of employment.
- For each year of employment when the employee was aged 22 or over, but below 41, the employee is entitled to 1 week's pay for each year of employment.
- For each year of employment not coming within either of the two previous categories, the employee is entitled to ½ week's pay for each year of employment.

The redundancy payments are calculated using these formulae, but for no more than 20 years' of employment. If an employee is made redundant after 23 years, say, the redundancy payment is calculated on the basis of his last 20 years' of employment, ignoring the first three years.

The maximum weekly wage for the purpose of these calculations was raised to £350 from 1 February 2009.

The basic rules are summarised in the following table:

Employee's age at the time of dismissal	**Payment for each year of service subject to a maximum of £310 per week**
41 +	1½ weeks pay
22 to 40	1 week's pay
up to 21	½ week's pay

This means that the maximum payment possible for redundancy under the ERA 1996 rules is (from February 2009):

- 20 years × 1½ weeks × £350 = £10,500.

These rules relate to minimum payments that the employer **must** make. An employer is free to make higher redundancy payment if it wishes to do so.

4.5 The redundancy process

If the employer is intending to make more than 20 employees redundant and there is a recognised trade union representing the employees, then the employer must carry out a consultation process with the union or alternative representative body: (Trade Union and Labour Relations (Consolidation) Act 1992). The employee needs to have been warned of the redundancy.

General guidelines for the redundancy procedure, that an employment tribunal would expect to see an employer follow, are as follows:

- The employer should provide the employees with as much advance notice as possible of the redundancy.
- Where the employer is making some employees redundant but not all of them, the basis for selecting which employees to make redundant should be based on fair and reasonable grounds, using an objective basis for making the decision, such as the length of service of the employees. (The employer might ask the employees initially whether there are any 'volunteers' for redundancy.)
- The employer should consider whether it might be possible to offer alternative employment.
- There should be full consultation with the employee and his or her representatives.

Claims relating to redundancy and unfair dismissal

Disputes relating to redundancy and unfair dismissal are referred loan employment tribunal. In hearing cases about redundancy claims, a tribunal might need to consider:

- whether the employee was made redundant (or has resigned without being made redundant), and/or

- in cases where redundancy is established, whether the manner of the redundancy was fair. If not, the employee has a claim for unfair dismissal.

The employment tribunal will consider whether the employer has acted reasonably. It will expect a 'reasonable' employer to follow the **ACAS Code of Practice** on Disciplinary Practice and Procedures in Employment. (ACAS is the Arbitration, Conciliation and Advisory Service.)

A tribunal might decide that a dismissal on grounds of redundancy (which ought to be a 'fair' reason for dismissal) is actually unfair, because the employer:

- did not operate a proper redundancy scheme, relative to the size and resources of the business
- did not use a fair and objective method to decide which employees should be made redundancy, or
- did not properly consider the offer of alternative employment.

When the tribunal finds that there has been unfair dismissal, a remedy for unfair dismissal will be applied.

CHAPTER 6

Agency law

Contents

Role of an agent

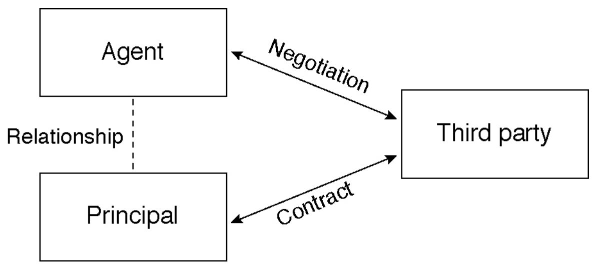
- Definition of an agent: the principal-agent relationship
- Types of agent
- Legal problems with agency relationships

1 Role of an agent

1.1 Definition of an agent: the principal-agent relationship

All types of business may use agents. An agent is a person who acts on behalf of someone else (a 'principal') to arrange a transaction with a third party. The transaction creates a legal contract, and the contract is between the principal and the third party.

- There is a legal relationship between the agent and the principal. The nature of this relationship is explained later.
- The agent acts on behalf of the principal, by negotiating with a third party. Under normal circumstances, there is no legal agreement between the agent and the third party. However, the agent may negotiate the terms of a contract between the principal and the third party.
- When the contract is made, it is between the principal and the third party.



An agent may act for a principal in arranging just one transaction. However, it is common in business for an agent to act regularly on behalf of a principal, arranging large numbers of different business transactions and contracts.

However, it might be useful to have a simple example of an agent-principal relationship in mind. One example is using an estate agent to sell a house. The estate agent will act on behalf of the house owner (the principal) and try to find a buyer (a third party). If the agent is successful and the house is sold, the contract for the sale and purchase of the house is between the seller and the buyer. The estate agent does not enter into a contract with the house buyer (the third party) although he has an agreement with the principal (from which he will earn a fee).

1.2 Types of agent

There are many different examples of agents. For example:

Commercial agent or mercantile agent	An agent who regularly buys or sells goods on behalf of a principal. For example, a UK company might have an agent in Germany, who arranges the sale of the UK company's goods with buyers in Germany.
Broker	A broker is an intermediary who arranges trades or transactions on behalf of clients (principals). An example is a stock broker, who arranges the purchase or sale of stock market investments on behalf of a client.
Auctioneer	An auctioneer is an agent who is authorised to sell property of a principal at auction.
Company directors and managers	It is important to be aware that company directors act as agents for their company; therefore the rules of agency law apply to the actions carried out by directors on behalf of the company. Employees, particularly senior managers, might also act as agents for their employer.
Partners in a business partnership	It is also important to be aware that under the provisions of the Partnership Act, business partners act as agents for their partnership business. The rules of agency law therefore apply to the powers conferred on a partner to bind the partnership to contractual agreements and obligations.

In a commercial agency agreement, the principal retains most of the business risk. Contracts are made directly between the principal and the other party, and the principal is liable on contracts made by his agent on the principal's behalf. The agent is responsible for marketing and selling the goods of the principal in his particular territory, and may be able to recover expenses incurred in carrying out work for the principal. The agent usually only receives commission on the basis of contracts that are successfully made, for example on sales contracts negotiated for the principal by the agent.

A commercial agency agreement is a continuing agreement, where the agent acts regularly for the principal. In other arrangements, an agent might act only occasionally for a principal, or even for just one transaction.

1.3 Legal problems with agency relationships

There are several possible legal problems with agency arrangements. In particular, there may be some doubt about the validity of a contract that an agent makes with a third party on behalf of a principal. For example:

- A person might claim to act on behalf of a principal P, and a third party might enter into an agreement believing the contract to be with P. However, P might deny that the person is in fact his agent.
- A person might be the agent of P with authority to make certain agreements on behalf of P. However, the agent might make an agreement with a third party and in doing so go beyond the limits of his authority as agent. The principal P might then refuse to accept the agreement as legally binding. An example of this is where a manager makes an agreement on behalf of the company he works for, and the company refuses to honour the agreement on the grounds that the manager did not have the authority to make the agreement.

Two important questions with agency relationships are therefore:

- When does an agency relationship come into existence?
- How is the authority of the agent established? To what extent can an agent bind the principal to an agreement that the agent has made, acting as agent and not in his own name as principal?

Forming an agency relationship: types of agency

- Why does it matter whether an agency relationship exists?
- Ways in which an agency relationship may be established
- Agency by express appointment (by agreement)
- Agency by ratification
- Agency by estoppel
- Agency by necessity

2 Forming an agency relationship: types of agency

2.1 Why does it matter whether an agency relationship exists?

It is important to establish whether or not an agency relationship exists.

If the third party reaches an agreement with a person it believes to be an agent, it may commit itself to decisions and a course of action that will result in a loss if the principal then rejects the agreement. The third party may wish to take legal action, to try to recover the losses (or to compel the principal to accept the agreement). However:

- if there is no agency agreement, the third party can take legal action against the so-called agent, but not the person it believed to be the principal.
- if there is an agency agreement, the third party can take legal action against the principal.

2.2 Ways in which an agency relationship may be established

An agency relationship does not have to be a written agreement between the principal and the agent, although it will certainly help to remove much of the uncertainty if there is a written agency agreement.

There are four ways in which an agency relationship, recognised in law, can be established:

- by express appointment (by agreement)
- by ratification
- by estoppel
- by necessity.

2.3 Agency by express appointment (by agreement)

The most common method of creating an agency relationship is by agreement and mutual consent. The principal appoints an agent (to carry out a particular task or to undertake a particular function) and the agent agrees to act for the principal.

- In many cases, the relationship is established formally, in writing. This written agreement would be a contractual agreement between principal and agent.
- An agency agreement may also be established by verbal agreement (although both parties may need to provide proof of a verbal agreement in the event that one party subsequently denies that the agreement ever took place).
- The principal may wish to give the agent the power to execute deeds. (A deed is a form of written legal document, and it is executed by signature.) In these cases, the agent must be appointed by a deed. When an agent is appointed by deed, he is '**given a power of attorney**' to act for the principal.

When an agency is created by agreement, the agreement will usually specify the ways in which the agent has authority to act on behalf of the principal. The agreement should therefore make it clear, between the principal and the agent, what the agent is allowed to do on behalf of the agent (and so what he is not allowed to do).

2.4 Agency by ratification

An agency relationship may be created retrospectively, by ratification. This may happen when a person who does not actually have actual authority as an agent negotiates with a third party, claiming to be an agent of a **named** principal. The agent may negotiate a transaction between the third party and the so-called principal.

At this stage, there is no agency relationship. However, the person who has been named as principal might then choose to accept the contract with the third party. This gives validity in retrospect to the actions of the person claiming to act as agent of the named principal, and an agency relationship is created by ratification. ('Ratification' means 'giving approval to' or 'giving validity to' something.)

For ratification to be valid:

- The principal must ratify the agreement within a reasonable time.
- The principal must accept the entire agreement that the agent has negotiated, and cannot select which parts of the agreement to accept and which parts to reject.

An agency relationship **cannot** be established by ratification in the following circumstances:

- If the principal did not exist at the time that the so-called 'agent' negotiated the agreement. For example, an agent cannot act on behalf of a company that has not yet been formed.
- If the principal did not have the legal capacity to enter into the contract when it was negotiated. For example, an agent cannot act on behalf of an individual who is under the minimum legal age for entering into the contract.
- The name of the principal must be disclosed to the third party. A 'principal' whose name remains undisclosed cannot subsequently ratify the actions of an 'agent' and an agreement that the agent has negotiated. Otherwise, it would be possible for anyone to become the principal in a contract that has been negotiated by someone else and to which he was not a party.

If the actions of a person claiming to be an agent are not ratified by the person named as principal, and there is no proof that an agency arrangement exists by agreement, the contract is between the agent personally and the other party.

If the other party suffers a loss due to breach of contract by the so-called agent, he would have to take action against the so-called agent to recover any losses suffered, because the so-called agent is actually the other party to the contract.

There are some cases that illustrate these principles of agency by ratification.

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Case: Kelner v Baxter [1866]

The promoters of a company that had not yet been formed to carry on a hotel business purchased some stock-in-trade (wine) from the plaintiff. The company was formed a few weeks later, sold the stock-in-trade but did not pay for it. The plaintiff sued the promoters for payment. The promoters claimed that they were merely acting as agents for the company, and the company had ratified the contract they had made as agents.

It was held that an agency by ratification did not exist. This was because at the time the contract with the plaintiff was made, the company did not exist. Since the company did not exist, they could not be its agent. The promoters were therefore personally liable to the plaintiff for the non-payment for the goods.

The legal position in this type of situation is now established by company law. The Companies Act states that, subject to any agreement to the contrary, when a promoter of a company enters into a pre-incorporation contract with another party, the promoter is a party to the contract and will be personally liable for any breach of contract.

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Case: Keighley, Maxsted & Co v Durant [1901]

This case demonstrates the rule that an agency cannot be ratified in cases where the other party was not aware of the existence of a principal, and the principal had not been named when the agreement was made. This rule protects the other party when the other party believes that he is dealing with the 'agent' as the other party to the contract, and that there is no-one else involved in the transaction.
KM & Co authorised a man called Roberts to buy wheat for them. Roberts also wanted to buy wheat for himself, so he was acting both for himself and as agent for KM & Co. Roberts bought wheat from Durant, but did not tell Durant that he was acting as agent for KM & Co for part of the transaction. Durant was therefore unaware of the interest of KM & Co in the transaction.

Having bought the wheat, both KM & Co and Roberts refused to take delivery or pay for it. Durant sued.

The court held that KM & Co could not be liable since Durant was not aware at the time of the transaction with Roberts that Roberts was acting for anyone other than himself.

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Case: Lass Salt Garvin v Pomeroy [2003]

This more recent case illustrates that the existence or non-existence of an agency by ratification will often depend on the circumstances of the case.

LSG was a firm of solicitors, seeking to obtain payment of £100,000 in fees for its services in connection with the sale of shares by one company to another. LSG had issued invoices to the defendants, but these had not been paid.

On being sued, P claimed that their agent T had not been given the authority to negotiate the legal fees with LSG. LSG argued, however, that P had authorised T to agree the amount of the legal fees and that T had done so. LSG also claimed that even if T did not have the express authority to agree the legal fees. P's silence and failure to challenge the invoices from LSG amounted to a ratification of T as agent with the necessary authority.

In this case, the court found that P had not given the necessary authority to T and T had agreed the fees without authority. The unauthorised actions of an agent are not normally ratified by the principal's silence or inaction. However in this case, P's failure to challenge the invoices until such a late stage in the proceedings indicated that they were prepared to ratify T's actions. T was therefore held to be an agent by ratification, with authority to agree the legal fees with LSG.

2.5 Agency by estoppel

'Estoppel' is a word used in law to mean 'stop' or prevent'.

An agency relationship may be created when someone has led others to believe that a person has the authority to act on his behalf. An express agency agreement does not in fact exist, but it may seem to other people that it does. If a third party then agrees a transaction with the person who appears to be an agent, the 'principal' may be prevented ('estopped') from denying that an agency agreement exists. In other words, the principal cannot reject the agreement by saying that the person who was apparently acting as an agent was not in fact an agent. The agency agreement does exist.

In this situation, the agent has '**ostensible authority**' or 'apparent authority', even though he does not have actual authority to act as an agent.

Agency by estoppel was defined by the judge in the case of *Freeman & Lockyer* (see below) as 'a legal relationship created by a representation made by the principal to the contractor, intended to be and, in fact, acted upon by the contractor, that the agent has authority to enter on behalf of the principal into a contract.'

For a third party to rely on the existence of an agency by estoppel, the following conditions must apply.

- A person (the principal) must give a clear **representation to others** that someone has the authority to act as his agent. The representation must be made by the principal. If a person claims to be an agent but the principal has given no representation to others that this person is an agent, an agency by estoppel cannot exist.

- This representation must have been made to the third party who then relies on the existence of the agency relationship.
- The third party who then negotiates the transaction with the 'agent' **must have relied on the existence of the agency relationship** in reaching a decision about the transaction.

If these circumstances apply, a third party who suffers losses resulting from the situation can hold the principal as liable, and take legal action against the principal.

In a simple situation, suppose that a father regularly pays the debts of his daughter to a particular shop. He may be denied (estopped) from denying that she acts as his agent, so that if he decides that he will not pay a particular bill to the shop for his daughter, he may nevertheless be legally obliged to do so.

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Case: Freeman and Lockyer v Buckhurst Park Properties [1964]

The defendant was a company which had four directors. The company's constitution (articles of association) provided for the appointment of a managing director, but none had been appointed. However, only one of the directors was active in the affairs of the business and effectively acted as managing director with the approval of the other directors and entered into contracts on behalf of the company.

He entered into a contract with a firm of architects. The company refused to pay on the grounds that the director who made the agreement did not have the authority and was not acting as agent of the company.

The court held, however, that the company had held the director to be its managing director and it was estopped from denying that he was its properly-authorised agent.

2.6 Agency by necessity

Agency by necessity occurs in circumstances where there is no agreement between the parties, but an emergency requires that one party (the agent) has to take action to protect the interests of the other party (the principal).

A typical situation that might create agency by necessity happens when one person (the agent) is in possession of property belonging to another person (the principal), and as a result of an unexpected emergency, the agent takes action to protect or safeguard the property of the principal. Unless the agent takes action, the principal will lose the property, or the property will suffer significant damage.

For agency by necessity to exist, the following conditions must apply.

- There must be a real emergency.
- It must be impossible for the person acting as the agent to contact the owner of the property and obtain instructions.

- The person acting as agent by necessity must act in the best interests of the principal.
- The person acting as agent must act in a reasonable way.
- In most cases involving agency by necessity, the person acting as agent by necessity is in charge of goods or other assets owned by the principal, and there is an emergency in relation to those assets.

Some legal cases illustrate the rules relating to agency by necessity.

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Case: Great Northern Railway Company v Swaffield [1874]

A horse was being transported by the railway company, but due to a delay that was not the fault of the company, the horse was not delivered on time to its intended recipient. The company did not know how to contact the horse's owner (Swaffield) and decided to put the horse into stables. Swaffield refused to pay the charges for putting the horse into stables. In this case, it was decided by the court that a real emergency had arisen, the railway company could not contact the horse's owner and it had acted in the best interests of the owner. Agency by necessity did therefore exist and the principal (Swaffield) was liable to pay the fees to the stable owners.

This case arose at a time when methods of communication were not as fast as they are today. Today, it would generally be held that an agency by necessity did not exist because the person in possession of the asset (the 'bailiff') should be able to contact the owner quickly and obtain instructions about what to do.

This view is already apparent in the 1921 case of *Springer v Great Western Railway*.

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Case: Springer v Great Western Railway [1921]

The railway company was hired to transport a consignment of tomatoes from the Channel Islands to London. However, the ship bringing the tomatoes to the UK mainland was late, and when it arrived in port, the railway's staff were on strike. By the time that the tomatoes were unloaded, some were 'bad'. The railway company therefore decided to sell the tomatoes locally on behalf of their owner. The owner took the railway company to court, claiming payment for the losses suffered by selling the tomatoes locally instead of in London. The railway company claimed agency by necessity. In this case it was held that agency by necessity did not exist, because the railway company should have been able to contact the owner of the tomatoes (who therefore won the case).

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Case: Sachs v Miklos [1948]

This case illustrates the rule that an agency by necessity can only come into existence when there is a real emergency.

A person was storing goods for another person and did not have the authority to sell them. However, the he sold the goods because it was no longer convenient for him to continue to store them. The owner of the goods sued for the losses he had suffered as a result of their sale. The keeper of the goods argued in his defence that he had sold the goods acting as an agent by necessity, because it was no longer possible to carry on storing the goods.

The court held that an emergency did not exist; therefore there was no agency by necessity.

(***Note***: Statute law has now changed the rules in this type of situation. A person holding goods as 'bailee' for someone else has the right to sell the goods after giving due notice to their owner to collect them and pay for the storage.)

The authority of the agent

- Agent's authority and the power to bind the principal
- Express authority
- Implied authority
- Ostensible authority (apparent authority)

3 The authority of the agent

3.1 Agent's authority and the power to bind the principal

A principal does not give an agent unlimited authority to arrange any contract on behalf of the principal. There are limits on the authority of an agent that restrict the type of agreement that the agent can arrange, and the principal is only bound to honour agreements that the agent makes within the limits of his authority.

When a third party deals with an agent who does not have the authority to make the transaction, the third party cannot sue the 'principal' for any breach of contract, only the agent.

Example

An agent A is acting on behalf of a principal P. He enters into a contract with another party T, stating that he is acting as agent for P. However, A has actually acted outside his authority. P refuses to carry out the terms of the contract. In this situation, the agent A will be potentially liable to both the other party T and to the principal for breach of warranty of authority.

However, there might be problems in identifying the authority of a particular agent. These arise mainly when an agent makes an agreement with another party, and the other party genuinely believes that the agent has the necessary authority, but in fact the principal has not given the agency that authority.

The authority of an agent to act on behalf of the principal may be any of the following types of authority:

- Express authority
- Implied authority
- Ostensible authority (apparent authority)

3.2 Express authority

An agreement is 'express' if both parties openly agree to create an agency relationship and the agent has express authority to act on behalf of the principal. A written agency agreement gives the agent express authority.

Express authority is not unlimited power to do anything on behalf of the principal. The principal should specify what task or tasks the agent is required to perform, and what power and authority the agent is given to perform those tasks.

If the agent subsequently acts outside the limits of his express authority, this will affect the contractual relationship between the principal and the third party. In such a situation, express authority does not exist, but there may be implied authority or ostensible authority (which would mean that the agent doe shave the authority to bind the principal, even though the agent exceeded the limit of his express authority). The legal consequences will depend on **whether the third party knew** that the agent was acting outside the limit of his authority.

3.3 Implied authority

Implied authority is authority of an agent in excess of his express authority. The scope of an agent's authority may be increased by implied authority.

Unless the third party has knowledge to the contrary, he is entitled to assume that an agent holding a particular position has all the powers that are normally given to a person in such a position.

For example, the purchasing director of a company may order a quantity of goods from a supplier. In doing so, the director might exceed the scope of his express authority, because the company policy might be that purchases above a certain value must be made by the managing director. Unless the supplier has knowledge that the purchasing director has exceeded the limits of his authority, he is entitled to assume that the director does have the authority to purchase the goods. The company must accept that in the circumstances the purchasing director had implied authority.

Several cases illustrate the nature of implied authority. These cases all concern the authority of a director or manager to act as agent for his company. Whether implied authority does exist in any particular situation will depend on the circumstances.

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Case: Watteau v Fenwick [1893]

The new owners of a hotel employed its previous owner as the hotel manager, but expressly forbade him from buying certain items for the hotel, including cigars. The manager disregarded this restriction on his authority and bought some cigars for the hotel. The owners refused to pay and were sued by the supplier.

The court held that the hotel owners must pay for the cigars. Although the hotel manager did not have the express authority to buy cigars, the supplier was unaware of this fact. It was usual for hotel managers to have the authority to buy such items for their hotel; therefore the hotel manager in this case had the implied authority to make the purchases.

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Case: Hely-Hutchinson v Brayhead Ltd [1968]

The board of directors of B Ltd had allowed one of the chairman of the board to act as though he were also the managing director, although he had not been formally appointed to this position. He agreed in the name of the company to provide a guarantee for a debt owed by another company. When the debtor company defaulted on the payment of the debt, B Ltd was asked to honour its guarantee. The rest of the board of directors, acting in the name of B Ltd, claimed that the guarantee was invalid because the chairman did not have the authority to bind the company to this type of agreement.

The court held that although the chairman of a company would not have such authority, a managing director would. The chairman also had the authority of managing director (agency by estoppel). The company was bound to honour its contract (the guarantee) because of the implied authority of a person holding the position of managing director.

This case is an example of how the law regards directors to be agents of their company.

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Case: SMC Electronic Ltd v Akhter Computers Ltd [2001]

The wages of a maintenance and repairs engineer might be a direct cost of the department in which he works. However, his wages are an indirect cost of each individual cost unit produced by the department. This is because the job of the engineer is to fix machines and other equipment when they break down, and he is not involved directly in producing the output of the department.
direct cost of all the units of production made in the factory.

This case is more recent, showing that disputes about the implied authority of agents continue. It also concerns a manager of a company, not a managing director.

B was an employee of Akhter Computers (AC). He negotiated a commission agreement with SMC whereby SMC would receive 50% of the profits of AC on certain sales projects. AC claimed that this agreement was invalid because B did not have the authority to act on behalf of the company to make such an agreement.

The court studied the employment contract of B and held that the authority to negotiate commission agreements was implied in the employment contract; therefore B did have the authority to commit AC to the agreement.

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Case: Sinclair, Moorhead & Co v Wallace & Co [1880]

The previous cases all illustrate situations where the court found that an agent had implied authority.

In this case, the general manager of the branch of a large firm borrowed some money on the firm's behalf, and then 'ran off' with it. The lender sued the manager's employer to recover the money that had been lent.

It was held in this case that the manger did not have authority, express or implied, to borrow money on behalf of the company. His (former) employer was therefore not liable for the debt.

3.4 Ostensible authority (apparent authority)

Ostensible authority, also called apparent authority, is an aspect of agency by estoppel.

Ostensible authority arises in two ways.

- Where a person makes a representation to third parties that another person has the authority to act as his agent, even though he has not actually been appointed as agent.
- Where a person has **previously** represented to a third party that another person has the authority to act as his agent and:
  - the authority was subsequently taken away/ended, but
  - the third parties who previously dealt with the agent have not been informed of this fact.

A person who is agent by estoppel has the ostensible authority that would be assumed for any such agent. The existence of ostensible authority is therefore found in cases of agency by estoppel, such as the case of *Freeman & Lockyer*, which was described earlier.

C

Case: Racing UK Ltd v Doncaster Racecourses Ltd [2005]

Doncaster Racecourse was owned by the Doncaster local authority but managed by a managing company D. D entered into an agreement with Racing UK, giving Racing UK television rights. To exercise these rights, Racing UK needed to have access to the racecourse, and permission for access could only be granted by the Doncaster local authority, as owners of the land.

The local authority refused access, claiming that it was not bound by the agreement made with Racing UK by D, since D did not have the authority to negotiate this type of agreement and Racing UK had made the agreement with D believing D to be the principal.

The court decided that Racing UK knew that the local authority was the owner of the racecourse, and it knew that it was not dealing with D as principal. Evidence produced in court showed that Racing UK believed that D was acting as agent in the transaction, with the necessary authority to make an agreement on behalf of the local authority. The Doncaster local authority had held out D to be its agent and it was therefore estopped from denying that D was its agent. D had the ostensible authority to make the agreement, which was therefore valid and binding on the local authority.

Rights and duties of the agent and principal

- The duties of the agent/rights of the principal
- The rights of the agent/duties of the principal

4 Rights and duties of the agent and principal

In a normal agency agreement, the principal appoints an agent to perform a task (or several tasks, or a particular function) on his behalf, and the agent agrees to carry out the task or the function.

The agreement between the principal and agent is a contractual agreement that should give both parties certain rights and duties. (The duties of an agent are rights of the principal, and rights of the agent are duties of the principal.)

An agency relationship also gives the agent certain authority and powers.

4.1 The duties of the agent/rights of the principal

The duties of an agent and rights of the principal are set out in the table below.

Performance of tasks or function	An agent has a duty to perform the tasks or function that he has agreed to do, and for which he will be remunerated by the principal. An agent who is unpaid is not bound to perform the agreed tasks, and an agent may (should) refuse to perform an illegal act.
Skill and Care	An agent who is paid or unpaid for his work has a duty to provide a standard of skill and care that should be expected of someone in his profession.
Personal performance	An agent has a duty to perform personally the tasks for which he has been appointed, and in most circumstances should not delegate the work and the responsibility to someone else.
Confidentiality	An agent must not disclose to anyone else information of a confidential nature about the principal and the principal's affairs.
Accountability	The agent must give full information to the principal about all his transactions as an agent, and must account for all money he has received from those transactions.
Fiduciary duty to avoid conflict of interest and not to make any secret profit	An agent must not put himself in a position where he has a conflict of interest, so that his personal interests may conflict with those of the principal. For example, if an agent is acting for a principal in the purchase of a property, the agent must not sell his own property to the principal (even if the sale price is fair and reasonable). If the agent receives any benefits from a third party whilst acting as agent (such as a payment of money from a third party), he must give these benefits to the principal – unless the principal decides that the agent can keep them).

C

Case: Boston Deep Sea Fishing and Ice Co Ltd v Ansell [1957]

Ansell was the managing director of the plaintiff company and accepted 'commissions' to buy items from a particular supplier. The court found that Ansell was in breach of his fiduciary duties to the company and the company could recover the commissions he had obtained. As an agent of the company, he held the commissions for the company.

4.2 The rights of the agent/duties of the principal

The agent also has certain rights.

Remuneration	The agent is entitled to remuneration from the principal for the performance of his tasks or function. (If the agent is not paid by the principal, he is under no obligation to perform the tasks or function.)
Indemnity	An agent acting within the scope of his authority is entitled to indemnity from the principal against losses or liabilities incurred during the performance of his task or function. The agent may also recover expenses he has incurred

CHAPTER

7

Partnership law

Contents

Definition and types of partnership

- Definition of partnership
- Types of partnership
- Partnerships in the business world
- The business name of a partnership
- The main features of an ordinary partnership
- Types of partner

1 Definition and types of partnership

1.1 Definition of partnership

A partnership is a relationship that exists between two or more persons acting in common 'with a view of profit'. (This is based on a definition given in The Partnership Act 1890).

- A partnership is a relationship between two or more persons, who are 'partners'.
- A partner can be any legal person, including a company. A company and an individual could therefore form a partnership.
- A partnership exists with a view to making a profit. The intention to make a profit must be present.
- A partnership business is commonly described as a '**firm**'. The Partnership Act 1890 defines a firm as a collective term for 'persons who have entered into partnership with one another.'

1.2 Types of partnership

There are three types of partnership:

- An **ordinary partnership**. The main statute law relating to ordinary partnerships is the Partnership Act 1890. An ordinary partnership is sometimes called an unlimited partnership.
- A **limited partnership**. A limited partnership is similar in most respects to an ordinary partnership, but the main statute law relating to limited partnerships is the Limited Partnership Act 1907.
- A **limited liability partnership** or **LLP**. This is a significantly different type of partnership, more similar in many respects to a limited company than to an ordinary partnership. LLPs were introduced into English law by the Limited Liability Partnership Act 2000.

The law relating to limited liability partnerships is explained later. This chapter begins by explaining the nature of ordinary partnerships.

1.3 Partnerships in the business world

The standard partnership has a small number of partners, and they are often fairly small businesses. In this respect they are similar to the business of a sole trader, except that there is more than one owner.

Partnerships are often found in **businesses that provide professional services**, such as architects, civil engineers, lawyers and accountants. This is because historically members of many professions have been unable to establish their businesses as limited companies.

Large professional firms and other partnerships may now be established as limited liability partnerships (LLPs).

Many individuals who want to set up a business in collaboration with others will often prefer to establish their business as a limited company, and not as a partnership. The reasons for preferring to establish a company rather than a partnership are considered in a later chapter.

1.4 The business name of a partnership

Partnerships operate under a business name, and are limited by the rules of the Business Names Act in their choice of business name. Ordinary partnerships will often operate under the name of their partners, or their most 'senior' partners. For example, a partnership between John Green, Peter Black and Mary White might be called 'Green, Black and White' or 'Green and Partners'.

1.5 The main features of an ordinary partnership

Some important features of the ordinary partnership need to be understood. (They will be considered in more detail later).

- **A partnership does not have a legal personality**. Unlike a company, it is not a legal person. A third party entering into business transaction with a partnership does not have a contractual agreement with the partnership: the contractual agreement is between the third party and all the partners as individuals. When partners make business agreement with another party, they are acting as agents (with actual or implied authority) on behalf of themselves and their fellow-partners.
- **Partners in an ordinary partnership do not have limited liability**. This means that they are personally liable for any liabilities of the partnership business that the partnership cannot pay. (Other types of partnership offer limited liability to some or all of the partners, but ordinary partnerships do not.)

Example

D, E and F are in partnership. The partnership has been making losses and the partners therefore agree to dissolve the partnership. The partnership has assets that can be disposed of for £50,000 and liabilities of £70,000. When the partnership is dissolved, the liabilities must be paid. Selling off the assets of the business will provide £50,000 to pay some of the debts, leaving £20,000 still to be paid. D, E and F will be personally liable for these liabilities. The actual amount owed by each individual partner is determined by the partnership agreement and/or the rules in the Partnership Act 1890.

1.6 Types of partner

There are a number of different types of partner.

- *General partner*. This term refers to any partner actively involved in the running and management of a partnership business.
- *Sleeping partner*. This type of partner contributes capital to the business but is not involved in the day to day running of the partnership business.
- *Limited partner*. This type of partner is found in a limited partnership, not in an ordinary partnership.

The internal regulation of ordinary partnerships

- When does an ordinary partnership come into existence?
- Rules to establish the existence of a partnership
- Partnership agreement (articles of partnership)
- The duties of each partner to the other partners
- The rights of partners

2 The internal regulation of ordinary partnerships

2.1 When does an ordinary partnership come into existence?

For many partnerships, there is a written partnership agreement. When a written agreement exists, the partnership agreement should establish the date that the partnership comes into existence. However, this is not conclusive evidence. The partnership might pre-date the written agreement.

Partnerships can exist without anything having been put into writing by the partners. The existence of a partnership is **always a matter of fact**.

2.2 Rules to establish the existence of a partnership

Section 2 of the Partnership Act 1890 contains certain rules to determine whether or not a partnership exists.

- Joint ownership or common ownership of property does not of itself create a partnership, even if the profits from using the jointly-owned property are shared between the owners. A partnership is for **carrying on a business**. So if two or more individuals are joint owners of property, for example a house that they rent out to tenants, the 'passive' receipt of income from the property does not constitute a partnership, because they are not carrying on a business.
- Sharing the **gross** income from a business does not of itself create a partnership. Gross returns are the total income of the business (for example, revenue from sales or fee income), as distinct from the net profits. This rule means that if a business employs sales representatives who are each paid commissions as a percentage of the sales they make, this is not of itself proof that a partnership exists and that the salesmen are partners.
- However, a receipt by a person of a share of the **profits** of a business is *prima facie* evidence that he/she is a partner.

The definition of a partnership provides a basis for determining whether a partnership exists.

- There must be a relationship between two or more people.

- They must carry on a business. This can be just one transaction or deal, for example a speculative transaction between individuals to buy a consignment of potatoes wholesale and re-sell them at a profit.
- They must carry on the business *in common*. Broadly speaking, this means that they should be associated in the business as joint proprietors. Evidence of this would be each person taking a share of the profits.
- They must carry on the business with a view to profit. Any activity not intended to make a profit does not constitute a partnership.
- A business cannot be an ordinary partnership if it has been established as a different form of business, in particular a limited liability partnership or a limited company.

2.3 Partnership agreement (articles of partnership)

A partnership is a contractual agreement between the partners. This is usually in written form, and is called the partnership agreement or 'articles of partnership'.

A partnership agreement sets out the purpose of the partnership, and the rights and duties of the partners. The agreement should also specify the amount of **capital** that each partner should put into the business, and keep in the business until the partner retires or the partnership is dissolved. (Note: Partnerships can employ individuals who are employees, not partners: the partnership agreement is between the partners only, and does not apply to employees.)

If the partnership agreement does not specify what the rights or duties of the partners should be in particular circumstances, the rules in the Partnership Act 1890 are assumed to apply. These are the 'default rules' in the absence of anything else.

- This means that if a partnership exists but does not have a written agreement, it will be assumed (unless there is evidence to suggest otherwise) that the rules or articles of the partnership agreement are those contained in the Partnership Act.
- If the partners do not want certain rules in the Partnership Act 1890 to apply, it is advisable for them to specify the rules that they do want in their written partnership agreement.
- The terms in the partnership agreement can be amended, but only with the consent of all the partners.

A partner who breaches any term in the partnership agreement is in breach of contract, and so may be liable to the other partners.

The benefits of a written partnership agreement

There are several important advantages on having a written partnership agreement that sets out the rules or articles for the partnership.

- The agreement can specify some features of the partnership that do not have to be specified as a legal requirement, such as the partnership name, the nature of its business, the bank that it will use to keep its account, and so on.
- The agreement can also specify rules that override the 'default rules' that would otherwise be applied by the law.

2.4 The duties of each partner to the other partners

Partners owe certain duties to each other, even though these may not be specified in the partnership agreement. A partner has a **fiduciary duty** to all the other partners. This is which is a duty to act in the utmost good faith. Deciding whether or not a partner is in breach of this duty will often depend on the circumstances of a particular situation.

However, some specific examples are given the Partnership Act 1890 (PA 1890).

- A **duty of disclosure** (section 28, PA 1890). A partner must give full information and provide true accounts to the other partners, in relation to everything affecting the partnership.
- **A duty to account** (section 29, PA 1890). A partner must 'account to the firm' for any benefit obtained, without the consent of the other partners, from any transaction involving the partnership, the partnership property, the partnership name or the partnership's business connection. In other words, if a partner uses the partnership property, name or business connections to make a secret profit (in other words, a personal profit that the other partners do not know about), the other partners can claim those profits for the partnership.
- **A duty not to compete** (section 30, PA 1890). If a partner competes in business with the partnership, without the consent of the other partners, he is liable to account to the partnership for all the profits that he earns from the competing business.

Some cases illustrate the application of these rules.

Case: Law v Law [1905]

Two brothers, W and J, were partners in a manufacturing business in Halifax. J ran the business and W who lived mainly in London took little part in the affairs of the business. J bought W's share of the partnership for £21,000, but W subsequently found out that the business was actually worth much more than J had led him to believe. J had not given W all the relevant information about the value of the firm's assets.

The court held that J's behaviour in withholding all the relevant information from W was sufficient to set aside the agreement for the sale of W's part of the business to J.

Case: Hogar Estates Ltd v Shebron Holdings Ltd [1980]

This is a case involving two companies in partnership. H and S were in partnership as property developers, owning a particular property. S offered to buy out H's share of the partnership, explaining that planning permission had been refused for the land. H agreed to sell.

After H agreed to sell but before the sale contract was drawn up, S found out that planning permission would be obtained for the land after all. S did not tell H, and H went ahead with the sale if its share of the partnership.

When H found out about the planning permission, it sued to have the sale agreement set aside. The court agreed. S was in breach of its fiduciary duty to H (and in breach of s28 PA1890) by failing to inform H about the planning permission, (even though it could not be proved that S had been deliberately dishonest!)

C

Case: Bentley v Craven [1853]

Bentley and Craven were in partnership with two other people. The firm bought and sold sugar. Craven was the firm's buyer of sugar, and he was occasionally able to acquire quantities of sugar at a very low price. He bought quantities of sugar in his own name at prices below the current wholesale price and resold it to the partnership at the wholesale price. He did not disclose to the other partners that he was trading with the partnership in his own name and making a personal profit.

When the other partners found out, they claimed that the profits he had made belonged to the partnership. The court agreed and decided that Craven should 'account to the partnership' for the secret profits he had made. (Craven would now be in breach of s29 PA1890.)

2.5 The rights of partners

The rights of the partners in a partnership should normally be set out in the partnership agreement. However, there are some basic rights of partners in a standard partnership:

- Partners should be involved in making key decisions that affect the business.
- Partners should have a right to share in the profits of the business, although the share of each partner need not be equal.
- Partners should have the right to examine the accounts of the business.
- Partners have a right to be treated in good faith by the other partners, and with openness and honesty.
- Partners should have the right to veto the admission of a new partner to the partnership business. New partners can only be introduced with the consent of all the other partners.

The Partnership Act gives partners other rights, **unless the partnership agreement states anything different** (which it often does!) The most important of these rights are as follows:

- Partners have the right to share equally in the capital and the profits of the business. (Partners do not take a salary, because they are not employees. However, it is usual for partners to receive regular monthly payments from the business that might be called a 'partnership salary'. In law, this is a withdrawal of some of the partner's share of the partnership profits.)
- Partners have the right to take part in the management of the business. (However, sleeping partners choose not to do so.)

These rights can be varied by the partnership agreement. The share of profits need not be equal, and the partnership agreement can give some partners specific management duties (such as having a 'managing partner' to lead the management of the business.)

Other rights that may be given to partners unless the partnership agreement states otherwise are as follows:

- The partnership agreement can be varied only with the consent of all the partners.
- A decision to change the nature of the partnership business should be unanimous.
- The firm should indemnify each partner against liabilities that he or she incurs in the ordinary and proper conduct of the partnership business, or in protecting the partnership property.

Partnership capital. Profit-sharing. Partnership property

- Partnership capital
- Profit-sharing arrangements
- Partnership property
- Why is it important to decide which property is partnership property?

3 Partnership capital. Profit-sharing. Partnership property

3.1 Partnership capital

The partners provide the long-term capital to the partnership business.

- Each partner might agree to contribute a certain amount of **'permanent' capital** to the business. This could take the form of a cash payment into the partnership bank account, or it could take the form of other assets. Partners undertake to retain this permanent capital in the business until they leave the partnership (for example, when they retire) or when the partnership is dissolved.
- When the partnership makes profits, the profits accumulate in the business, until each partner withdraws some of this profit share as drawings. **Accumulated profits retained in the business** add to the total of the partners' capital, but are not regarded as permanent capital.
- In addition, a partner might agree to provide a further contribution of long-term capital, in excess of the capital he has agreed to subscribe. This additional contribution might take the form of a partner's **loan**.

The amount of capital provided by each partner

The partnership agreement, or any subsequent amending document, should set out the amount of long-term capital to be provided by each partner, and in what form (cash or other assets). Each partner might contribute a different amount of permanent capital.

Interest on loans from partners

Where one or more partners provide a loan to the business, interest will usually be paid on the loan. In the absence of any agreement to the contrary, a partner making a loan to the business is entitled to interest on the loan at the rate of 5% per annum (s24(4) PA1890). This applies only to an 'actual payment or advance', and does not apply to a partner's share of retained business profits. For example, if a partnership makes a profit of £2 million and leaves £1 million in the business as retained profits, the partners would not be entitled under s24(4) to interest at 5% on their share of the retained profits.

A written partnership agreement might provide for interest on partners' loans at a rate other than 5% per annum (for example, a commercial rate of interest).

Interest on a partner's loan is an expense, of the partnership business, and is not an allocation of the partnership profits to the partner providing the loan. The partner receives the interest as a creditor of the partnership, not as an owner of part of the business. In the event of a dissolution of the partnership, a partner's loan is treated as a liability, not as a part of the partners' capital.

Accounting for partners' capital

Accumulated profits that are retained in the business do not form part of the long-term capital that each partner has agreed to contribute. They are therefore 'kept separate' in the accounting 'books' of the partnership and added to the partners' 'current accounts'. The balance sheet of a partnership might therefore include:

- a 'capital account' for each partner, for the long-term (permanent) capital provided by that partner
- a 'current account' for each partner, for the share of the business profits attributable to that partner and not yet withdrawn from the business (the retained profits attributable to the partner)
- a loan account for any partner's loan provided by that partner, as a creditor of the partnership.

3.2 Profit-sharing arrangements

Section 24 PA1890 includes certain rules that are deemed to apply **in the absence of any partnership agreement to the contrary**.

Share of capital

All the partners are entitled to share equally in the capital and profits of the business, and they must also contribute equally to any losses of the business (s24(1) PA1890). This means, for example, that in the absence of an agreement to the contrary, if there are, say, ten partners in a firm, each partner would be entitled to 10% of the capital and profits of the business.

In practice, however, the entitlement of each partner to the capital of the business is unlikely to be affected by s24(1), because an **implied agreement** to the contrary is assumed when partners provide different amounts of long-term capital. For example, if a partnership is set up by X, Y and Z, with X providing £300,000 of long-term capital, Y providing £200,000 and Z providing £100,000, there will normally be an implied agreement that they will continue to hold these amounts as their individual shares of the long-term capital of the business.

More commonly, a partnership agreement will specify the long-term capital to which each partner is entitled, and this is usually the amount of permanent capital they have each contributed.

Profit-sharing arrangements

The arrangements for sharing profits between partners varies from one partnership agreement to another. As a broad rule, however, partnership profits might be shared out in a combination of the following ways:

- in the form of partners' salaries
- in the form of notional interest on partners' capital
- in the form of a sharing of 'residual' profits, after providing for interest on capital and partners' salaries, in an agreed profit-sharing ratio.

The Partnership Act 1980 includes the following default provisions, which will apply in the absence of any other agreement between the partners.

- A partner is not entitled to notional interest on the permanent capital that he has subscribed to the business. (Note: Do not confuse notional interest on partners' long-term capital with interest on loans provided by partners.)
- No partner should be entitled to any remuneration for working in the business (s24(6) PA1890). This means, for example, that in the absence of an agreement to the contrary, no partner is entitled to draw a salary.
- Partners should divide the profits equally.

In practice, partnership agreements make their own particular arrangements for sharing profits.

- There may be an agreement that some of the profits should be allocated to partners by allowing each partner **notional interest** at a specified rate on their permanent capital contribution to the business.
- There may be an agreement for some or all individual partners to receive some of their profit share in the form of a 'salary'. Although this is called a **partner's salary**, it is actually an allocation of some of the partnership profits.

Many professional partnerships, such as solicitors' and accountancy practices, provide for **junior partners** who receive only a salary and are not entitled to either interest on capital or a share of the residual profits. Although receiving only a salary out of the partnership profits, a junior partner may nevertheless be considered a full partner, with a partner's full duties and rights.

Sharing residual profits

The partnership profits left over after providing for interest on capital and partners' salaries will be shared out between the partners in an agreed way. These residual profits might be shared out equally, but they are commonly shared out in unequal proportions in accordance with the partnership agreement.

When there is no notional interest on partners' capital and no partners' salaries, all the profits of the partnership (or losses) are shared between the partners in their agreed profit-sharing ratio.

3.3 Partnership property

The assets used by a partnership are either:

- partnership property, or
- property of the partners (in other words, personal property of individual partners).

A partnership will usually have assets that are owned beneficially by all the partners ('by the firm'). In addition, the partnership business may use property (assets) that is owned exclusively by one of the partners.

A fairly common example is a partnership that uses a building for its business operations that is owned by one of the partners, and for which the partnership might pay a rent.

This can become a source of dispute between the partners, unless the legal ownership of property is made clear in all transactions. For example, if a partner buys a building that is then used by the partnership business, there has to be a clear understanding about:

- whether the partner bought the building as an agent for the other partners, so that the building is owned by the partnership (by the partners collectively), or
- whether the partner purchased the building and owns it exclusively himself, and has allowed the partnership business to use it.

If the property is sold at a profit at some time in the future, the answer to this question is important, because it affects who is entitled to the profit.

When is property 'partnership property'?

Section 20 PA1890 states that partnership property is 'all property and rights and interests in property originally brought into the partnership stock or acquired … on account of the firm, or for the purposes and in the course of the partnership business.'

Section 21 goes on to state that property bought with money belonging to the firm is deemed to have been bought on account of the firm (and so is partnership property) 'unless the contrary intention appears'.

The Act is therefore not as clear as it might be, and the partnership agreement should ideally clarify which assets are deemed to be partnership property and which will be considered as assets belonging personally to an individual partner.

C

Case: Miles v Clarke [1953]

Clarke had been carrying on the business of a photographer from premises on a long leasehold. Miles, a well-known photographer then joined as a partner, bringing the 'goodwill' of his reputation to add to the prestige of the firm. The agreement was that profits and losses should be shared equally. The partnership was then dissolved and a dispute arose about whether Miles was entitled to an equal share in the leased premises.

The court decided that the lease was held by Clarke before the partnership was created, therefore it was his personal property. It was only the other assets of the business that should be shared equally.

3.4 Why is it important to decide which property is partnership property?

There are several reasons why it might be important to decide which property is partnership property.

- The Partnership Act 1890 states (s20) that partnership property must be used exclusively for the purposes of the partnership and in accordance with the partnership agreement.
- If the asset increases in value (such as the value of land and buildings) all the partners benefit if it is partnership property, but the individual partner benefits if he is the personal owner.
- If the partnership is dissolved, partnership property is used to pay off the debts of the partnership. If the property belongs to an individual partner, it cannot be used to pay off the partnership's debts.
- If a partner has a creditor for personal debts and the creditor takes legal action to recover the debt, the creditor cannot take action against partnership property. He can take action against property owned by the partner personally (if the partner has any), or he can apply for a charging order against the partner's share in the partnership. This means that the personal creditor of a partner can obtain a charging order that entitles him to recover the debt out of the partner's share of the partnership profits (but not by taking possession of any partnership property).

The authority of partners

- Actual and implied authority of partners
- Transactions not connected with the ordinary course of business
- Knowledge of absence of authority
- Ratification of actions taken by a partner outside his actual authority
- The significance of authority for partners' liability

4 The authority of partners

4.1 Actual and implied authority of partners

The partners in an ordinary partnership manage the business. The authority of each partner to take decisions for the business, and enter into transactions with other parties, may be specified in the partnership agreement. Since the partnership agreement is a contract, its terms are the terms of a contractual agreement between the partners.

Partners act as agents for their partnership. Since the partnership is not a legal person, a partner acts as an agent for the other partners. The authority of a partner may be **actual** or **implied**.

- **Actual authority**. The authority of each partner to take decisions for the business, and enter into transactions with other parties, may be specified in the partnership agreement. Since the partnership agreement is a contract, its terms are the terms of a contractual agreement between the partners.
- **Implied authority**. Unless he has knowledge to the contrary, another party can assume that a partner has the usual authority normally possessed by partners in the type of business carried on by the partnership. In other words, partners may have implied authority, in addition to actual authority.
- In a trading partnership, all the partners have the **implied authority to borrow money on the credit of the partnership**, and a lender is under no particular obligation to investigate the purpose of the loan. This means that unless a lender has knowledge that a partner does not have the actual authority to borrow on behalf of the partnership, he can rely on the partner's implied authority.

Actual and implied authority is similar for partners as for agents. This is not surprising, since partners act as agents for their partnership.

4.2 Transactions not connected with the ordinary course of business

Where a partner incurs a debt in the name of the firm, but the transaction is one that has no connection with the ordinary course of the firm's business, the firm is not bound, unless the partner has been given the **actual** authority by the other partners. The individual partner would be personally liable (section 7, PA1890)

A transaction by a partner that is not connected with the firm's ordinary business might be for the partner's private purposes. The other partners might therefore decide that the firm should not be liable for the debt, but that it is a matter for the individual partner.

If the partner has used the firm's money to pay for such a transaction, they have the right to claim back the money for the partnership.

4.3 Knowledge of absence of authority

A partner might deal with another party in the name of the firm, in connection with a normal transaction for the firm's business, in spite of a decision by the other partners that he should not have the authority to make the transaction. In such circumstances, the third party can rely on the implied authority of the partner.

However, implied authority does not exist (and the firm is not bound by the act of the partner) **if the other party has been given notice of the restriction on the partner's authority**.

This is stated in section 8 of the Partnership Act 1890 as follows: 'If it has been agreed between the partners that any restriction shall be placed on the power of any one or more of them to bind the firm, no act done in contravention of the agreement is binding on the firm with respect to persons having notice of the agreement.'

4.4 Ratification of actions taken by a partner outside his actual authority

When a partner enters into a contractual agreement that is outside his actual authority, the other partners are able to approve the contract retrospectively and ratify what he has done.

By giving their retrospective approval to the contract made by another partner, even though it was outside the partner's actual authority at the time, the partners can remove any questions about whether implied authority existed or whether the other party knew that the partner did not have the actual authority to make the contract.

4.5 The significance of authority for partners' liability

The authority of partners is significant when it comes to deciding:

- who is liable for the debt when a partner enters a contract with another party to buys goods or services
- who is liable when there is a breach of contract with another (outside) party
- whether a partner should be held liable to the other partners for transactions entered into by the partner that were outside the partner's actual authority.

The legal relationship between partners is a complicated mix of contractual agreement (the partnership agreement), an agency-principal relationship, where the partner is both agent and principal (agency law), and owing a fiduciary duty to fellow partners.

The liability of partners

- The liability of partners to other parties
- Joint liability of partners
- Personal liability of the contracting partner
- Civil Liability (Contribution) Act 1978
- An agreement between partners to limit the liability of a partner
- Liability of persons 'holding out' to be a partner
- The liability of new partners
- The liability of retiring partners
- The liability of a 'sleeping partner'

5 The liability of partners

5.1 The liability of partners to other parties

A partnership is not a legal entity. It is a group of individuals, the partners, operating together. Because a partnership firm is not a 'legal person' it cannot sue or be sued in a court. This means that a firm cannot be held liable for breach of contract, because it is not recognised as a 'person' by the court.

The nature of a partnership raises some questions about contractual liability for transactions carried out on behalf of the business. In particular, suppose that a partner makes a transaction with a third party in the name of the partnership and incurs a debt that the partnership business is either unable or unwilling to pay. The creditor wants payment, but who in this situation is liable for the debt? The partner personally, the firm, or all the partners jointly?

The liability of partners for debts incurred by other partners is likely to be a regular examination topic.

Partners' liability for contractual obligations made by other partners

Each partner is an agent of the firm, and has actual or implied authority to bind the firm to legal agreements. All the partners in the firm are then liable under these agreements.

For activities in the normal course of the partnership business, a partner can bind the firm (and so make all the partners liable) unless:

- the partner did not have the actual authority, **and**
- the third party with whom the partner dealt knew that the partner did not have the authority (or did not know that he was a partner, or did not believe him to be a partner).

In these circumstances, the individual partner is bound by the agreement he has made, and is therefore liable under the contract, but the other partners are not liable. In many cases (probably in most cases), a partner will have the implied authority to enter into a transaction in the name of the partnership; therefore it is reasonable for the other party to assume that the partner does have the authority to incur the debt or obligation.

C

Case: Mercantile Credit v Garrod [1962]

P and G were in partnership in a garage business where the partnership agreement excluded the sale of cars as a business activity. G was a sleeping partner not involved in the day to day running of the business. A car which was not owned by the garage was sold to Mercantile Credit, who sued G for the recovery of the cost of the car (£700).

The court held that a partner in a garage business has the implied authority to sell a car; therefore Mercantile Credit had a right of legal action against the partners of the garage and did not have to claim against the buyer of the car. G (as a partner) was therefore liable to Mercantile Credit.

5.2 Joint liability of partners

When a partner binds the firm to a contractual obligation, all the partners become liable. Normally, this means that the liability must be settled by the partnership business. A problem arises, however, when either:

- one or more partners argue that the business should not be liable, and the partner who incurred the liability should be personally liable, or
- the partnership business is unable to pay the debt itself.

In either of these situations, both the creditor and the partners need to know who is responsible for the debt, and how the creditor should be able to recover the money owed, particularly if the partners and the partnership business refuse to pay.

Section 9 of the Partnership Act states that **partners are jointly liable with the other partners** for the debts of the partnership incurred while he is a partner. So, how should a partnership be sued?

When all the partners are liable under a contract, and the other party to the contract takes legal action for breach of contract, for example for non-payment of a debt, the other party can take legal action against:

- all the partners jointly (usually in the firm's name), or
- any individual partner.

A firm can be sued as a group of people in the firm's name. This is the most common procedure. All the partners who were partners at the time the liability was incurred will be jointly liable.

An alternative course of action is for the plaintiff to sue the individual partner with whom the contract was made and with whom there is 'privity of contract'. Suing a partner individually is an unusual course of action when all the partners in the firm are jointly liable. However, if an individual partner is sued when all the partners are liable, and if judgment is obtained against the individual partner, the partner can then claim indemnity from the firm as a whole, and so share the liability with the other partners. In other words, if one partner is required to pay a debt of the partnership business, he is able to claim repayment from the other partners of their share of the debt.

If judgment is obtained against the partners in the firm's name, it can be enforced against:

- the partnership assets, and
- the personal assets of all the partners who are liable.

Normally, any damages will be payable out of the partnership assets, but if these are insufficient the individual partners will then be (jointly) liable to pay out of their personal assets.

If the assets of the firm and the individual partners are insufficient to make the full payment, both the firm and the individual partners will be insolvent, and insolvency proceedings may be started.

Example

B, C and D are in partnership. Partner B purchases equipment for the partnership business. The equipment itself cost £20,000 and the installation costs were £15,000. There is a dispute with the supplier, and the firm refuses to pay the installation costs. The supplier decides to sue for the unpaid £15,000.

If the supplier succeeds in his action, all the partners will be liable jointly for the £15,000 liability.

If the dispute goes to court, the supplier can either:

- sue all three partners jointly, or
- he can sue any individual partner, B, C or D.

If he sues the partners jointly and wins damages, the payment of damages will be out of the partnership assets, provided that these are sufficient.

If he chooses to sue B personally, and succeeds with his claim, B will be required to pay the supplier. It will then be for B to obtain from his partners C and D their share of the liability.

5.3 Personal liability of the contracting partner

When a partner makes a business transaction with another party on behalf of the firm, he or she becomes personally liable to the other party. Personal liability exists because a partnership is not a legal entity, and there is 'privity of contract' between the individual partner making the transaction and the other party.

- If the firm is not bound by the transaction of the partner, the partner is personally liable to the other party.
- If the partner had actual authority and the firm is bound by the partner's action, the firm (as well as the individual partner) is liable for any debt or obligation arising.
- If the partner did not have actual authority, but had implied/apparent authority, so that the firm is bound by the partner's action, the firm is liable. However, in this situation, the partner acting without actual authority is liable to indemnify the other partners, or is liable to compensate them for any loss they incur as a result of the transaction.

Example

S, T and V are in partnership as property developers, buying, renovating and selling houses in Birmingham. Partner T borrows £75,000 from a bank, but uses the money to build an extension to his own private home in Stratford.

The other partners discover what T has done, and refuse to pay the bank interest or repay the bank loan.

What is the legal position?

Answer

S and V cannot deny the liability of the partnership for the bank loan. As a partner of the business, T has the implied authority to borrow money for the business, and the bank acted properly. The partnership owes the money to the bank, and all three partners are jointly liable for the debt.

However, T used the money improperly. He acted outside his actual authority, and he is in breach of his fiduciary duty to the other partners. S and V are entitled to claim back the money from T personally that the partnership owes to the bank. (Given the nature of T's action, S and V will probably also decide to dissolve the partnership, but T remains liable to them.)

5.4 Civil Liability (Contribution) Act 1978

When a creditor takes legal action against an individual partner for the recovery of a debt of the partnership, and as a result of this action receives part-settlement of the debt, the creditor can take further action against any of the other partners for payment of the remaining unpaid debt.

A provision in the Civil Liability (Contribution) Act 1978 is that: 'Judgment recovered against any person liable in respect of any debt or damage shall not be a bar to an action, or to the continuance of an action, against any other person who is … jointly liable with him in respect of the same debt or damage.'

The law therefore provides as much protection as it can for the creditor. The partners, jointly or individually, are together liable for unpaid debts of the partnership. When the creditor has been paid in full, it is then for the partners to sort out which of them now owes money to the other partners for their individual share of the debt.

5.5 An agreement between partners to limit the liability of a partner

A partnership agreement for an ordinary partnership can contain an agreement between the partners that the total liability of one of the partners should not exceed a certain amount. For example X, Y and Z might set up in partnership, each contributing £40,000 and sharing profits equally. Because Z is much less wealthy than either X or Y, they agree between themselves that the liability of Z, in the event of the partnership being dissolved, should not exceed his capital contribution of £40,000.

Suppose that the partnership is dissolved and the partnership assets are insufficient to pay the debts of the business by £150,000. Each partner would be required to pay £50,000 out of their personal assets to cover the unpaid debts of the businesses.

- Z would be jointly liable to the creditors of the business for the £150,000 that the partners must pay out of their personal assets.
- However, to the extent that Z is required to make a payment out of his personal assets, the agreement between the partners will then allow him to reclaim the money he has paid back from the other two partners.

5.6 Liability of persons 'holding out' to be a partner

A person who is not a partner in a firm might 'hold himself out' to be a partner, or might allow other people to hold him out to be a partner. Holding out occurs when:

- the person says that he is a partner in the firm
- the person states or indicates in writing that he is a partner
- the person acts in a way that seems to show that he is a partner
- the person knowingly allows someone else to represent him as a partner, by what they say, write or do.

When a person holds himself out to be a partner, he will be liable as though he were a partner to any third party giving credit to the firm 'on the faith of any such representation' (s14(1) PA1890).

Example

Lord Tonbury and several partners of the firm Barber & Riding attended a cocktail party where they got into discussion with Charles Penn, the managing director of a company that arranged corporate hospitality at major sporting events. They discuss the difficulty of obtaining tickets for the Wimbledon tennis championships in July. `

Lord Tonbury is not a partner of Barber & Riding. However, he told Charles Penn that, as a partner in Barber & Riding, he was particularly keen to invite some important clients to the Men's Final. Charles Penn is impressed by the partners in the firm, and in particular by the fact that a member of the House of Lords is one of their number.

Several days later, Charles Penn telephoned Barber & Penn and told the managing partner that he had obtained twelve tickets for Men's Finals day at Wimbledon, and that he hoped Lord Tonbury's clients would be appreciative. The senior partner thanked him, and gave him the address of the firm's head office to send the tickets and the invoice to.

Barber & Riding used the tickets and the associated hospitality. Charles Penn's company submitted an invoice for £8,000, which Barber & Riding did not pay.

Analysis

In this situation, the firm will be liable for the debt of £8,000. The managing director would have the apparent authority to agree to the transaction, and the firm also made use of the tickets.

In addition, Charles Penn's company could also sue Lord Tonbury, as well as the partners in the firm, on the grounds that:

- he had held himself out to be a partner, and
- Charles Penn had granted credit to the firm on the strength of the fact that he was a partner.

5.7 The liability of new partners

When a new partner comes into the partnership, he does not become liable, on joining, for liabilities of the firm that were incurred before he became a partner.

'A person who is admitted as a partner into an existing firm does not thereby become liable to the creditors of the firm for anything done before he became a partner.' (s17(1) PA1890).

5.8 The liability of retiring partners

A partner who retires from the partnership is still jointly liable for the debts of the partnership that were outstanding at the time of his retirement (unless the creditor has agreed to release him from his liability).

A partner who has retired is also jointly liable for debts of the partnership incurred after his retirement, if the creditor knew that he was a partner of the firm and had not been notified that the partner was now retired. It is therefore extremely important for a partner, on retirement, to notify all the suppliers and creditors of the firm about his retirement. The retiring partner should also advertise in the London Gazette which acts as a general notice to anybody who had not previously had contact with the partnership.

C

Case: Tower Cabinet v Ingram [1949]

C and I were in partnership trading as Merry's. The partnership was dissolved and C continued to trade alone. C ordered goods from Tower Cabinet on note paper showing I's name on it (without I's knowledge). Tower Cabinet was not paid and brought an action against I to recover the loss.

Held: Ingram was not liable as he had not knowingly held himself out as a partner and Tower Cabinet had not dealt with the business prior to I's retirement.

5.9 The liability of a 'sleeping partner'

A 'sleeping partner' is not recognised in UK law. However the term 'sleeping partner' is often used to describe an individual who invests capital in a partnership, as a partner, but has nothing to do with the running of the business. A sleeping partner leaves the running of the business to the other partners.

Sleeping partners in an ordinary partnership are liable in exactly the same way as 'active' partners. A sleeping partner has the same liability for the debts of the partnership as the other partners, and cannot claim non-involvement in the business operations as a reason for avoiding any such liability.

A sleeping partner therefore takes a huge risk, relying on the other parties to avoid excessive exposure to debts for which all the business partners may become personally liable if the business itself is unable to pay them.

The liability of a sleeping partner can be limited to the capital he has put into the firm, but only if the partner is made a limited partner in a **limited partnership** or if the partnership is a **limited liability partnership**.

Limited partnerships and limited liability partnerships are described later.

Dissolution of a partnership

- When a dissolution of a partnership occurs
- Sharing the partnership assets or liabilities on dissolution

6 Dissolution of a partnership

6.1 When a dissolution of a partnership occurs

A partnership is dissolved when:

- a partner leaves the partnership
- a new partner is admitted into the partnership
- the partners agree that the partnership should be dissolved, perhaps because it is losing money
- the partnership is for a fixed time or project and the time has expired or the project is completed
- a partner dies or is personally made bankrupt.

Example

V, W and X are in partnership. W decides to retire, and V and X decide to admit Y and Z to the partnership.

To the outside world, the business of the partnership may carry on unchanged. Legally, however,

- the V, W, X partnership is dissolved when W retires, and W is entitled to recover assets from the partnership business, including the capital he invested and
- A new partnership (V, X, Y , Z) is formed, with a new partnership agreement. Y and Z may be required, as a condition of the new partnership agreement, to invest capital in the business.

When a partnership is dissolved, any partner can insist that the assets of the partnership should be sold off ('realised'), and after payment of the firm's debts, the balance should be shared between the partners in the proportions stated in the partnership agreement.

In practice, when a partner leaves a partnership, but the partnership business continues, the partners will negotiate and agree arrangements for the departing partner to receive his share of the partnership capital and profits, without disrupting the business.

6.2 Sharing the partnership assets or liabilities on dissolution

When a partnership is dissolved, the assets of the partnership are used to pay off the liabilities of the firm.

- If the assets of the partnership exceed the liabilities, there is a surplus on dissolution, and this is shared out between the partners.
- If the assets of the partnership are less than its liabilities, the partners in an ordinary partnership are personally liable to contribute their own personal assets to help pay the liabilities in full.

Unless the partnership agreement makes different provisions, the rules on the distribution of assets on dissolution of an ordinary partnership are set out in section 44 of the Partnership Act 1890.

Sharing out the accounting losses of the business

Any losses should be paid:

- initially out of any profits
- next, out of capital and
- lastly, if necessary, by the partners individually **in the proportion in which they were entitled to share profits**.

Using the assets of the firm or partners to settle debts

The assets of the firm (the partnership assets, not the property owned personally by individual partners), and any personal assets that the partners are required to provide in addition, should be used in the following manner and order of priority:

1. First to **pay the debts** of the firm to persons who are **not partners**.
2. Next, to pay the debts of the firm to persons who are also partners (**partners' loans** to the partnership).
3. Next, to **repay the capital of each partner**. If the assets remaining after paying the debts of the firm are insufficient to repay the capital of the partners in full, they should be used to repay capital to each partner **pro rata to the amount of capital each partner put into the business**.
4. Finally, if there are still assets left over after the capital of each partner has been repaid in full (the 'ultimate residue') should be divided between the partners **in the proportion in which they were entitled to share profits**.

Example

When the partnership of B, C and D is dissolved, the partnership assets realised £600,000 and the liabilities of the partnership were £400,000. B and C had each contributed capital of £120,000 and D had contributed capital of £60,000 (= £300,000 in total).

The assets are sufficient to pay off the debts of the partnership in full, leaving a surplus of £200,000. The capital contributed by the partners totals £300,000. In the absence of any agreement to the contrary in the partnership agreement, the assets of £200,000 should be distributed to the partners in proportion to their capital contribution.

B will receive £200,000 × (120,000/300,000) = £80,000

C will also receive £80,000

D will receive £200,000 × (60,000/300,000) = £40,000.

Example

When the partnership of E, F and G is dissolved, the partnership assets realised £600,000 and the liabilities of the partnership were £150,000. E and F had each contributed capital of £120,000 and G had contributed capital of £60,000 (= £300,000 in total). The partners share profits equally.

The assets are sufficient to pay off the debts of the partnership in full, leaving a surplus of £450,000 (= £600,000 - £150,000). The capital contributed by the partners totals £300,000, so the assets are sufficient to repay the capital in full to the partners, leaving an ultimate residue of £150,000. In the absence of any agreement to the contrary in the partnership agreement, this £150,000 should be distributed to the partners in their profit-sharing ratio. Since the partners share profits equally, they should each receive £50,000 of the ultimate residue.

Example

When the partnership of H, J and K is dissolved, the partnership assets realised £600,000 and the liabilities of the partnership were £780,000. H and J had each contributed capital of £120,000 and G had contributed capital of £60,000 (= £300,000 in total). The partners share profits equally.

The partnership assets are insufficient to pay the debts of the firm in full. The partners are therefore personally liable for the shortfall of £180,000. They must contribute personal assets to meet the debts of the partnership, in proportion to their profit-sharing ratio. Each partner must therefore contribute £60,000 in personal assets so that the debts are paid in full.

Example

When the partnership of L, M and P is dissolved, the partnership assets realised £600,000 and the liabilities of the partnership were £400,000. These liabilities included a loan from L of £80,000. L and M had each contributed capital of £100,000 and P had contributed capital of £50,000 (= £250,000 in total). The partners share profits equally.

The assets of the partnership should be used first to pay creditor of the firm who are not partners (£320,000). Next, partners' loans should be repaid (£80,000 to L). This leaves £200,000 to distribute. The total capital contributed by the partners is £250,000, so the assets of £200,000 should be shared between the partners in proportion to their capital contribution.

Other types of partnership

- Limited partnership and the Limited Partnerships Act 1907
- Limited liability partnerships (LLPs)
- Main features of limited liability partnerships
- Regulations relating to LLPs

7 Other types of partnership

In addition to ordinary partnerships, there are other types of partnership. These are:

- limited partnerships and
- limited liability partnerships (LLPs).

7.1 Limited partnership and the Limited Partnerships Act 1907

An important feature of an ordinary partnership is that all the partners are liable for the debts of the partnership, to the full extent of their personal wealth. A limited partnership is different: one or more of the partners are given limited liability.

Limited partners are not liable for any debts of the partnership above the amount of their capital contribution to the partnership. (In this respect, limited partners have limited liability in the same way as shareholders in limited companies.)

A limited partnership may be established, but only if the following conditions are met.

- In the ordinary course of events, limited partners are not allowed to withdraw their capital from the partnership.
- One or more of the partners in the partnership must have unlimited liability for the debts of the firm. This means that although some partners are limited partners, **at least one of the partners cannot be a limited partner**.
- A **limited partner cannot take part in the management of the partnership business**.
- A limited partner cannot bind the partnership in any transaction (and so cannot be an 'agent' for the firm). If a limited partner breaches this rule, he loses his limited liability.
- The limited partnership must be **officially registered**.

Limited partnerships might be appropriate for a partnership in which one or more 'sleeping partners' provide capital for the business, but do not want to be involved in managing the business, and one or more 'active' partners, who may not be able to invest as much capital, do all the work of managing and running the business.

However, limited partnerships are relatively uncommon because a limited partner cannot be involved in running the partnership business.

7.2 Limited liability partnerships (LLPs)

Although its name is similar to a limited partnership, a limited liability partnership (LLP) is very different. LLPs were made a legal business form by the **Limited Liability Partnership Act 2000**.

The Act provided a general framework for establishing LLPs, but the detailed regulations applicable to LLPs are contained in the Limited Liability Partnership Regulations 2001 (which were introduced as secondary legislation).

The intention was to create a form of corporate body that combines the advantages of the corporate form of companies with the flexibility of a partnership. In many respects, an LLP is more similar to a company than to a standard partnership.

Some of the major professional firms in the UK, including major firms of accountants and auditors, have turned themselves into an LLP.

7.3 Main features of limited liability partnerships

The main features of an LLP are as follows.

- An LLP is a corporation (corporate body) It has a legal personality, separate from its individual partners. In this respect, LLPs are similar to limited companies and different from ordinary partnerships.
- LLPs must be incorporated in much the same way as a company.
- The **liability of all partners is limited** to their capital investment in the partnership. An LLP, like a company, therefore provides limited liability for its owners.
- Each member of the LLP is an agent and can bind the LLP.
- The business name of the LLP **must** end with the words Limited Liability Partnership or LLP.
- **For tax purposes** LLPs are treated as a partnership. In other words, the profits of the partnership are not taxed directly, unlike the profits of a company. The individual partners in an LLP are taxed personally on their share of the partnership profits, which is treated as one of their sources of taxable income.

Consequences of separate legal personality

Since an LLP has a separate legal existence (like a limited company) and is a 'legal person':

- It can own property in its own right.
- It can create 'floating charges' over its business assets. (Floating charges are explained in a later chapter. Briefly it is a method of giving security to a lender, which only companies and now LLPs are able to give.)
- It can enter into a contract in its own name, as a party to the contract.
- It can sue and be sued in its own name.

Because it has its own legal existence, it has 'perpetual succession'. This means that its existence is not affected by the retirement of existing partners or the introduction of new partners to the business.

Consequences of limited liability

A consequence of limited liability for the partners in an LLP is that each partner cannot be held liable for the debts of the LLP beyond the amount of capital they have been contributed. This greatly reduces the potential risk for each partner.

Suppose for example that on dissolution, an ordinary partnership has assets of £300,000 and debts of £500,000. The individual partners in the firm would be personally liable for the £200,000 of debts that cannot be paid out of the partnership assets. In contrast, if an LLP is dissolved with assets of £300,000 and debts of £500,000, there will be unpaid creditors of the business for £200,000. The partners will not be required to pay the unsettled debts of the partnership out of their personal assets. (The partners can agree, in the event of the LLP going into liquidation, to contribute to the liabilities of the LP and the costs of winding up, but this is not compulsory.)

7.4 Regulations relating to LLPs

Creation of an LLP and membership

To create an LLP, it must be registered with the Registrar of Companies. This registration must specify:

- the name of the partnership, which must end with the words Limited Liability Partnership or the letters LLP
- the registered office of the business
- the names and addresses of the persons who will be members of the LLP (partners) on incorporation. There must be **at least two designated members**, and there is no maximum limit on membership. Not all members have to be designated members.

In addition, a statement of compliance must be submitted, stating that all the necessary requirements for creation of the LLP have been complied with. This must be submitted by a solicitor or a subscriber to the incorporation document.

Membership of LLPs is not restricted to individuals. Other legal entities can be members of an LLP. This includes companies and other LLPs.

An LLP has a special type of member, known as a **designated member**. Designated members are responsible for ensuring that the LLP complies with its duty to file annual accounts with the Registrar of Companies.

Disclosure requirements

LLPs are required to disclose certain information to the public, by filing it with the Registrar of Companies. The filing requirements relate to:

- Annual accounts (which are audited and give a 'true and fair view')
- An annual 'return' containing specified information
- Details of changes in membership
- Details of changes in designated members
- Any change in the registered office of the LLP.

Relationship between members and the LLP

Every member of an LLP is an agent of the LLP, with power to bind the LLP to contracts with other parties within the scope of their actual, implied and apparent authority.

The LLP is liable to the same extent as an individual member for any wrongful act or omission by the individual member in relation to the business of the LLP.

Relationship between members in LLPs

The rights and duties of individual members should be governed by the partnership agreement between them. In the absence of a specific agreement, the Limited Liability Partnership Regulations apply default regulations, which are similar to those in the Partnership Act for ordinary partnerships.

Relationship between members and third parties

An LLP is a separate legal person; therefore when a member enters into a contract with another party, acting as an agent of the LLP, the contractual relationship is between the other party and the LLP. There is no contractual relationship between the other party and the individual member; therefore the individual member has no personal liability for breach of contract.

However, an individual member can be held liable for wrongful acts and omissions. When this happens, he also makes the LLP liable to the same extent.

Example

Kim, Len and Meg want to set up a partnership business. Kim and Len intend to put in permanent capital of £500,000 each and Meg will put in £100,000. Meg will take on a large part of the management responsibilities, but she does not have much personal wealth and she wants to limit her liability to the business to the £100,000 of capital she will contribute.

How might the partnership be established to meet the requirement of Meg for limited liability?

a

Answer

Since Meg will be involved in the management of the business, a limited partnership (with Meg as a limited partner and Kim and Len as unlimited partners) would be unsuitable. As a limited partner, Meg could not be involved in the management of the business.

They could establish a limited liability partnership. To do this they would need to incorporate the business by registering it with the Registrar of Companies. The partners could limit their liability to the amount of capital they contribute. However, as an LLP they would have to comply with the regulations relating to disclosure of information by filing annual returns etc with the Registrar of Companies.

Another possibility is that they should establish an ordinary partnership, and agree between themselves that the liability of Meg should be restricted to £100,000. The liability of Meg would be unlimited to third parties. However, in the event that the liability of Meg to third parties does exceed £100,000, the other parties would then be liable, under the terms of their agreement, to recompense Meg to the extent of the excess liability.

CHAPTER

8

Companies and legal personality

Contents

The features of a limited company

- Comparison of companies with other forms of business
- The meaning of separate legal personality ('doctrine of separate personality')
- Limited liability
- Separation of ownership from control
- Transfer of ownership and perpetual succession
- Loan capital
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- Public information about companies
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- The regulation of financial institutions: Financial Serivces and Markets Act 2000

1 The features of a limited company

Companies are an alternative form to sole trader businesses and partnerships as a form of business entity.

1.1 Comparison of companies with other forms of business

Companies differ significantly from other forms of business.

- A **sole trader** is an individual who owns and runs his or her own business. The law does not recognise the business: the law recognises only the individual who runs it. The individual is liable for the debts of the business and is also personally liable for any breaches of the law by the business.
- An ordinary **partnership** is a group of individuals who own and run their own business. Each partner contributes capital to the business. An ordinary partnership business is not recognised as a 'person' by the law. Individual partners are personally liable, jointly with the other partners, for the debts of the business.
- Most **companies** are companies limited by shares. The capital of a company is represented by shares, and the 'ordinary' shareholders are its owners. Company law refers to shareholders who are owners of the company as **members** of the company.
  - Companies are created by a process established by company law. A company must also have a written constitution. (Partnerships often have a constitution in the form of a partnership agreement, but this is not a legal requirement.)
  - Unlike sole traders and ordinary partnerships, a company is a legal person, separate from its owners. This is the **doctrine of corporate personality**. The law recognises a company as a person, with legal rights and obligations similar to those of ordinary individuals.

- Companies are managed by their directors, not their members (shareholders). In small companies, the shareholders and directors may be the same individuals, but in large companies, the directors might hold a small proportion of the shares or even no shares at all.
- Any legal person can own shares in a company. This includes other companies. It is very common in practice for some companies to own some or all of the shares of other companies.

Note: **Limited liability partnerships** have much in common with limited companies. This will be explained in more detail later.

1.2 The meaning of separate legal personality ('doctrine of separate personality')

It is important to understand what separate legal personality means. This may be referred to as the 'doctrine' of separate personality.

The law regards a company as a person, separate from its owners. For example, suppose that Mr X sets up a limited company X Limited with ten shares of £1 which he owns. Mr X the individual and X Limited, for the purpose of the law, would be two separate persons - both would have a separate legal existence.

A company is an 'artificial person', whereas individual people are 'natural persons'. Essentially, however, the law treats persons in the same way, whether they are artificial or natural.

- Because it is a person, a company can enter into contractual agreements with other persons – individuals or companies.
- If a company incurs a debt, the company itself is liable and its owners (the shareholders) are not.
- A company owns its own assets. Although the members (ordinary shareholders) own the company, they do not own the assets of the company. The shareholders are simply owners of the shares in the company. The company itself is the legal owner of its assets.
- If a company is owed money, the debtor owes the money to the company, and not to its owners.
- A company is personally liable to pay tax on its income (profits).
- If a company breaks the law, it is usually the company itself that is liable, although there are circumstances in which its owners or its 'officers' (mainly directors) may be personally liable.

Corporations

You might come across the term 'corporation'. In law, this is a corporate body with a separate legal existence. Both companies and limited liability partnerships (LLPs) are types of corporation.

The effects of separate legal personality

The separate legal personality of companies has several consequences:

- limited liability
- separation of ownership from control
- transfer of ownership and perpetual succession/perpetual existence.

1.3 Limited liability

The concept of limited liability applies to the owners (shareholders) of a company. The liability of the owners of a company for the debts of the company is limited to the amount of their investment in the company.

If a company is unable to pay its debts, it may be forced into liquidation. The assets of the company will then be used to pay some of its unpaid liabilities. However, the shareholders of the company will not be required personally to pay the remaining unpaid debts of the company. The shareholders will lose what they have invested, but will not be required to pay any more.

For example, if Mr X owns 100% of the share capital of X Limited, and X Limited goes into liquidation with assets of £2,000 (realisable value) and liabilities of £5,000, the company's creditors will be unpaid for £3,000 of the £5,000 they are owed, when the company is liquidated. There is no requirement on Mr X personally to pay the remaining £3,000 that the creditors are owed.

In this respect, limited companies are very different from ordinary partnerships. Limited liability applies to **all** limited companies.

- This is why private limited companies are required to include the word 'Limited' or the letters 'Ltd' in their name.
- It is also why public companies are required to include the words 'public limited company' or the letter 'plc' in their name.

The word 'limited' in the name of the company draws the fact of limited liability to the attention of anyone dealing with it.

There is an exception to this rule of no further liability, but only when the shares issued by a company have not yet been fully paid up. For example, suppose that a company has issued 1,000,000 shares with a face value ('nominal value') of £1 each, and £0.75 of the face value has been paid ('subscribed') by the shareholders. If the company goes into liquidation, the holders of the 1,000,000 shares will be liable to subscribe the remaining £0.25 per share, and this money can be used to help to pay the company's debts.

A few court cases illustrate the nature of the separate legal personality of companies, and its potential consequences. Perhaps the most well-known is the case of *Salomon v Salomon*.

C **Case: Salomon v Salomon & Co Limited [1897]**

Salomon was a leather merchant and maker of boots. He decided to form a limited liability company, Salomon & Co Limited to purchase the business. When the company was formed, Salomon and six members of his family each subscribed for one share each. The company then bought Salomon's business, and paid for it with 20,000 new shares, debentures of £10,000 and about £9,000 in cash. Salomon therefore held 20,001 of the company's 20,007 shares. As a holder of debentures, he was also a 'secured' creditor of the company.

The company was unsuccessful and after a year it was wound up and put into liquidation. The liquidator, representing the company's unpaid creditors, argued that the business still effectively belonged to Salomon, and Salomon personally should be liable for the unpaid debts. In addition, the liquidator argued that Salomon should not be a creditor of the company for the amount of the debenture debt.

The ruling in the case was that the business was owned by the company and the debts were liabilities of the company. Salomon as an individual was under no further liability to the company or its creditors, and he was a secured creditor of the company owed £10,000 for the debenture debt. (As a secured creditor, he was entitled to payment from the company's assets in the liquidation before any payment could be made to the company's unsecured creditors.)

C **Case: Macaura v Northern Life Assurance Company [1925]**

M owned land and he sold the timber on his land to a company. He owned 100% of the company. Before selling the timber to the company, he insured the timber on his land with Northern Assurance. After selling the timber, he did not transfer the insurance policy to the company's name. A few days later, a fire on the land destroyed most of the timber. M made a claim under the insurance policy, but the insurance company refused to pay it, on the grounds that the timber belonged to the company, not to him.

Held: M did not have an insurable interest in the timber as it belonged to the company, and he could not therefore make a claim. He was entitled to the refund of his insurance premium, because he did not own any timber to insure. The company would have been able to claim, but it did not have any insurance.
This case is important as it confirmed that the owner of shares in a company is a different legal person from the company.

C **Case: Lee v Lee's Air Farming Ltd [1960]**

L held all but one of the shares in a company involved in crop spraying in New Zealand, and his wife held the other share. He was also the sole 'governing director' of the company, as well as its chief pilot. He was killed in an air crash whilst flying for the company. His wife sued the company for compensation: if the wife's claim was valid, the company would be able to reclaim the money under a government insurance scheme. The argument against the wife's claim was that L, as owner and sole governing director, had taken the decision to employ himself as pilot, and a claim could not therefore be made as if L were an employee of his company.

It was held that L's contract of employment with the company was valid, and his wife could therefore claim against the company on the basis that he was killed as an employee acting in the service of the company.

The liability of a company itself and its directors

Limited liability applies to the shareholders of a company. It does not apply to the company itself. A company is fully liable for all its debts and other liabilities, just as any other person is fully liable for the debts that he or she incurs.

The directors and other officers of a company act on behalf of the company, and provided that they act within their powers and in accordance with the law, they will not be personally liable for debts of the company. However, the concept of limited liability does not apply to them.

1.4 Separation of ownership from control

In company law, a company is run by its directors. In many small companies, the main shareholders also run the business (as directors). A Single Member company is likely to be a company that is managed by its sole shareholder. However, since companies are a separate legal person, there is no requirement that it must be run by its owners.

A company's shareholders can give the power to run the company to 'professional' directors, and the directors need not be shareholders. The powers of the directors are set out in the company's written constitution. The shareholders have the right to appoint or re-appoint directors, or to remove them from office. However, the power to run the company, within the terms of the written constitution, belongs to the directors.

In large companies, it is common to have several hundred, if not thousands, of shareholders. Some of the directors of the company may also be shareholders, but may own only a small proportion of the total number of shares in issue. The directors exercise their powers to run the company as directors, not as shareholders.

The ownership of companies (by the ordinary shareholders or members of the company) is therefore separated from the control (by the directors).

1.5 Transfer of ownership and perpetual succession

Another feature of the separate legal personality of a company is that its shareholders can transfer their share in the ownership of the company to someone else, but this change of ownership does not affect the company in any way. (The same applies to a limited liability partnership, but not to ordinary partnerships.)

- Shareholders can transfer some or all of their shares to another person (who may be a natural person or an artificial person). The most common methods of share transfer are sale, gift and inheritance. Shares can also be transferred by putting them into trust.

- When shares are transferred, the rights associated with the shares, such as the right to receive a portion of any dividend paid by the company or the right to attend and vote at general meetings of the company, are transferred to the new owner.
- However, the transfer of shares does not affect the legal status or legal existence of the company. The company continues to exist and its existence is unaffected by the change in share ownership.

In practice, it is common for shares to be transferred many times during the life of a company. Some companies have been in existence for many years, during which time its ownership has changed many times. The company has continued, even when its owners have changed. This phenomenon is called '**perpetual succession**' or '**perpetual existence**'.

1.6 Loan capital

Another feature of the company form compared with sole traders and partnerships is that, if they wish to do so, companies may raise loan capital by issuing:

- loan stock, or
- debentures.

These are particular forms of loan capital that will be explained in more detail in a later chapter.

In addition, companies are able to give security to a lender by providing a **floating charge** over their business and assets. Charges are also explained in a later chapter. Here, where the company form is being compared with other types of business, it is sufficient to note that only corporations (companies and LLPs) can give a floating charge over their assets as security for a loan: ordinary partnerships and sole traders cannot.

1.7 Capital maintenance

Another aspect of separate legal personality for companies is the need to provide some protection to their creditors.

Suppose that a company with 100,000 shares of £1 each in issue borrows £50,000 from a bank. What is to stop the company from paying out the £50,000 to its shareholders, and then going into liquidation because it is unable to repay the loan? If the company is a separate legal person, the bank can only claim repayment from the company itself, not its shareholders, even though the shareholders have obtained benefits of £50,000 that the company could not properly afford.

To some extent, people who lend or give credit to a company need to be careful about how much credit they allow. Before lending or giving credit, they might be well advised to carry out a check on the company, to satisfy themselves that the risk is not too great.

In addition, company law provides some protection to creditors of companies, against extreme bad behaviour, in the form of the doctrine of capital maintenance. Companies are not allowed to reduce their shareholders' capital below a minimum level specified by law, and they cannot make payments to their shareholders if this would result in the company's capital falling below the minimum amount.

In the example above, for example, the company would be unable to make the payment of £50,000 to its shareholders if this would reduce its capital below the minimum level.

The minimum amount of capital that a company must maintain depends on the capital structure of the company. The doctrine of capital maintenance is explained in more detail in a later chapter.

1.8 Public information about companies

Companies are subject to extensive regulation. One aspect of company regulation is that, compared with sole traders and partnerships, companies are required to make much more information available to the public. Much of this regulatory information is filed with the Registrar of Companies.

Examples of the information that has to be filed and made available for public inspection include:

- details of the company's name, registered office and directors
- the names of its major shareholders
- its annual report and accounts.

When a business is incorporated (becomes a company), its owners need to recognise that rules on publicity/disclosure will be much more extensive. This is a disadvantage of becoming a company, compared with being a sole trader or partnership business.

1.9 The statutory regulation of companies: Companies Act 2006

Companies are subject to extensive regulation by statute and secondary legislation. The main legislation relating to companies is the Companies Act 2006, which has replaced the previous company legislation in the Companies Act 1985. Some of the requirements of the Companies Act 2006 were new; others continued requirements that were previously contained in the Companies Act 1985.

References in this text to CA2006 are to the Companies Act 2006. References to 's' followed by a number are to a section number in the Act; for example s171 means section 171 of the Act and ss 171 – 177 means sections 171- 177 of the Act.

1.10 The regulation of financial institutions: Financial Services and Markets Act 2000

All companies are subject to regulation by the Companies Act. Companies that are also financial institutions, including banks and insurance companies, are also subject to extensive regulation under the provisions of the Financial Services and Markets Act 2000 (FSMA 2000).

The FSMA established a regulator for the financial markets and institutions operating in those markets. This is the Financial Services Authority or FSA. The main roles of the FSA are to:

- maintain confidence in the UK financial system, by monitoring and regulating financial markets and institutions
- protect the consumer against unfair practices by financial institutions
- reduce financial crime, by helping to combat fraud, insider dealing, money laundering and other criminal conduct by financial institutions and in financial markets.

Financial institutions are not allowed to operate in the financial markets unless they are authorised. UK-registered financial institutions must be authorised by the FSA.

Other responsibilities of the FSA include:

- establishing and enforcing rules for the conduct of business in financial markets and by financial institutions
- monitoring the financial stability of financial institutions: this includes ensuring that banks and other financial institutions maintain an adequate amount of capital
- taking action against banks and other financial institutions that are in breach of the rules.

A detailed knowledge of the FSMA 200 is not required for your examination.

Types of company

- Companies limited by shares, companies limited by guarantee and unlimited companies
- Private companies and public companies
- Quoted companies and listed companies
- Parent companies and subsidiary companies

2 Types of company

2.1 Companies limited by shares, companies limited by guarantee and unlimited companies

Limited liability may be in the form of a company limited by shares or a company limited by guarantee.

- With a **company limited by shares**, the limited liability of its owners is restricted, in law, to the face value of the shares they own. This is the limited liability described above.
- With a **company limited by guarantee**, its owners do not have shares. Their share of the ownership of the company is recognised, and they are 'members' of the company. Their liability to the company is limited to an amount that the member guarantees to contribute in the event that the company goes into liquidation.

It is possible to register an **unlimited company**. This has all the advantages of a normal company except that the liability of its members is not limited. Such companies do not have to file their accounts, are free to purchase their own shares and have special articles of association. In practice unlimited companies are fairly rare but are sometimes used by a 'partnership style' business.

Businesses that incorporate as companies are companies limited by shares. The great advantage of this form of company is that the company is able, if the shareholders approve, to raise additional capital by issuing new shares. (Companies limited by guarantee are not able to raise capital in this way. A company limited by guarantee is a form often used by charities, trade associations and private members' sports clubs (where the club is owned by the members).

The rest of this text on company law will concentrate on companies limited by shares.

2.2 Private companies and public companies

When it is formed, a company must register as either a private company or a public company.

A **private company** is a company in which the ability to issue and transfer shares is restricted.

- A private company may not issue its shares to the public.
- Shares in a private company cannot be offered for sale and transferred in a public market, such as a stock exchange.

Most companies whose shares are not traded on a stock market are private companies. A private company is defined by what it is not: **a private company is a company that is not a public company**.

(***Note***: The Companies Act 2006 allows private companies to offer shares to the general public, but only if they are in the process of re-registering as a public company.)

Private companies

Private companies may issue shares privately, to anyone willing to subscribe for them. Similarly, shareholders in private companies may transfer some or all of their shares to another person in a private transaction (for example by selling them privately).

Private companies are subject to many aspects of company law, but they are less regulated than public companies. A private company can have any number of members (ordinary shareholders). The minimum number of members required is just one.

Private companies may choose to become public companies. However, to become a public company, a private company must go through the required regulatory procedures to re-register as a public company, and it must also meet the minimum requirements for being a public company.

Public companies

A public company is a company whose constitution states that it is a public company and that has complied with the regulatory requirements for registering as a public company. Public companies must have at least two directors, but one person acting alone can form any type of company, either a public company or a private company. Both public companies and private companies may therefore have as few as one shareholder or 'member'.

A new company may be formed as a public company. Alternatively, a private company may re-register as a public company.

Key differences between a public and a private company are as follows:

- As stated earlier, **a public company may offer its shares to the public** and the public may subscribe for shares in a public company.
- **Shares in a public company can be traded on a public market**, such as a stock market.

All companies whose shares are traded on a stock market are public companies. However, a company may be a public company without having to offer its shares to the public or allow them to be traded on a stock market.

The owners of a public company can decide to 'take it private' and re-register it as a private company. However, by doing this, they will be obliged to comply with the rules for private companies, and its shares can no longer be offered to the public or traded on a stock market.

Conditions for becoming a public company

To be registered as a public company, a company must meet certain conditions about share capital and ownership that differ from those for private companies. Some of the detailed regulations are as follows:

- A public company must have a minimum authorised share capital of £50,000. There is no minimum requirement for private companies (sections 761 and 763 CA2006).
- As stated earlier, there may be 'Single Member Companies' with just one shareholder, and these may be either a public or a private company.
- A public company must have at least two directors, whereas a private company is required to have at least one director.
- A public company must identify itself as a public company. This means that the name of the company must include the words 'public limited company' or the letters 'plc'.
- A public company must receive a trading certificate before it is permitted to trade (section 761 CA2006). A public company will not be given a trading certificate until it can show that it has at least the authorised minimum share capital for a public company.
- Public companies are generally subject to stricter regulation than private companies. These cover many areas of law including capital maintenance, disclosure requirements and allowable dividend payments.

Comparison of the public and private companies

The main differences between public companies and private companies are set out in the table below.

	Public company	**Private company**
Sale of shares	Shares can be offered for sale to the general public. Shares can be traded on a public stock market.	Shares cannot be offered for sale to the public or sold on a stock exchange. Shares may be sold or transferred, but only in private transactions.

	Public company	Private company
Name	A public company's name must end with the letters 'plc' or the words 'public limited company'.	The name of a private company must end with the word 'Limited' or the letters 'Ltd'.
	(Note: Welsh language equivalents are also allowed.)	
Minimum number of members (ordinary shareholders)	Two under CA1985.	One
Minimum authorised share capital	£50,000	-
Trading certificate	Must have a trading certificate as well as a certificate of incorporation in order to commence trading.	Requires only a certificate of incorporation in order to commence trading.

The statutory regulations relating to the administration of public companies and private companies differ in some respects. Some of the more important differences will be described in later chapters.

2.3 Quoted companies and listed companies

A public company whose shares are quoted by dealers on a stock exchange are called **quoted companies**.

A **listed company** is a special type of quoted company. A listed company is a public company whose shares have been:

- admitted to an official list of shares, and
- accepted for trading on the country's main stock market.

A UK listed company is a company whose shares have been admitted to the Official List (which is managed by the Financial Services Authority, which is the UK regulatory body for financial services and markets) and accepted by the London Stock Exchange for trading on its main market.

Listed companies are therefore the main stock market companies. They are subject to even stricter regulation than other public companies, in matters where some additional protection for the investing public is considered appropriate. Quoted companies include companies whose shares are quoted and traded on a stock exchange, but which are not on the Official List: these include companies whose shares are traded on the Alternative Investment Market (AIM).

2.4 Parent companies and subsidiary companies

Companies, as legal persons, may own shares in other companies.

- A **parent company** is a company that owns shares in another company, and exercises control over that company. The law defines 'control', but control is generally considered to exist when one company owns more than 50% of the voting shares in another company.
- A **subsidiary company** is a company that is controlled by another company. Again, a company is usually considered to be a subsidiary of another if the other company owns more than 50% of its voting shares.

A parent company may have many subsidiary companies. Some parent companies may themselves be a subsidiary of another company.
A parent company and its subsidiaries (and sub-subsidiaries etcetera) is a **group of companies**. In company law, some special rules apply to groups. For example, parent companies are required to prepare consolidated financial accounts for the group as a whole.

However, it is important to recognise that each company in a group is a separate legal person. If someone lends money or gives credit to a subsidiary company in a group, the subsidiary has the legal liability to pay the debt, but the parent company does not, nor do other subsidiaries in the group. A subsidiary in a group can be put into liquidation for inability to pay its debts, but the other companies in the group will be unaffected – unless they have accepted liability for the debts of the subsidiary, for example by providing the lender with a guarantee.

At one time, it was considered that in some circumstances, the court might treat a parent company and a subsidiary as if they were parts of the same legal entity. However, recent court decisions suggest that the courts will recognise the separate legal personalities of parent companies and their subsidiaries.

C

Case: Firestone Tyre & Rubber Co Ltd v Lewellin [1957]

This case raised the possibility that the courts would 'lift the veil of incorporation' on subsidiary companies, to pass judgment against a parent company.

A US company obtained orders from customers in Europe, and arranged for the goods to be manufactured by a subsidiary in the UK and shipped directly to the customers. The customers paid the US parent company direct. To avoid UK tax on its profits, the US company paid its UK subsidiary the cost of the goods sold costs plus 5%, retaining the rest of the profits itself. In this way it intended to avoid tax on profits in the UK.

The court decided that the UK subsidiary acted as agent for the US parent company, and the US parent was therefore liable to UK tax on the profits made on the transaction.

C

Case: Adams v Cape Industries plc [1990]

This case, and judgments in other cases, has since cast doubt on the validity of the judgment in the Firestone Tyre case.

Cape Industries was a UK company that had a large number of wholly-owned subsidiaries. Some of these mined asbestos in South Africa. Others marketed the asbestos in other countries, including the US. A large number of plaintiffs had been awarded damages by a Texas court for personal injuries suffered as a result of exposure to asbestos dust. One of the defendants in these US actions was NAAC, a wholly-owned US subsidiary of Cape.

The case involved an attempt in the UK courts to make the parent company Cape liable for judgment debts against NAAC, its subsidiary, either on the basis that Cape had been 'present' in the US through its local subsidiaries or because it had carried on business in the US through the agency of NAAC.
The court held however that judgment should not be enforced against an English holding company (Cape Industries), and it refused to 'lift the veil of incorporation' (and make the shareholder of the subsidiary company liable for the debts of the company).

The judge in the case commented that English law 'for better or worse recognises the creation of subsidiary companies … which would fall to be treated as separate legal entities, with all the rights and liabilities which would normally be attached to separate legal entities.'

Whether desirable or not, English law allowed a group structure to be used so that legal liability falls on an individual company in the group rather than on the group as a whole. There is no general rule that the commercial activities of a subsidiary are to be treated as the acts of the holding company merely because there is a relationship between them. The Court of Appeal in this case stated specifically that it could not ignore the Salomon principle 'merely because it considers that justice so requires'.

The court held that there were various indicators that NAAC was carrying on business on its own, leasing premises, carrying on various activities on its own account, making profits and paying taxes. In addition, NAAC's debtors were its own, not those of the holding company Cape Industries. The judgment in Cape Industries has therefore restricted the extent to which the judgment in the Firestone Tyre & Rubber case applies.

The Cape Industries case has reinforced the basic principles of Salomon that a company is a distinct legal entity. Any identification by a court of a group as being a single commercial entity is therefore likely to be exceptional.

Advantages and disadvantages of incorporation: the veil of incorporation

- Comparison of private limited companies and partnerships
- Advantages and disadvantages of incorporation
- The veil of incorporation
- Lifting the veil of incorporation

3 Advantages and disadvantages of incorporation: the veil of incorporation

3.1 Comparison of private limited companies and partnerships

In order to understand the advantages and disadvantages of incorporation as a company, it is important to understand the main differences between a company and the alternative business forms. The table below compares the main differences between a private company and an ordinary partnership, although a similar comparison could be made between private company and the business of a sole trader.

The limited liability partnership is another alternative business form, and in many respects the LLP is similar to a limited company. Comparisons with LLPs are also included in the table.

	Ordinary partnership	**Private company or LLP**
Liability	The liability of partners to other parties is unlimited.	The liability of the owners (shareholders or LLP partners) is limited to their capital contribution.
Legal personality	Does not have a separate legal personality. Cannot sue or be sued as a legal person. Cannot own business assets as a legal person.	Has a separate legal personality. Can sue or be sued as a legal person. Can own business assets as a legal person.
Liabilities	Liabilities of the partnership are owed by the partners jointly.	Liabilities are owed by the company or LLP, not by the owners (shareholders or partners).
Ability to borrow	Can borrow (for example, from a bank) but cannot borrow by issuing debentures or loan stock.	Companies can borrow (if they wish to do so) by issuing debentures or loan stock.

	Ordinary partnership	Private company or LLP
Giving security for loans	Cannot give security in the form of a floating charge.	Companies and LLPs can give security in the form of a floating charge.
Capacity of the owners	Partners have the capacity to bind the partnership (other partners).	LLP partners have the capacity to bind the partnership. Shareholders do not have the capacity to bind the company: separation of ownership and control.
Tax	Partners are assessed personally for income tax on their share of the partnership profits.	Partners of LLPs are assessed personally for income tax on their share of the partnership profits. Companies, not shareholders, are assessed for tax on the profits of the company. However, shareholders are liable for tax on dividend income received.
Formality and regulation	Flexible form of business entity. Partnership can be formed without even a written agreement.	Subject to more regulation, including a requirement for formal incorporation and a requirement to submit returns to the Registrar of Companies.

3.2 Advantages and disadvantages of incorporation

Companies take various forms, and membership can range from one to thousands of shareholders. Although companies differ in size and constitution, there are some advantages and disadvantages of becoming a company, compared with being a sole trader or partnership business. These apply to most types of company.

Advantages

Most of the advantages of incorporation of a business have been described.

- **Limited liability**. Shareholders in a company have limited liability, and usually have no liability for the debts of their company (above their investment in the company). Limited liability does not apply to sole traders or partnerships, except limited liability partnerships.
- **Permanent succession**. A company remains in existence even when its ownership changes. Shareholders can transfer their shares without affecting the company. This makes it much easier to invest in a business.

- **Ownership of assets**. A company is the legal owner of its assets, not the shareholders. This means that when the ownership of a company changes (and shares are transferred), the company's ownership of its assets is unaffected.
- **Ability to make contracts**. A company is able to enter into contracts with other persons in its own name. The company itself is then liable for carrying out its obligations under the terms of the contract. The owners and directors do not have personal liability for contracts made by the company.
- **Separation of ownership and control**. It is much easier to invest in a company than in other forms of business without having to be involved in the management of the business. Companies (particularly public companies) are therefore an ideal form of business for many investors.
- **Wide ownership and raising new finance**. Companies, particularly public companies, can have a large number of shareholders. Wide share ownership can make it much easier for companies to raise new capital for investment and growth of the business.
- **Floating charge**. A point that has not been made previously, that will be explained in more detail in a later chapter, is that a company is able to give security to a lender in the form of a floating charge. Other forms of business cannot do this. A floating charge, by giving security to a lender, can make it easier for a company to borrow.

Disadvantages

There are some disadvantages to incorporation: these are mainly lack of privacy, regulations and 'red tape', and costs of compliance with the regulations.

- **Publicity**. Companies must make much more information available that can be accessed by the public, such as their annual report and accounts. Public companies must make more information available than private companies.
- **Regulation and compliance**. Companies are subject to many more regulations than other forms of business. The cost of compliance with the regulations can be very high.
- **Audit**. Companies, unless they are 'dormant' and inactive, are usually required to appoint auditors to carry out an audit of their annual financial statements.

3.3 The veil of incorporation

Since a company has a separate legal personality, the law does not need to know the identity of its owners. Similarly, when a person enters a transaction with a company, it is dealing with the company and does not need to know the identity of its owners.

The owners of a company are therefore 'hidden from the view' of the people who deal with the company. If a legal dispute arises, they must deal with the company, not its owners or directors, who do not have personal liability.

The fact that the owners of a company are 'screened from view' in this way is sometimes called the '**veil of incorporation**'.

3.4 Lifting the veil of incorporation

In some exceptional circumstances, the law does not treat a company as a separate person from its shareholders and directors. For example, it may treat the company and its shareholders as being the same, so that the shareholders have unlimited liability for the debts of the company. In other situations, a company might commit an offence, and the director who is personally responsible might be made liable, rather than the company.

When these exceptions arise and a company and its shareholders are treated as the same, we can say that 'the veil of incorporation is lifted'.

There are several circumstances in which the veil of incorporation may be lifted. Most of these relate to fraudulent misuse of the company form and wrongful trading. When the veil of incorporation is lifted, the shareholders may become personally liable for the debts incurred by the company. (The possibility of lifting the veil of incorporation in the case of subsidiary companies, to make a parent company liable, has been explained earlier.)

Situations where **statute law** allows the veil of incorporation to be lifted are as follows.

- When a public company trades **without having obtained a trading certificate**. Public companies are not permitted to commence trade until they have received a trading certificate from the Registrar of Companies. If the company trades before the issue of the certificate, then the directors are personally liable for any debts of the company.
- When the company is **trading wrongfully**. If a company is wound up as insolvent and the directors should have known that there was no possibility of the company being wound up without being insolvent then the courts may declare that those directors are personally liable for the debts of the company incurred whilst it was trading 'wrongfully'.
- When the company is **trading fraudulently**. If a court finds that a company has been carried on with intent to defraud shareholders, directors and employees who were knowingly party to the fraud themselves may be held liable for any liabilities that the company incurs. The liability is not restricted to the company itself.

There are also a number of situations in **case law (common law)** where the courts have drawn aside the veil of incorporation:

- Where the company is being used as a 'sham' to allow an individual to avoid a legal responsibility
- In the case of companies owned by the 'enemy' in time of war.

C

Case: Gilford Motor Co Limited v Horne [1933]

Horne was a former employee of Gilford Motor Co Ltd. His service contract with the company included a clause that he should not solicit business from customers of the company after leaving the company's service. To get round this restriction, Horne set up a company in which his wife and an employee were the shareholders and directors. He used this company to solicit business from customers of Gilford Motor Co Ltd. Gilford Motor brought the case to court.

Held: The company created by Horne was a 'device, a stratagem… a mere cloak or sham'. The veil of incorporation was lifted and Horne was identified as being the same as the company. The court rules that Horne must comply with his agreement and must not use the new company to solicit business from Gilford Motor's customers.

C

Case: Daimler v Continental Tyre and Rubber Co GB [1916]

The defendant was a UK company that refused to pay a debt to a UK-incorporated company during World War I on the grounds that the company was largely owned by Germans and to pay the debt would be trading with the enemy.

Held: The debt did not need to be paid as the claimant company was effectively in enemy hands.

CHAPTER

9

Company formation and constitution

Contents

Promotion and pre-incorporation contracts

- Promotion of a company
- Promoter of a new company
- Duties of a promoter
- Pre-incorporation contracts
- Avoiding liability for pre-incorporation contracts

1 Promotion and pre-incorporation contracts

This chapter deals with how companies are formed and their constitutional documents. It also describes the statutory books and records that companies must keep, and considers the rules on company names.

1.1 Promotion of a company

The **promotion** of a company involves taking the actions that are necessary to:

- incorporate the company, by having it registered
- ensure that it has share capital (and possibly loan capital)
- acquire assets for the company that the company is being formed to own and control.

1.2 Promoter of a new company

A person who promotes a company is a promoter. However, there is no specific legal definition of a promoter, and deciding whether a person is a promoter is a question of fact rather than law.

In the UK, the following definitions of 'promoter' have been given by judges.

- 'One 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.'
- 'The term "promoter" is a term not of law, but of business, usefully summing up in a single word a number of business operations familiar to the commercial world by which a company is generally brought into existence.'

A promoter is therefore someone who is involved in setting up a company, and who is in a controlling position and able to make decisions relating to the company. In many cases, a promoter will go on to become one of the first directors of the new company. If there is any legal dispute, the court will decide on the facts of the case whether or not an individual should be considered a promoter of a company.

Examples of the activities that a promoter might be involved in are:

- authorising a firm of solicitors to prepare a draft of the company's constitutional documents or to prepare other legal documents
- nominating directors, bankers, solicitors and other agents for the company
- arranging for shares in the new company to be placed with subscribers
- purchasing assets for the proposed company or acquiring premises for the company before its incorporation.

A person is not a promoter of a company simply because he or she provides professional advice relating to the company formation. This means for example that solicitors and accountants who are used by a promoter are not themselves promoters of the company. However, the clients of solicitors or accountants involved in a company formation are likely to be promoters of the company.

1.3 Duties of a promoter

The duties of a promoter may vary between countries. In the UK, a promoter has a 'fiduciary duty' to the company he is forming. This means that he cannot make a **profit** out of his promotion activities unless:

- he discloses his interest in any transaction from which a profit has arisen, and
- he is permitted to take the personal profit if approved.

The promoter must declare his profit to either an independent board of directors (after the company has been formed) or to the existing or prospective shareholders. If a promoter fails to disclose a profit, or if he discloses the profit but is not allowed to keep it, he becomes liable to surrender the profit to the company.

C

Case: Gluckstein v Barnes [1900]

A promoter disclosed a profit that he was making on the sale of assets to the company but failed to disclose a secret profit that he had made on the issue of debentures to him at a discount. Held: The profits on the debentures should have been disclosed and represented a secret profit that should be returned to the company (in this case to the liquidator of the company).

C

Case: Erlanger v New Sombrero Phosphate Co [1878]

A likely situation where a profit may arise is when the promoter sells his own property or assets to the company in a pre-incorporation contract.

In this case E acquired on his own account the lease on a phosphate mine in the West Indies for £55,000. He then sold the mining rights to a newly-formed company for £110,000. E was a promoter of the company, and the directors that he had appointed to the board approved the personal profit he had made. However, the shares on the new company were offered for sale to the general public and the secret profit of E was not disclosed.

The original board was then replaced by a new board of directors. When they found out about E's transaction, they sued to have the contract for the mining rights rescinded. The court agreed. E had not declared the profit to an independent board of directors; therefore as promoter of the company, he could not be allowed to profit personally from a transaction involving the company if its board of directors does not give its consent.

A promoter will probably incur **pre-incorporation expenses** in setting up the company. He does not have an automatic right to recover these expenses from the company after it has been formed. However, he should usually be able to obtain agreement from the first directors of the company (and the promoter may be one of these himself) for the company to refund the expenses incurred by the promoter or pay the promoter's creditors for expenses incurred.

1.4 Pre-incorporation contracts

A pre-incorporation contract is a contract:

- made by a promoter of a new company
- naming the company as a party to the contract
- before the date of the certificate of incorporation, and so before the company actually exists as a separate legal person.

The legal problem with pre-incorporation contracts is that a company cannot be a party to a contract before it comes into existence. If this is so, a company cannot be bound by the terms of a pre-incorporation contract, even if it has been named as a party to the contract.

C

Case: Kelner v Baxter [1866]

This case has already been described in the chapter on agency.

Prior to the incorporation of a new company, a promoter entered into contracts for the supply of goods in the company's name. The company collapsed shortly after incorporation and the supplier brought an action against the company.

Held: The company could not be liable for debts entered into prior to its existence. The promoter was personally liable for the debt.

Since a company cannot be bound by a pre-incorporation contract, the legal position is that the person who contracts on behalf of a new company in a pre-incorporation contract is treated as if he has made the contract on his own behalf.

The Companies Act (s 51 CA2006) states that, subject to any agreement to the contrary, when a pre-incorporation contract is made on behalf of a company, it is treated as having been made with the person claiming to act for the company or as its agent (the promoter), and this person is personally liable for the contract.

Pre-incorporation contract containing a 'condition precedent'

A '**condition precedent**' is a condition that must be fulfilled before the terms of a contract are applied.

If a promoter enters into a pre-incorporation contract, he might arrange for the contract to include a condition precedent that the contract should be '**subject to adoption**' by the company after it has been formed. This means that the promoter and the other party agree the terms of a contract, but for the obligations under the terms of the contract to become effective:

- the (named) new company must be formed, and
- the company must take over the obligations of the promoter by 'adopting' the contract.

There is a disadvantage for the other party with this type of condition in a pre-incorporation contract. The new company is not obliged to adopt the contract. This means that it is free to decide whether or not to agree to the contract, after it has been formed. The other party therefore will not know whether there is a contract until this happens.

Pre-incorporation contracts: the legal position summarised

The legal position relating to pre-incorporation contracts can be summarised as follows.

- When a new company is formed, it cannot be bound by a pre-incorporation contract, even if it obtains some benefit from the contract.
- A new company cannot sue the other party to a pre-incorporation contract for failing to comply with the obligations under the contract. This is because the company itself is not a party to the contract.
- Unless the agreement has been made specifically to the contrary, a pre-incorporation contract is treated as a contract made between the promoter of the company (or other agent) and the other party (s51 CA2006).
- A company cannot ratify a pre-incorporation contract, even after it has been formed.
- However, a pre-incorporation contract might include a condition precedent (if the other party agrees) that the contract should be subject to adoption by the new company after its formation. The contract then does not create obligations for either party until the new company is formed, and then only if the new company agrees to adopt it.

Case: Phonogram Ltd v Lane [1981]

Some pop musicians decided to form a new group with the name of Cheap, Mean and Nasty. It was decided to form a new company, Fragile Management Limited ('Fragile') to run the group.

Before Fragile was formed, negotiations took place between Phonogram Ltd (a music company) and Lane, who was acting on behalf of Fragile. Phonogram Ltd agreed to pay £12,000 for the group's first album, and made an initial payment of £6,000. It went into the bank account of a company of which Lane was a director. Fragile was never formed. The new group did not perform under the terms of the agreement, but the £6,000 was not repaid.

Phonogram sued Lane for repayment of the money. The court's eventual decision was as follows.

- Fragile could not be liable to repay the money because it never existed.
- Lane had signed a contract (a letter) with Phonogram 'for and on behalf of Fragile Management Ltd'. However, this made no difference to his personal liability. He would be personally liable even if these words had not been in the agreement.
- The agreement did not make any specific exclusion of Lane's personal liability.
- Lane was therefore personally liable for the money paid by Phonogram, and was obliged to pay back the money.

1.5 Avoiding liability for pre-incorporation contracts

Since promoters and other agents are personally liable for pre-incorporation contracts, a question that arises is: What can promoters do to avoid personal liability?

There are three ways of avoiding personal liability, but these must be acceptable to the other party to the pre-incorporation agreement.

- It might be possible to avoid entering into any pre-incorporation agreement, and wait until the company has been formed. The company is then able to make the agreement itself as an existing legal person.
- The promoter might be able to reach an agreement with the other party that is 'subject to contract'. This means that there is not yet a contract, and the agreement is an indication of future intent, not an actual contract. The intention is that the company will then agree the contract after it has been formed. If a promoter who makes an agreement subject to contract then becomes one of the first directors of the new company after it has been formed, he or she should be in a position to get the company to enter the contract. This may give the other party sufficient reason to believe in the honest intentions of the promoter.
- The pre-incorporation contract may include wording that expressly excludes any personal liability for the promoter.

Formation of a company: procedures

- Registration procedure
- Certificate of incorporation
- Additional requirement for public companies: trading certificate

2 Formation of a company: procedures

2.1 Registration procedure

Companies must be registered when they are formed. The register of companies is maintained by the Registrar of Companies.

An application is made to the Registrar for a company to be registered, and the company is incorporated (and comes into existence) when the Registrar issues a certificate of incorporation. A company does not come into existence until it has been registered and the certificate of corporation has been issued.

In order to obtain registration, an application must be submitted, together with certain documents about the constitution of the company. The application is made by 'subscribers': these are persons who will be taking shares in the new company.

Previous requirements of the Companies Act 1985

Before the implementation of the Companies Act 2006, an application for the registration of a new company required the submission of certain documents, including the constitutional documents of the company. These constitutional documents consisted of a memorandum of association and articles of association.

The requirements of the Companies Act 2006 are similar, but differ in some details. In particular the memorandum of association now contains less information, which is provided instead on the application form for registration.

Requirements of the Companies Act 2006

A company is formed by one or more persons:

- subscribing their names to a memorandum of association, and
- complying with the other requirements for registration of the new company.

The memorandum of association states the names of the subscribers who are forming the company and is signed by them. The memorandum of association for a company **limited by shares** should include a statement that each subscriber will take at least one share each in the company, and it must be 'authenticated' by each subscriber.

The following documents must be delivered to the Registrar of Companies.

- the memorandum of association, as explained above
- an application for registration
- certain documents, and
- a statement of compliance, which is a statement that all the requirements for registration have been complied with.

The application for registration must state:

- the company's name
- whether the company's registered office is to be in England and Wales (or Wales), Scotland or Northern Ireland
- a statement whether the liability of the members is to be limited, and if so whether liability is to be limited by shares or by guarantee
- whether the company is to be a public or a private company.

The application must also include the following statements or documents:

- In the case of a company limited by shares, a statement of capital and initial shareholdings. This states the total number of shares to be taken on formation by the subscribers to the memorandum and their nominal value, and the total number of shares to be taken by each subscriber.
- A statement of the company's proposed officers. This should provide details of the persons who will be the first directors (or sole director) and company secretary. A company secretary is not required for a private company, but a private company may choose to have one. A public company should have a company secretary.
- A statement of the intended address of the company's registered office.
- A copy of the company's proposed **articles of association**. The articles of association contain the detailed constitutional rules for the company. If the company does not supply a copy of its proposed articles, standard 'default' articles of association will apply.

2.2 Certificate of incorporation

If the registrar is satisfied that the submitted documents are in order, and that all the requirements for incorporation have been complied with, he will register the documents provided in the application for incorporation and issue a certificate of incorporation. This is a document providing official evidence of the existence of the company.

In the case of a company with share capital, the subscribers to the memorandum become shareholders of the number of shares they have indicated they will take in the company, and the persons named as the proposed officers of the company become the directors (or director) and company secretary.

On receipt of a certificate of incorporation, a **private** company is free to start business as a company and borrow money.

2.3 Additional requirement for public companies: trading certificate

A **public** company cannot start trading and exercising its borrowing powers until it has obtained a certificate of trading from the Registrar. A public company therefore needs both a certificate of incorporation and a trading certificate before it can start in business and borrow money.

A trading certificate will be issued if the Registrar is satisfied that the company will meet the minimum statutory requirements for share capital for a public company. The company must submit a declaration to the registrar stating that it has met with these requirements.

The requirement is that the company must have allotted share capital of at least £50,000 in face value (nominal value) and that this allotted share capital must be at least 25% paid up as to nominal value and 100% as to any share premium.

The law relating to share capital and allotted share capital is explained in more detail in the next chapter.

When the registrar issues a trading certificate stating that the public company has complied with the requirements relating to minimum capital requirements, it may start in business and start to borrow.

Note: When a private company re-registers as a public company, it is not subject to this rule, and it is permitted to continue trading without interruption.

Constitutional documents and statutory records

- Constitutional documents
- Memorandum of association and the Companies Act 2006
- Articles of association
- The legal status of the company's constitution
- Altering the articles of association
- A company's objects
- Definition of company records: statutory registers
- Accounting records
- Annual financial statements
- Annual return
- Off-the-shelf companies

3 Constitutional documents and statutory records

3.1 Constitutional documents

A company must have a 'written' constitution, in the form of printed documents or an electronic file.

Under the provisions of the Companies Act 2006, the constitutional documents of a company are:

- the company's **articles of association**, and
- any resolutions and agreements relating to the company's constitution: these may include special resolutions concerning the constitution of the company which have been agreed by a general meeting of the company's members (shareholders) and filed with the Registrar of Companies.

The articles of association define what the company is, and how its business and its affairs should be conducted. For example, they should include rules about the size and composition of the board of directors, and the conduct of board meetings and general meetings of shareholders.

When they have been registered (and the company has been formed), the articles are a contract between each shareholder and the company, and between the shareholders themselves.

3.2 Memorandum of association and the Companies Act 2006

Under the provisions of the Companies Act 2006, the memorandum of association became a much less significant document than in the past. Companies formed and registered under the provisions of the Companies Act 1985 included some items in their memorandum that were part of the company's constitution.

Under the provisions of the Companies Act 1985, a memorandum of association contained details about the company that were relevant to the 'outside world', such as the name of the company and the purpose for which it has been established.

Although it may contain additional details, a memorandum of association of a company formed under the provisions of the Companies Act 1985 had to contain, as a minimum requirement, the following details, each in a separate 'clause':

- **Name clause**, containing the name of the company.
- **Registered office clause**, stating which country the registered office is situated in. This could be England and Wales, Wales, or Scotland.
- **Objects clause**. The objects clause stated the purpose for which the company has been formed.
- **Limited liability clause**, stating that the liability of the members is limited.

  Authorised capital clause, stating the maximum amount of share capital that the company may issue. The concept of authorised share capital was abolished by the Companies Act 2006.
- **Public company clause**. A public company had to state in its memorandum that it is a public company.
- **Association clause**. This is the statement by subscribers that they intend to subscribe for shares in the company and for each subscriber, the number of shares that he will be taking.

A memorandum of association might include other clauses, but these were not a statutory requirement. For example, the memorandum **might** include a clause containing express powers for the company to borrow. This might state a maximum fixed amount above which the company cannot borrow. Alternatively, it might state that the company's borrowing must not exceed a specified amount of its issued share capital.

With the implementation of the Companies Act 2006, the contents of the memorandum of association of all existing companies are now treated as part of their articles of association. The articles are now the main (and in most cases, the only) constitutional document of a company, even for companies registered before the Companies Act 2006 was implemented.

Under the provisions of the Companies Act 2006, the memorandum of association is simply a historical document once the company is formed. It has to be submitted to the Registrar of Companies in the application to form the company. After that, it has no significance, except that the subscribers in the memorandum are required to subscribe for the number of shares in the company as given in their undertaking in the memorandum.

3.3 Articles of association

The articles of association of a company set out its internal rules and regulations. Every company must have articles of association (s18 CA2006).

Standard articles of association (also called model articles or default articles) have been produced by the government, to simplify the task for companies of preparing their constitutional documents. Companies are able to adopt these standard articles, or make amendments to the standard articles and adopt their amended version. By adopting standard articles, or amended standard articles, the task of preparing the articles for a new company becomes very quick and inexpensive. Unless a company adopts standard 'default' articles of association, it must register its articles with the Registrar of Companies.

Model articles

There are model articles ('default' articles) for public companies and different model articles for private companies. On applying for registration of a new company, these default articles will be assumed to apply to the company unless the company provides different articles of association, or indicates how its own articles of association should differ from the default model articles.

The content of articles of association

In broad terms, the content of the standard default articles for a public company under the Companies Act 2006 include articles relating to the following constitutional arrangements:

Companies Act 2006 model articles: public companies	
Directors	Powers of the board of directors
	'Reserve powers' of the shareholders to prevent the directors from following a particular course of action
	Ability of the board to delegate powers, to a managing director or committees of the board
	The appointment and retirement of directors
	Termination of a director's appointment
Decision-making by the members	Calling general meetings of the company
	Voting arrangements at general meetings
Shares	Power of the company to issue new shares
	Share certificates and shares held in non-certificate form (in electronic form)
	Issuing new shares: rules on partly-paid shares
	Transfer of shares
Dividends	Rules relating to the approval and payment of interim and final dividends to shareholders
Communications with shareholders	Provisions relating to electronic communications with shareholders (by company website or e-mail)
Liability of directors	Powers of the company to indemnify the directors from liability for the cost of legal proceedings against them and to provide directors' and officers' liability insurance

The default model articles for **private companies** are shorter than the default model articles for a public company. They are mainly provisions relating to the company directors and there are no provisions relating to shareholders' meetings (general meetings).

Entrenched provisions

A company may want to include **'entrenched provisions'** in its constitution. An entrenched provision is a provision in the company's constitution that cannot be altered without agreement of all the members of the company. For example, an entrenched provision may specify the nature of the business activities that a company may conduct, or may specify rules about maximum borrowing limits.

Entrenched provisions, if required, must be included in the articles of association

Section 22 CA2006 states that entrenched provisions may only be included in the articles:

- if they are included in the articles on formation of the company, or
- if they are introduced by an amendment to the articles with the agreement of all the members (ordinary shareholders) of the company.

3.4 The legal status of the company's constitution

A company's constitution is binding on the company and its members. Section 33 CA2006 states that the provisions of the company's constitution bind the company and its members 'to the same extent as if they were covenants' given by the company and each member to observe the provisions.

This means that:

- The members are bound to the company, the company to the shareholders and the members between each other.
- There might only be one or two subscribers to the memorandum of association, but after the company comes into existence, there may be many other shareholders in the new company. The company's constitution is binding on all of them, even though they were not members when the company was formed.
- When new shareholders acquire shares in the company, for example by purchasing shares from other shareholders, they are also bound by the company's constitution.

C

Case: Hickman v Kent and Romney Marsh Sheep Breeders Association [1920]

The articles of association of the company stated that in the event of any dispute between the members and the company, the dispute would be settled through arbitration. Following a dispute, a member brought an action through the courts.

Held: The member was bound to the company by the articles and the correct process was to use the arbitration rather than litigation in the courts.

C

Case: Pender v Lushington [1877]

The articles of a company provided for one vote for every 10 shares held subject to a maximum of 100 votes. One member with more than 1,000 shares transferred surplus shares to a nominee in order to be able to use the votes effectively. The company refused to accept the votes cast by the nominee. (Note: A nominee shareholder is a person who owns shares in name only, and acts on behalf of the 'beneficial' shareholder.)

Held: the company was bound to the shareholders by the articles and the right of the nominee to vote was enforceable against the company.

3.5 Altering the articles of association

A company may alter any of its articles of association by **special resolution** of its members (s21 CA2006) A special resolution is an agreement requiring a vote of 75% or more of shareholders in favour among the shareholders voting at a general meeting of the company. However, articles should not be altered if the change would be contrary to the requirements of the Companies Act.

An **exception** applies in the case of any **entrenched articles**. Entrenched articles introduced into a company's articles of association cannot be amended or removed without the consent of **all** members (or by order of the court in circumstances where the court has the power to alter a company' articles).

When a company alters its articles of association, it must send a copy of the amended articles to the Registrar not later than 15 days after the amendment takes effect.

Section 25 CA2006 contains a provision that a member of a company is not bound by an amendment to the company's articles if the amendment:

- requires him to subscribe for more shares in the company, or
- in any other way requires him to increase his liability to the company or contribute more capital to the company.

3.6 A company's objects

A company's objects are the purpose for which it has been established. The Companies Act 2005 required companies to include a statement of their objects (an 'objects clause') in their memorandum of association. There were legal implications of a company carried on activities that were outside its stated objects ('ultra vires').

Unless a newly-formed company specifies what its objects should be in its articles of association, it is free to carry on any type of business. Section 31 CA2006 states: 'Unless a company's articles specifically restrict the objects of the company, its objects are unrestricted.' The problem of *ultra vires* actions by a company will therefore not apply to newly-formed companies.

For companies that were already in existence before the provisions of the Companies Act 2006 were implemented, the objects clause in their memorandum of association became a part of their articles of association. If they wish to remove the objects clause from their constitution or amend the objects clause, this may be done by means of a resolution to amend the articles of association.

Acts by a company that are 'ultra vires'

If a company does include an objects clause in its constitution, or if the articles contain any other restriction on the acts or activities of the company, a question arises about what would be the consequences if a company acted in a way that is not permitted by its articles.

For example, if a person entered into a transaction with a company, so that the company incurred a liability or obligations, what would be the legal implications if the company had acted outside the rules of its constitution? Would the company still be liable to the other party?

Section 39 CA2006 states 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.'

Section 40 CA2006 states that: 'In favour of a person dealing with a company in good faith, the powers of the directors to bind the company, or authorise others to do so, is deemed to be free of any limitation under the company's constitution'.

This means that the company is required to meet its liabilities and obligations, even if these are 'ultra vires' or not permitted by its articles.

3.7 Definition of company records: statutory registers

The Companies Act 2006 introduced a definition of company records. Company records are any registers, indexes, records, agreements, memorandum, minutes or documents that a company is required to keep by the Companies Acts. They include the company's 'statutory registers.'

Statutory registers

Companies are required by law to keep certain registers. These are the 'statutory registers'. These are usually kept at the registered office of the company, and should be open to public inspection.

The statutory registers that a company must keep under the provisions of the Companies Act 2006 are as follows.

- **Register of members**. This is a list of the shareholders in the company, containing details of the name and address of each shareholder, the number (and class) of shares held and the amount paid up on the shares. The entry for each member must also show the date of becoming a member (and the date of any changes in shareholding) and the date of ceasing to be a member.
- **Register of directors.** This is a record of the directors of the company and the company secretary. The details that must be recorded include name, nationality,

a service address (possibly the address of the company's registered office), usual country of residence, business occupation (if any) and date of birth.

- **Register of directors' residential addresses.** For security reasons, the residential addresses of directors are not required in the register of directors, where a service address is sufficient. The register of directors is available for inspection by members and possibly members of the public. Residential addresses should be recorded in a separate register that is not available for inspection.
- **Register of company secretaries.** There should be a register of company secretaries, providing details of the current company secretary. This is not required for a private company if it chooses not to have a company secretary.
- **Register of charges**. Charges may be given by a limited company as security for some of its debts, such as a bank loan. Fixed and floating charges are described in a later chapter. Details of any such charges must be recorded in a register of charges.
- **Register of debenture holders**.

Under the provisions of the Companies Act 1985, companies were required to keep a **register of directors' interests**. This was a record of any interests that directors have in the shares of the company such as direct ownership of shares in the company. The requirement to keep this register was abolished in April 2007.

Inspection of the statutory registers

A point to note about most of the statutory registers is that they should be open to inspection, which means that members of the company (free of charge) and members of the public (on payment of a fee) should be able to obtain these basic details about any company its ownership and its leadership.

There has been a problem in practice with third parties buying copies of company registers of members and using these for direct mailing (and in some cases, for intimidation). In some cases, lists of shareholders have been used for unregulated and fraudulent financial marketing activities. To help with preventing this sort of activity, the Companies Act 2006 introduced a requirement that any third party (someone who is not a member of the company) asking to inspect the register of members or obtain a copy of it must provide information about themselves and the purpose for which they intend to use the information. If it wishes to do so, the company can then apply to the court for an order that it should not provide the information requested.

3.8 Accounting records

Every company is required by law to maintain accounting records (s386 CA2006). These records will be used to prepare the annual financial statements that companies must submit to their shareholders for approval.

The accounting records must be sufficient to show and explain the financial transactions of the company, so that it should be possible to:

- disclose at any time, with reasonable accuracy, the financial position of the company and

- prepare financial statements for the company (a balance sheet and an income statement).

The accounting records should contain in particular:

- day-to-day entries for all money received and spent by the company
- a record of the assets and liabilities of the company.

If the company deals in goods, the accounting records should also contain:

- a statement of inventories held at the end of each financial year
- statements of stocktaking that are used to prepare any such statement of inventories
- (except in the case of retail companies) statements of goods sold and purchased that enable the buyers and the sellers of the goods to be identified.

3.9 Annual financial statements

Every company must prepare a set of annual reports and financial statements. These comprise of the following statements and reports:

- A balance sheet (s396 CA2006)
- A profit and loss account (s396 CA2006)
- Director's report (s415 CA2006)
- The directors' report must include a narrative business review (s417 CA2006)
- Auditor's report (ss495 – 497 CA2006) – this is prepared by the auditors of the company, but is included with the annual report and accounts
- In the case of a quoted company, a directors' remuneration report (s420 CA2006).

3.10 Annual return

Every company must deliver an annual return to the Registrar of Companies (s854 CA2006). This consists of an annual return of information that all companies have to return to the registrar of companies. The return must be made within 28 days after the date to which it is made up.

The information that has to be returned is as follows:

- Address of the registered office.
- What type of company it is and the principal business activities.
- Particulars of directors and company secretary.
- Details about shares issued.

3.11 Off-the-shelf companies

The formation of a new company can sometimes be a lengthy process, but the time and effort required to obtain registration and become incorporated can be greatly reduced by acquiring an off-the-shelf company. This is a company that has already been formed, and is available for anyone to acquire by purchasing it.

Law stationers and some forms of solicitors have a supply of companies that they have already incorporated.

- There will usually be two named subscribers in the memorandum, both employees of the law stationery firm or the firm of solicitors.
- The directors and secretary of each company will also be employees of the firm.
- The company will be a private company.
- The company will typically have allotted just two shares of £1, one share to each of the two subscribers.
- The company will have standard articles of association.
- It will have a name, usually a meaningless one, and the Registrar will have issued a certificate of incorporation.
- The company will not have done any trading since its formation.

Someone wishing to set up a company can buy an off-the-shelf company from a law stationery firm or a firm of solicitors. When the purchase is made, the shares are transferred to the buyer. The existing directors and company secretary resign and notify the Registrar of their resignation. The seller also hands over the statutory registers to the buyer.

The buyers then adapt the purchased company to their specific requirements. New directors and a company secretary are appointed. The new owners of the company will probably change its name, and alter other clauses in the memorandum, for example by increasing the company's authorised share capital. They may also change some of the articles of association.

The main advantages of buying an off-the-shelf company to create a new trading company are that the process is quicker and it is not expensive. In addition, since the company already exists, there are no pre-incorporation contracts, and the company is able to enter into contracts immediately.

Company names

- Business Names Act 1985
- Requirement to indicate private or public company status and limited liability status
- Restrictions on the use of some company names
- Index of company names
- Disputes about business names: 'passing off'
- Statutory right to object to a company name
- Change of company name

4 Company names

4.1 Business Names Act 1985

The Business Names Act 1985 has two main purposes:

- To require the approval of business names for any business that trades under a name that is not the surname of the owner (sole trader business), any partnership that does not trade under the names of all the partners (partnerships) or any company that does not trade under its registered name
- To require appropriate display of the ownership or identity of the business in anyplace where the business carries on its operations, and also in business correspondence, invoices, web sites and so on.

For example, the Act applies to:

- A sole trader who conducts business under the name 'Jones the Shoe Mender' or 'Speedy Shoe Repairs', rather than the owners actual name 'J Jones'
- A partnership that operates under the name 'Smith and Parters' rather than the names of a ll the partners 'Smith, Brown and Fox'.
- A company that operates under the name 'Easy Eating' rather than its registered name 'Easy Eating (Great Britain) Limited.

The Act controls or restricts the use of certain words in the name of any type of business, and the approval of the Secretary of State is required for the use of a business name containing any 'sensitive' word.

- The use of a word indicating that the business is in some way connected to the government or a government department
- The use of certain words is prohibited because it would constitute a criminal offence.
- The use of other 'sensitive' words – provided in a list as an appendix to the Act – must also be approved by the Secretary of State. Sensitive words include 'British', 'National', 'United Kingdom', 'European', 'International', 'Insurance', 'Institute' and so on.

- In asking for permission to use business names including certain sensitive words, the business is required to submit written approval from a named official registration body. For example a business wishing to use the words 'Veterinary Surgeon' or 'Vet' in its name must supply written approval of the registrar for the Royal College of Veterinary Surgeons. Companies wishing to use the word 'Bank', 'Banking' or 'Deposit' in its name would need approval from the Financial Services Authority (under the Financial Services and Markets Act 2000).

Businesses to which the requirements of the Business Names Act apply are required to provide information about their identity of ownership at all places where they do business, and in business documentation such as business correspondence and invoices.

Taking the combined requirements of the Business Names Act and the Companies Act 2006, a company trading under the name 'Easy Eating' would be required to show in its correspondence or invoices the following details:

Easy Eating (Great Britain) Limited, registered in England and Wales
Registration number 1234567
Registered office: 1 High Street, Newtown, Baxtershire, NN1 1BB

For companies, many of the requirements of the Business Names Act 1985 are replaced by similar requirements in the Companies Act 2006 from October 2009. The requirements of the Companies Act with regard to company names are set out below.

4.2 Requirement to indicate private or public company status and limited liability status

A company with limited liability status must indicate this fact in its name. A private company must use the word 'Limited' (Ltd) in its name and a public company must include the words 'public limited company' (or plc) in its name. Similar Welsh language requirements apply for Welsh companies.

This is a requirement of the Companies Act 2006 (ss 58 – 59).

4.3 Restrictions on the use of some company names

There are some restrictions on the names that companies can have when they register as new companies.

- A company must not be registered under a name that, in the opinion of the Secretary of State, is offensive or would constitute an offence (s53 CA2006). For example, it would be an offence for a company that is not a bank to include the word 'Bank' in its name unless it has been registered with the Financial Services Authority.
- The approval of the Secretary of State is required for company names suggesting a connection with the government or a public authority (s54).

- The approval of the Secretary of State is required for company names containing any other sensitive word or expression (s55).

The requirements in sections 54 and 55 of the Companies Act are similar to those that apply to business names generally in the Business Names Act 1985.

The Secretary of State also has the power to make regulations about any characters, signs or symbols that may be used in the name of a registered company.

4.4 Index of company names

There are some restrictions on companies using names that are very similar to the name of another company already in existence, when there is a risk of confusion between the companies.

A company cannot register a name that is the same as one that is already included in an index of company names that is kept by the Registrar of Companies.

The Registrar of Companies keeps an index or register of company names (required by s1099 CA 2006). This is simply an alphabetical list of names of registered companies.

The Registrar will prohibit a company from registering a name that is **identical** to a name that is already on the index. If for some reason a company is registered with a name that is identical to the name of a company that is already on the index, the Secretary of State (the government minister for BERR, the Department of Business, Enterprise and Regulatory Reform) has the power to order a company to change its name.

A company will also be prohibited from using a name that is very similar to ('**too like**') a name that is already on the index. If a company is registered with a name that is 'too like' the name of a company that is already on the index, the Secretary of State has the power to order a company to change its name.

4.5 Disputes about business names: the tort of 'passing off'

From time to time, a new company might use a name, or a company might use a new business name, that is very similar to a name already in use by another business. This may happen when the authorities have failed to spot any similarity, and have given approval to the new name.

When a business starts to use a name that is similar to another business name, there is a possibility that customers will confuse the two, or associate the two names with each other, assuming that the business are in some way related. Clearly, the company (or other business) that obtained the name first should have the right to protect its name against the tort of '**passing off**' by the other business. The law of tort has already been described in an earlier chapter. Two further case examples are given here.

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Case: Ewing v Buttercup Margarine Company Ltd (1917)

The case of *Ewing v Buttercup Margarine Company Ltd* illustrates passing off well. Ewing had been carrying on business since 1904 dealing in margarine and tea, with a chain of retail shops in Scotland and the North of England. The business traded under the name 'The Buttercup Dairy Co'. Ewing had plans to expand the business in the South of England.
The Buttercup Margarine Company Ltd was a completely different business, incorporated in 1916 as a wholesaler of margarine in and around London. Ewing applied to the court for an order to stop this company from trading in its name.

The company argues that it was a wholesaler of margarine in London, whereas Ewing's business was a retail business in the North. The court ruled that there was nothing in the objects clause of the company to prevent it from expanding into retail operations, and if Ewing expanded into the south of England, there could easily be confusion between the names.

The court therefore found that the Buttercup Margarine Company Ltd should be prohibited from using this name to trade.

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Case: Stringfellow v McCain Foods (1984)

The court is unlikely to prohibit a company from using a name that is very similar to another when the two companies are operating in different businesses or industries. In such a situation, the likelihood of confusion between the two companies is small. If the company accused of 'passing off' chose its name 'innocently' and without any intention to 'pass off', the court will probably allow it to keep its name.

In this particular case where the defendant was accused of passing off, the judge commented: 'Even if it considers that there is a limited risk of confusion of this nature, the court should not, in my opinion, readily infer the likelihood of resulting damage to the plaintiffs as against an innocent defendant in a completely different line of business. In such a case, the onus falling on plaintiffs to show that damage to their business reputation is in truth likely to ensue and to cause them more than a minimal loss is, in my opinion, a heavy one.'

4.6 Statutory right to object to a company name

A new right was introduced by the Companies Act 2006 that gives any person (for example a company) to object to the name of another company if it is the same or misleadingly similar to one in which the objector has goodwill ('reputation of any description').

Under the provisions of the Companies Act 1985, a person wishing to object to the name of another company, because it is the same as or too similar to its own, could write to the Registrar of Companies, but the Registrar had limited powers of intervention.

Under the provisions of the Companies Act 2006 (ss 69 – 74 CA2006), a person can make an objection to a 'company names adjudicator' – a person appointed by the

Secretary of State. If the objection to the name is upheld, the company names adjudicator will have the power to order the other company to change its name.

This will provide a method of taking legal action against the name of another company that is an alternative to legal action against 'passing off' under the law of tort.

4.7 Change of company name

A company can change its name. A change of name requires a special resolution by the shareholders in a general meeting of the company.

When a company changes its name, acceptance of the new name will be subject to the same regulations as for new company registrations.

A company must change its name when it changes its status from private to public company or from public to private company.

CHAPTER

10

Capital and financing of companies

Contents

Shares in companies

- Division of share capital into shares of fixed amounts
- The nature of shares
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- Minimum share capital requirement for public companies
- Issued and paid up share capital
- The value of shares: nominal value, exchange value and market value
- Classes of shares: class rights
- Altering class rights
- Preference shares
- Ordinary shares

1 Shares in companies

1.1 Division of share capital into shares of fixed amounts

In a company limited by shares, the share capital represents capital introduced into the company by the company's 'members', the shareholders.

The share capital of a company may be divided into several different 'classes', or there may be just one class of shares. Within each class of shares, all the shares must be of the same fixed amount. This is the **nominal value of the shares**.

For example, the ordinary shares in a company may be divided into 500,000 shares, all of £1 each. Within the same class, there cannot be shares for differing nominal amounts.

When new shares are created, they are issued to persons who become shareholders (or who are already shareholders and are acquiring additional shares). In normal language, we speak of 'issuing' shares. In company law, the term '**allotment** of shares' is used rather than 'issue of shares'.

1.2 The nature of shares

Shares in companies have several characteristics.

- A share is a form of property, carrying rights and obligations, and is transferable from one person to another. In other words, ownership of shares can be transferred.
- A share can be described as a form of bargain between the shareholders, who must all comply with the company's constitution.
- A share must be paid for. It may be paid for in full when it is allotted to the shareholder. Alternatively it may be paid for in two or more stages, with an initial part-payment on allotment and two or more subsequent 'calls'.

1.3 Authorised share capital

All companies limited by shares were required by the Companies Act 1985 to have an **authorised share capital**, and the amount of the authorised share capital had to be specified in the company's memorandum of association.

Authorised share capital is the maximum amount of shares (in each class) that the company may issue. It is expressed in terms of the nominal value of the shares.

The authorised share capital can be increased, but only with the formal approval of the shareholders.

This means that most companies incorporated under the Companies Act 1985 have:

- an authorised share capital, and
- an allotted share capital that may be a smaller amount of shares than the authorised maximum

If a company wanted to increase its allotted share capital above its authorised share capital limit, the approval of the shareholders had to be obtained for an increase in the authorised share capital to a higher amount.

Companies Act 2006: abolition of authorised share capital

The Companies Act 2006 abolished the requirement for authorised share capital.

However, for companies already in existence, the authorised share capital limit in their memorandum of association became a part of their articles of association and the capital restriction continues to apply. Such companies would need to alter their articles of association if they want to remove this limitation on the ability to issue new shares.

Although there is no longer a statutory requirement for authorised share capital, a company may include in its articles of association an article limiting the amount of share capital that it may issue.

1.4 Minimum share capital requirement for public companies

It was stated in an earlier chapter on the formation of companies that a public company must not do business unless it has a trading certificate, and the Registrar of Companies will not issue a trading certificate unless the nominal value of the company's allotted share capital is at least the 'authorised minimum.

The authorised minimum share capital for a public company is £50,000 or its prescribed equivalent amount in euros (s763).

The Secretary of State has the power to alter the authorised minimum capital.

The authorised **minimum** share capital for public companies under the Companies Act 2006 should not be confused with 'authorised share capital', as described earlier.

1.5 Issued and paid up share capital

The **issued share capital**, also called **allotted share capital**, is the nominal value of the shares (in each class) that have been issued to shareholders. The issued share capital may be less than the authorised share capital, but cannot exceed it.

When shares are issued, they must be paid for. In most cases, the shareholders must pay for the shares in full when the shares are issued. Sometimes, however, the shares are paid for in two or more stages, known as **calls**. **Called-up share capital** is the nominal value of the shares that has so far been called up for payment.

Paid-up share capital is the total amount of called-up share capital that has so far been paid. When a new issue of shares takes place, some buyers of the shares might be a bit slow making the payment, and the paid-up share capital might (for a short time) be less than the called-up share capital.

Issued share capital and the liability of shareholders

A share represents the maximum liability of a shareholder in a limited liability in the event that the company is wound up with unpaid debts. The actual liability of the shareholders is limited to any unpaid capital on their shares.

- There is no liability on authorised share capital that has not been issued.
- When issued shares are fully paid, the shareholders have no further liability for the unpaid debts (liabilities) of the company. If the company goes into liquidation with unpaid debts, the shareholders will not be required to contribute anything to the payment of the company's debts. The maximum amount they will lose is the amount already contributed as share capital.
- When shares are partly-paid, the maximum liability of the shareholders is the unpaid portion of the share capital. If the company goes into liquidation with unpaid debts, the shareholders will be required to contribute extra capital up to the amount unpaid on the shares.

Example

MGC plc has **authorised share capital** of 800,000 ordinary shares of £1 each (= £800,000 in total). The **nominal value** of the shares is £1 per share.

The issued share capital is 500,000 ordinary shares. Of these, 400,000 shares are fully paid, but a recent issue of 100,000 shares is only 75p per share called and paid.

In this example:

- Authorised share capital is £800,000 (800,000 shares of £1).
- Issued share capital is £500,000 (500,000 shares of £1).
- Called and paid-up share capital is £400,000 + (100,000 × £0.75) = £475,000.
- The maximum liability of the shareholders for the unpaid debts of the company, in the event of the company's liquidation, is (100,000 × £0.25) = £25,000.

If this company wishes to abolish its authorised share capital, it must do so by amending its articles of association to remove the article relating to its authorised share capital.

1.6 The value of shares: nominal value, exchange value and market value

It is important to be aware of the difference between the nominal value of shares, their issue price and their market value or transfer value.

- The **nominal value** or par value of shares is their face value, as specified in the memorandum of association.
- A share might be issued (allotted) at a price in excess of its nominal value. Shares issued at different times might be issued at different prices. For example, a company might issue ordinary shares of £1 for £3 each in 2005 and later issue more ordinary shares of £1 for £4.50 each in 2009. These shares will each carry the same rights as every other ordinary share of £1 in the company, regardless of their issue price.
- After issue, shares may be transferred and will have a **transfer value** for taxation purposes. (The former shareholder may be liable for tax on the capital gain from the transfer.) In addition, shares in private companies may be sold privately by one person to another, and the transfer value is the price they agree for the sale. Transfer value is usually above nominal value, but might be lower. Similarly, shares in public companies that are not traded on a public stock market have a transfer value.
- Shares of a public company that are traded on a stock market have a current **market value**, which may change continually. Like the transfer value of other shares, the market value of shares in these public limited companies has no relationship whatsoever to the nominal value of the shares.

1.7 Classes of shares: class rights

A share gives its owner certain rights. Shares might all be of one type or 'class', in which case they all have the same rights attached to them. However, there may be more than one class of shares, each with different 'class rights' attached to them.

Examples of rights are the right to:

- the right to dividends paid by the company
- the right to vote on certain issues in general meetings of the company and
- the right to a return of capital in the event that the company is wound up.

The rights attached to shares should be specified in the company's constitution.

A company might issue shares with differing rights attached to them, for example with respect to:

- entitlement to receive dividends out of profits
- voting rights
- priority for the return of capital if the company is wound up.

Shares with identical rights constitute a 'class' of shares. If all shares have the same rights, there is only one class of shares. The most common classes of shares are:

- ordinary shares, sometimes referred to as 'equity shares'
- preference shares.

In some companies, there is more than one class of ordinary shares. For example, a company might have 'A' ordinary shares and 'B' ordinary shares, with each class of shares having different voting rights.

Similarly, a company might have different classes of preference shares, each with different rights in relation to dividends, redemption and priority for return of capital in a winding up.

1.8 Altering class rights

The rights attached to a particular class of shares may be varied. The procedure for making a variation in class rights depends on whether there are provisions in the articles of association. Basically, however, the variation in class rights must be proposed to the shareholders in that class, and those shareholders must agree by the required majority.

- If the articles of association contain provisions relating to the variation of class rights, the requirements of the articles must be followed. This situation will apply to most companies.
- If the company's constitution does not contain provisions relating to the class rights and their variation (which is uncommon), a variation in the class rights of any class of shares requires the approval of the holders of the shares affected, by means of either:
  - the written consent of the holders of at least 75% of the issued shares in the class, or
  - a resolution at a meeting of the holders of the class of shares affected, requiring the approval of at least 75% of the holders of the shares in the class who vote at the meeting.

1.9 Preference shares

A preference share normally carries a prior right (ahead of ordinary shares) to:

- receive a dividend: the dividend payable on preference shares is normally a fixed amount each year
- receive a repayment of capital in the event that the company is wound up.

Holders of preference shares therefore receive preferential treatment, ahead of the ordinary shareholders. For example, 4% preference shares of £1 each are entitled to an annual dividend of £0.04 per share. This dividend must be paid before any dividend is payable to ordinary shareholders.

Preference shareholders are referred to as 'members' of the company, but unlike the ordinary shareholders, they are not the 'real' owners of the company. This is because although they have preferential rights ahead of the ordinary shareholders:

- their right to dividends is limited to a fixed amount, and

- their entitlement to a repayment of capital, in the event that the company is wound up and liquidated, is restricted to the nominal value of the shares. (In contrast, the right to payment of capital in a winding up is unlimited for ordinary shareholders.)

The other priority rights of preference shareholders are set out in the following table.

The **right is to receive an annual dividend** (a fixed percentage amount of the nominal value of the share) **before any dividend is paid to ordinary shareholders.**	It does not oblige the company to pay a preference dividend. The company's directors may choose not to pay any dividends at all, in which case neither the preference shareholders nor the ordinary shareholders will receive a dividend.
The right to receive preference dividends is assumed to be **cumulative**, unless they are **specifically 'non-cumulative'**.	Dividend is cumulative when any dividend that is not paid in one year accumulates, and is payable the next year, and the year after, and so on, until it is eventually paid. For example, if 4% preference shares of £1 are cumulative, and dividend is not paid in one year, the preference shareholders are entitled to a dividend of £0.08 in the next year (the accumulated unpaid £0.04 plus £0.04 for the next year). This full amount must be paid to the preference shareholders before any dividend can be paid to the ordinary shareholders. If preference shares are **non-cumulative**, unpaid preference dividend does not accumulate from one year to the next.
When a company goes into liquidation with accumulated unpaid preference dividends, the preference shareholders are usually **not** entitled to receive the arrears of dividend in the winding up.	There are exceptions to this rule, and the articles of the company might include an express provision that arrears of unpaid preference dividends are payable in a winding up
Holders of preference shares normally have no entitlement to receive dividends above the fixed rate. For example, holders of 6% preference shares of £1 are entitled to dividends of £0.06 per share each year, and no more.	
Preference shareholders are entitled in a winding up of the company to the repayment of the nominal value of their shares, before any payment of capital is made to the ordinary shareholders.	When there are two different classes of preference shares, the constitution of the company will need to specify which class of preference shares has the prior right to repayment of capital in a winding up.

Preference shares and voting rights

Preference shareholders do not usually have any voting rights in general meetings of the company.

However, the articles of association will specify the voting rights that preference shareholders do have, and the circumstances in which the approval of the preference shareholders is required for a proposed transaction. For example, proposals that affect the rights of the preference shareholders should require their approval.

In particular, when their dividend payments are in arrears, cumulative preference shareholders are usually entitled to vote with the ordinary shareholders in general meetings of the company.

Different classes of preference shares

A company might have more than one class of preference shares. For example, a company might have some 5% non-cumulative irredeemable preference shares of £1 each and some 4.5% cumulative redeemable preference shares of £1 each. These are different classes of preference shares because the rights attaching to each are different.

Redeemable preference shares

A class of preference shares may be redeemable. This means that at a specified date in the future, the company will be obliged to redeem the shares, which means buy them back from their holders, at a specified price (such as their nominal value/par value). When redeemable shares have been redeemed, they are cancelled.

The redemption of (preference) shares is explained in more detail later, in the context of capital maintenance.

1.10 Ordinary shares

The ordinary shareholders are the owners of their company. Ordinary shares are often called 'equity' shares.

- The ordinary shareholders 'own' the distributable profits of their company, after preference dividends have been paid, but are only entitled to a dividend:
  - if the directors propose a dividend, and
  - (in the case of a final dividend) the shareholders vote for the payment of a dividend.
- There is no limit to the amount of dividends that a company can pay to its ordinary shareholders out of its distributable profits, **subject to** complying with the rules on capital maintenance (which are explained later).
- Ordinary dividends cannot be paid until all unpaid cumulative preference dividends payable have been paid to the preference shareholders, and until all preference dividends for the current year have been paid to all classes of preference shareholders.

- In a winding up of the company, the ordinary shareholders are not entitled to receive payment of any capital from the liquidation of its assets until all creditors have been paid and the nominal share capital of all preference shareholders has been repaid.
- The ordinary shareholders are entitled to vote at general meetings of the company. Normally, all ordinary shareholders have one vote per share. (However, this general rule does not apply all the time in the rare cases where a company has more than one class of ordinary shares – 'class A' and 'class B' ordinary shares will usually have different voting rights.

Issuing shares (allotment of shares)

- Allotment of shares
- Power of directors to allot shares
- Pre-emption rights
- Issuing shares at a premium: share premium

2 Issuing shares (allotment of shares)

2.1 Allotment of shares

The allotment of shares is the issue of new shares by a company. A person wanting to obtain new shares in a company applies to the company for a specified number of shares. The company accepts the offer by allotting shares.

When a company is first formed, the persons to whom the shares are allotted will be the persons who signed the memorandum of association as subscribers.

When shares are allotted, the shareholder and the number of shares allotted should be entered in the company's register of members (a statutory register).

2.2 Power of directors to allot shares

Shares are allotted by the directors of the company. They decide formally who to allot shares to and how many shares should be allotted to each applicant. (A company may allot to each applicant the exact number of shares he has applied for, but it may allot a smaller number. This will be necessary when the number of shares applied for exceeds the number that the company wishes to allot.)

The power of the directors to allot shares, up to a specified limit, is normally given to them in accordance with the company's articles of association or by a resolution of the shareholders at a general meeting of the company (s551 CA 2006).

A common practice amongst listed companies is for the shareholders to be asked each year at the annual general meeting to give the directors authority to allot new shares up to a specified maximum limit, and for the authority to last until the next annual general meeting (one year).

Companies Act 2006: exception for private companies with just one class of shares

The Companies Act 2006 introduced a change to the basic requirement that the directors may allot shares only if they are authorised to do so by the articles of association or a shareholders' resolution.

The directors of a private company with only one class of shares may allot shares without the prior consent of the company's members, provided that they are not prohibited from doing so by the company's articles of association. A private company might therefore need to alter its articles to allow directors to allot shares without the prior consent of the members. Alternatively, if a private company's members want to restrict the power of the directors to allot shares, they might need to introduce restrictions into the articles of association.

Other amendments to share capital

A company limited by shares may also alter its share capital in other ways.

- It may divide its shares into a larger number of shares with a smaller nominal value. For example, a company with share capital of 10,000 shares of £1 each may change this to 20,000 shares of £0.50 each.
- It may consolidate shares of a smaller nominal value into a smaller number of shares with a higher nominal value. For example, share capital may be changed from 40,000 shares of £0.25 each into 10,000 shares of £1 each.

2.3 Pre-emption rights

Pre-emption rights are the first right to buy. They are a right of a person to purchase something before the opportunity is offered to anyone else. Shareholders in a company may have pre-emption rights to buy any new shares allotted by the company. For example, if a company has 200,000 shares in issue, and decides to issue another 50,000 shares, pre-emption rights would give the existing shareholders the right to buy the new shares, by applying for 1 new share for every 4 shares they hold.

The Companies Act 2006 includes the following provisions about pre-emption rights:

- When a company allots new equity shares **for cash**, it should give pre-emption rights to its existing holders of the same class of shares. The pre-emption rights should be given to each existing shareholder in proportion to their shareholding (s561).
- Shareholders who are offered the opportunity to buy new shares in a rights issue can accept the opportunity. If they do not want to buy the shares offered to them, they can transfer their rights to buy (usually by selling them to another person: this is called 'renouncing rights' in favour of another person). Alternatively, they can simply do nothing, and choose not to buy the shares or sell their rights.
- Pre-emption rights do not apply unless a company allots new shares for cash (s565). This means, for example, that if a company issues new shares in exchange for shares in another company, as a part of a takeover deal, the shareholders in the company do not have any pre-emption rights.
- The articles of association usually include a rule that allows shareholders to agree, by means of a special resolution in general meeting, that their pre-emption rights should not apply to the issue of new shares for cash up to a specified amount. (This is common in listed companies, where the shareholders

might agree that the company should be allowed to allot up to a certain number of shares for cash, without pre-emption rights applying. This allows the company to issue shares, for example, to employees who are exercising share options.)

The articles of association of a **private** UK company may include a provision to exclude pre-emption rights entirely (s567).

2.4 Issuing shares at a premium: share premium

Shares may be issued at a price above their nominal value (face value). The difference between the issue price and the nominal value is a share premium. For example, if a company issues £1 shares for £3.50, it will issue shares of £1 each that have a share premium of £2.50.

These shares will have a nominal value of £1 each. The share premium is recorded separately. In the financial accounts of a company, a share premium must be recorded in a **share premium account** (s610 CA2006). This is a capital account, meaning that the **funds recorded as 'share premium' cannot be distributed to shareholders as dividends**.

Application of the share premium account

Reducing the share premium account is permitted in UK law in certain circumstances. Section 130 CA85 states that the capital represented by the share premium account can only be used ('applied') for the following four purposes:

- A company can convert share premium into share capital by means of a bonus issue of shares.
- The share premium can be reduced when funds raised when a new company is incorporated are used to pay pre-incorporation expenses.
- The share premium can be reduced to write off expenses incurred in issuing any shares or debentures of the company, or to pay the discount allowed on an issue of debentures.
- The share premium can also be used to pay any premium payable on the redemption of debentures.

The Companies Act 2006 (s610) restricts the permitted uses of the share premium account to:

- paying up new shares issued as fully paid bonus shares (in other words, converting the share premium reserve, or part of it, into fully paid bonus shares that are then issued to existing members), and
- paying the expenses of an issue of the shares where a premium arises and any commission incurred in issuing the shares. For example, if a company issues 1 million new shares of £1 at a price of £3 per share, the share premium would be £2 million. However the expenses of the share issue and any commission payable in relation to the share issue could be set off against this premium.

Example

HJK Limited has 2 million shares of £0.50 each in issue, and it has a share premium account with a balance of £600,000.

The company may decide to make a bonus issue of new shares, and issue one new 'bonus' share to its shareholders for every two shares that they hold.

This will involve the issue of 1 million new shares of £0.50 each, which have a nominal value of £500,000.

When the bonus shares are issued, the issue can be paid up by using share premium. The issued share capital will increase by £500,000, and the share premium account will be reduced by £500,000, from £600,000 to £100,000.

Capital maintenance and share capital reduction

- The reason for a legal requirement for capital maintenance
- Prohibition on issuing shares at a discount
- Payment for the issue of shares in a form other than cash
- Reducing share capital
- Procedures for reducing share capital: court approval
- Private companies: simpler procedure for reducing share capital
- Redemption of shares
- Purchase of its own shares by a company
- Private companies and the purchase of own shares out of capital: permissible capital payment
- Financial assistance by a public company for the purchase of its shares

3 Capital maintenance and share capital reduction

3.1 The reason for a legal requirement for capital maintenance

The existence of limited liability means that shareholders in a company limited by shares cannot be required, after their shares have been paid in full, to contribute more money to enable the company to pay its debts.

This limited liability that is given to shareholders is given on the assumption they fully subscribe to the company's capital. The capital of a company can be seen as a capital fund out of which debts to unpaid creditors will be payable, should the need arise.

A creditor of a company faces the risk that the company might be unable to pay what it owes, because it is making losses and does not have the money to pay its debts. This is a risk of carrying on business and giving credit. However, creditors should be able to expect that:

- a company's shares will be paid for in full, and
- the company will not return any capital to its shareholders.

The Companies Act therefore includes regulations:

- preventing a company from failing to obtain full payment for shares: in particular, companies are not allowed to issue new shares fully paid at a discount to their nominal value
- placing restrictions on the ability of a company to reduce its share capital, after the shares have been issued.

3.2 Prohibition on issuing shares at a discount

Companies are not permitted to issue shares at a discount to their nominal value. This is stated clearly in section 580 CA2006: 'A company's shares must not be allotted at a discount. If shares are allotted in contravention of this section, the allottee is liable to pay the company an amount equal to the amount of the discount, with interest at the appropriate rate.'

- If shares are issued at a discount to nominal value, the amount of the discount will be treated as unpaid share capital. In the event that the company is wound up, the shareholders will be liable to make payments to the company for the unpaid amounts on the shares. The holders of shares issued at a discount will also be liable to pay interest at 5% on the unpaid amount of the shares.
- Similarly, any subsequent holder of the shares who is aware that the shares were issued at a discount will be liable for the unpaid amount.

Although companies are not permitted to issue shares at a discount, they are permitted to issue **debentures** at a discount.

Example

ASK plc is a listed company. It has issued share capital of 1,000,000 ordinary shares of £1, all fully paid. The company has been performing badly and the current market value of the shares is £0.20.

The company's directors, recognising that a refinancing of the company was essential to keep it in business, obtained shareholder approval for the issue of 400,000 preference shares of £1 each, credited with £0.60 already paid. The shareholders were therefore required to pay just £0.40 per share to make them fully paid.

Some time later, the company went into insolvent liquidation.

Required
Do any shareholders have any liability for the debts of the company in the liquidation?

Answer

The ordinary shares are fully paid and these shareholders have no further liability for the unpaid debts of the company.

The preference shares have a £1 nominal value but were issued for £0.40. There is a discount on issue of £0.60 per share. The preference shareholders are therefore liable to pay £0.60 per share in the winding up towards payment of the company's unpaid debts.

3.3 Payment for the issue of shares in a form other than cash

The general rule in the Companies Act is that when a company issues shares, it does not have to receive cash as payment. Payment can be in another form. A common method of paying for shares is by giving shares in another company in return: this is common in takeovers of one company by another.

In addition, shares can be paid for in assets other than cash.

This creates some problems for capital maintenance, however, because one way that a company could effectively issue shares at a discount would be to receive undervalued assets in return for the issue of shares. For example, if a company issues shares to an individual with a nominal value of £10,000 and receives a motor car in exchange valued at £3,000, the shares have effectively been issued at a discount of £7,000. Any creditor of the company could not rely on the 'value' of the new share capital - £10,000 – as being the true addition to the company's capital.

There are some rules in the Companies Act to prevent the issue of shares at an under-value, as follows:

- **Private companies** are permitted to issue shares in return for assets without any valuation rules. However if there was obviously a fraud then the courts might query the value of the consideration.
- **Public companies** are permitted to issue shares in return for consideration other than cash, but only on certain conditions:
  - It cannot issue shares for an undertaking which will be performed more than 5 years in the future (section 587 CA2006).
  - It cannot issue shares in return for the performance of services, for example in return for a promise by a director to do some work for the company (section 585 CA2006).
  - Where a public company issues shares for a non-cash consideration, the assets that it receives in exchange must be properly valued. The report from the professional valuer must be sent to the allottee of the shares and also filed with the Registrar of Companies (section 593 CA2006). However, this rule does not apply to a takeover of one company by another, where the buying company issues shares in exchange for shares in the target company.

3.4 Reducing share capital

There are some circumstances in which UK law allows companies to reduce their issued share capital. This is a much more serious problem, however, because a reduction in issued share capital is a reduction in the company's capital.

The reasons for wanting to reduce share capital might be any of the following:

- A company has suffered losses so that its net assets are worth less than the nominal value of its shares, and it wants the share capital to reflect this lower value.
- A company is changing its capital structure, and wants to cancel some shares and replace them with debt capital.
- The company now has more capital than it needs, and wants to return the unwanted capital to shareholders.

Examples

A company has 600,000 shares of £1 in issue, but due to accumulated losses, its net assets are now worth only £300,000. The company may therefore want to reduce its share capital to 600,000 shares of £0.50 each.

Another company might have 1,000,000 shares of £1 in issue, but has more capital than it needs. It may therefore decide to return some capital to its shareholders. For example, it may decide to reduce its share capital to 800,000 shares of £1 each, and buy back 200,000 shares (at an appropriate price) and cancel them.

3.5 Procedures for reducing share capital: court approval

A company may reduce its share capital if three conditions are satisfied:

- It has the **authority to do so in its articles of association**.
- The **shareholders have approved the reduction** in share capital (by means of a special resolution).
- The reduction in share capital is **approved by a court**. If the court is satisfied that the reduction in share capital is acceptable, it issues a court order.

The Companies Act 2006 (s641) specifies, as examples, three situations where a reduction in share capital might be approved:

- When the company wishes to extinguish the liability on shares in respect of share capital not paid up. For example, if a company has 1 million shares of £1, paid up as to £0.75 per share, it might wish to reduce its share capital to 1 million shares of £0.75 each, fully paid.
- When it wishes to cancel any share capital which has been 'lost' due to losses incurred by the company, so that the share capital no longer represents available assets.
- When the company wants to pay off issued share capital that is in excess of its wants.

Court order confirming the reduction in capital

When the shareholders have approved a reduction in share capital, the company must apply to the court for a court order approving the reduction.

The court sets a date for hearing the application. It also draws up a list of creditors of the company and publishes notices to anyone who may be a creditor and wishes to be placed on the list. Any creditor on the court's list has the right to object to the reduction in share capital at the court hearing.

The court will consider applications from any creditor who objects to the reduction in share capital and will try to deal with the objection, for example by means of the company agreeing to pay the debt or provide security for the debt. If all creditors then consent to the share reduction, the court will issue an order giving permission for the reduction in capital to occur.

When it gives this order, the court may also, **at its discretion**:

- Require the company, for a specified period of time, and the words 'and Reduced' to the end of its name – for example, ABC Limited and Reduced
- Require the company to publish the reasons why it is reducing its share capital.

Registration of the court order with the Registrar of Companies

The court order giving approval to the reduction in share capital must be filed with the Registrar of Companies, together with a minute written by the company (and approved by the court) providing details of the new share capital structure. The resolution by the company to reduce its share capital only takes effect when this court order and the minute have been registered.

When the share capital of the company has been reduced, the liability of the shareholders is limited to any unpaid capital on the new amount of issued share capital, after the reduction.

3.6 Private companies: simpler procedure for reducing share capital

The Companies Act 2006 introduced a simpler procedure for **private companies** to reduce their share capital, which does not require court approval. It provides that private companies should be allowed to reduce their share capital by an alternative procedure. This involves **obtaining shareholder approval** by means of a special resolution, based on a **statement of solvency** by the directors. The solvency statement is a statement by the directors that the company is solvent and will be able to pay all its debts at all times within one year of the capital reduction.

A director will be guilty of a criminal offence if he makes a solvency statement without having reasonable grounds for the opinion expressed in the statement. This potential criminal liability might persuade directors of private companies to use the court procedure, should they wish to reduce the company's share capital.

3.7 Redemption of shares

A limited company has the power to issue redeemable shares (section 684 CA2006). Redeemable shares are a form of preference share. A company may have one or more classes of redeemable preference shares in issue.

Redeemable shares must be redeemed when they reach their maturity date. At redemption, the company takes back the shares and cancels them. To redeem the shares, it must pay the shareholders a pre-determined amount, which is usually the nominal value of the shares. However, shares may be redeemed at a premium. For example a condition attached to the issue of redeemable preference shares of £1 each may be that they will be redeemable at, say, £1.05 each.

When a company redeems shares, it can do so in any of the following ways:

- It can pay for the redemption out of accumulated distributable profits (retained profits).

- It can pay for the redemption out of the money raised from an issue of new shares. When this happens, the redeemed share capital is replaced by the new share capital, and the capital of the company is not reduced.
- UK law permits private companies, in certain circumstances, to redeem shares (or purchase its own shares) out of capital.

Under the provisions of the Companies Act, public companies can only issue redeemable shares if they are authorised to do so by their articles of association. Private companies, however, have the right to issue redeemable shares unless they are prohibited or restricted from doing so by their articles.

Capital redemption reserve

When shares are redeemed wholly out of distributable profits, the amount by which the company's issued share capital is reduced must be transferred to a non-distributable capital reserve, called a capital redemption reserve (section 733 CA2006).

Example

A UK company has 500,000 redeemable preference shares of £1 each that it must now redeem at par. It has accumulated retained profits of £2,000,000. It decides to redeem the shares out of its accumulated distributable profits.

The company will pay £500,000 to redeem and cancel the preference shares. The company must transfer £500,000 from its accumulated profits reserve account to a **capital redemption reserve**, which is a capital reserve and is non-distributable.

This transfer to the capital redemption reserve prevents a reduction in the company's capital, because the redeemable preference shares have been replaced by a non-distributable capital redemption reserve.

The transaction would be recorded in the ledger accounts of the company as follows.

	Debit	**Credit**
	£	£
Accumulated profits	500,000	
Cash/Bank		500,000
Share capital	500,000	
Capital redemption reserve		500,000

3.8 Purchase of its own shares by a company

If it has obtained the authorisation to do so, a company may purchase its own shares. Having purchased the shares:

- the company might then cancel them, or
- if the shares are shares of a quoted company in the UK (or any other state of the EEA) it may hold the shares itself, as **'treasury shares'**. Treasury shares may

subsequently be re-issued, for example as shares issued to employees in a share option scheme or share incentive scheme.

There are several reasons why a company might want to purchase its own shares.

- A private company might want to purchase and cancel shares owned by a dissident shareholder who disagrees with what the company is doing.
- A quoted company with too much share capital may want to reduce the number of shares that it has in issue, so that the profits and dividends per share will be higher for the remaining shares.

The ways in which a company may purchase and cancel its own shares are similar to those for the redemption of shares.

- **A company can pay for the repurchase out of accumulated distributable profits** (retained profits). When this happens, the **nominal value** of the shares purchased must be transferred to a **capital redemption reserve**. By making a transfer to a non-distributable capital redemption reserve, the minimum equity capital of the company will be maintained.
- It can pay for the purchase of the shares with the money raised from an issue of new shares.
- Private companies, in certain circumstances, may purchase their own shares out of capital.

Purchases of own shares by a company: market purchase and off market purchase

A company may purchase its shares in a **market purchase** or an **off-market purchase**.

- A **market purchase** is possible for companies whose shares are traded on a stock market. The company may buy its shares in the stock market at the available market price.
- An **off-market purchase** is a purchase that is not made through a stock market. Private companies must purchase their shares off-market, but public companies may use this method too.

The rules for market purchases of shares and off-market purchases are summarised in the table below.

Market purchase	Off-market purchase
Must be approved by the shareholders by means of an ordinary resolution.	Must be approved by the shareholders by means of a special resolution.
The resolution must specify the maximum number of shares to be purchased and the maximum and minimum prices to be paid.	Shareholders who are intending to sell their shares to the company should not vote.
The resolution must specify a date after which the authority to purchase shares will expire.	If the resolution is made by a public company, it must specify a date after which the authority to purchase shares will expire.

e

Example

A UK company has obtained approval to purchase 500,000 of its ordinary £1 shares, and cancel them. It will pay for the purchase out of retained distributable profits. The purchases are made off-market, at a price of £2.50 per share.

The reduction in the issued share capital, at nominal value, is £500,000, but the actual purchase cost is £1,250,000 (£2.50 per share). This must be accounted for as follows:

	Debit	Credit
	£	£
Accumulated profits	1,250,000	
Cash/Bank		1,250,000
Share capital	500,000	
Capital redemption reserve		500,000

3.9 Private companies and the purchase of own shares out of capital: permissible capital payment

In certain circumstances, a private company may purchase its own shares out of capital, but the conditions are strict (sections 709 – 720 CA2006). The amount of the payment made out of capital is called the **permissible capital payment**.

- The company must first use all its distributable reserves to purchase as many of the shares as possible. It may use its capital to purchase the remaining shares.
- The directors of the company must make a statutory declaration, stating the intention of the company to purchase a quantity of its own shares and that the directors believe the company to be solvent and that it will be able to pay its debts in full in the year following the purchase of its shares.
- The company's auditors must also provide a report, annexed to the directors' statement, stating that they have looked at the company's state of affairs and see nothing to indicate that the statement by the directors is unreasonable.
- Within the next week after issuing the directors' statement, the company must obtain the approval of its shareholders to the share purchase (by special resolution at a general meeting of the company). Any shareholder intending to sell his shares to the company cannot vote on this proposal.
- The company must also publish details of its intention to purchase its shares (in the *London Gazette* and a national newspaper), and this must include a statement that any creditor objecting to the share purchase may apply to the court for the purchase to be prohibited.
- Any creditor or shareholder can apply to the court for the share purchase to be prohibited. The court will make its decision (to allow or prohibit the share purchase) on the basis of the facts.
- If the company purchases its shares and then goes into liquidation within the next 12 months, the following persons may be liable if the assets of the company on liquidation are insufficient to pay the company's creditors in full:
  - the directors (who made the statutory declaration), and

- any shareholder who sold shares to the company (up to the amount of the payment they received).

3.10 Financial assistance by a public company for the purchase of its shares

A person wishing to buy shares in a company has to obtain the money from somewhere to make the purchase. It would be possible for some or all of the money to be provided by the company itself. Alternatively, a company might provide a buyer with financial assistance in another form, such as the provision of a guarantee for a loan that the buyer makes to finance the share purchase.

The Companies Act 2006 states that as a general rule a company is not allowed to give someone financial assistance to enable them to buy its shares. (There are some exceptions to this general rule, that will be explained later.)

- Where a person is acquiring shares in a company it is illegal for the company to give any financial assistance, direct or indirect, either before or when the acquisition of shares takes place (s678).
- Where a person has acquired shares in a company and has incurred a liability in doing so, it is illegal for the company to give any financial assistance, direct or indirect, for the purpose of reducing or paying off the liability (s678).

For example, suppose that an individual wants to buy shares in a company for £1 million. A company should not be allowed to provide financial assistance by:

- lending £1 million to the individual to enable him to buy the shares
- paying off a bank loan or providing a guarantee for a £1 million bank loan to the individual, so that the individual can borrow to buy the shares.

This statutory rule against the provision of financial assistance applied to private companies as well as public companies under the provisions of the Companies Act 1985. Under the provisions of the Companies Act 2006, the prohibition applies to public companies only.

The removal (by the Companies Act 2006) of the prohibition on financial assistance by private companies should greatly simplify:

- arrangements where a public company is 'taken private' (after it has become a private company), and
- internal reorganisations of a private company or group of private companies.

Example

Financial assistance may be provided in a more complex way than by lending money or paying off loans.

One example from UK case law (when the Companies Act 1985 applied) involved an individual, G, who wanted to buy the shares of B Ltd at an agreed price of £489,000. The directors of B Ltd agreed to buy shares in M Ltd from G for £500,000, and G used the money from the sales of these shares to buy the shares in B Ltd.

The directors of B Ltd claimed that the purchase of the shares in M Ltd was a commercial transaction, unrelated to the purchase by G of the shares in B Ltd. The court disagreed. It ruled that the purchase of the shares in M Ltd was an artificial transaction, whose purpose was to provide G with the money to buy the shares in B Ltd.

C

Case: Brady v Brady [1989]

It does not matter that financial assistance is given for a sensible and worthwhile reason. As a general rule, if the purpose of giving financial assistance is to help a person to buy shares in the company, it is illegal for the company to give the assistance.

In this case, one shareholder had a dispute with a fellow shareholder that they could not resolve. They agreed that the only solution to the disagreement was for one shareholder to be 'bought out' by the other. However, the person who agreed to buy the shares of the other needed financial assistance with the purchase, which the company proposed to give.

The court held that this would be illegal. Although the **reason** for the company's assistance would be to resolve the dispute between the two shareholders, its **purpose** was nevertheless to give financial assistance, which was not permitted.

Exceptions to the restrictions on providing financial assistance

There are some exceptions to the restrictions on providing financial assistance for the purchase of shares.

- A transaction may be permitted if its main purpose is not to give financial assistance, and it is a part of a scheme with a larger overall purpose. The directors of the company providing the assistance must also act in good faith in the interests of the company, and not in the interests of the person receiving the financial assistance.
- A company may provide financial assistance if its normal business is to lend money. This means, for example, that ABC Bank plc can lend money to individuals who then use the money to buy shares in the bank.
- A company can lend money to employees to buy fully-paid shares in the company, provided that the employee intends to hold the shares as a beneficial owner.

Dividends and the law on distributions

- Definition of distribution
- Declaring dividends
- Restrictions on distributions
- Consequences of breaching the rules on distributions

4 Dividends and the law on distributions

4.1 Definition of distribution

'Distribution' means the distribution of assets by a company to its members (shareholders). The most common form of distribution is a **dividend paid in cash**. However, distributions also include:

- dividends paid in the form of new shares (a 'scrip dividend')
- distributions in the form of other assets of the company, such as inventory.

4.2 Declaring dividends

Dividends are payments made to shareholders by a company, out of its distributable profits. Unless there are specific restrictions in the company's constitution, every company has an implied power to use its profits to pay dividends to its shareholders.

The power to declare a dividend should be specified in the company's articles of association. The articles should provide for the company to declare a dividend in a general meeting, by means of an ordinary resolution of the shareholders (requiring a majority vote), and should specify the procedures for agreeing to a dividend payment.

In practice, companies might make two dividend payments each year, or possibly more. For example, a listed company might pay an interim dividend in the middle of its financial year, and then a final dividend after the end of the financial year. The articles should give the directors the power to pay interim dividends.

Standard articles of association specify the following procedures. The directors recommend an amount of dividend for payment. The recommendation is made to the shareholders at the annual general meeting of the company, and the shareholders vote to declare a dividend.

- The recommendation of the directors relates to the final dividend if the company has already paid an interim dividend during the year. Otherwise the recommendation relates to the annual dividend.
- The shareholders cannot vote to declare a dividend above the amount recommended by the directors, but they can vote to declare a lower dividend.

- If the directors do not recommend any dividend, the shareholders cannot declare a dividend.

4.3 Restrictions on distributions

Company law imposes restrictions on the amount of distributions that a company can make to its shareholders. The main purpose of having a legal restriction on distributions is to ensure that the capital of a company is maintained, so that the creditors of the company have some protection.

The rule (section 830 Companies Act 2006) is that all companies, both public and private, must have **sufficient profits** available to make a distribution. Distributions can only be made out of profits that are available for the purpose.

Available profits are defined as **accumulated realised profits minus accumulated realised losses**. Realised profits and losses may be either 'revenue' or 'capital' in nature.

- Revenue profits or losses are simply the profits or losses from operations.
- Capital profits are not available for distribution unless they are realised. For example, if a company re-values its land and buildings upwards by £20 million, the profits are unrealised and so cannot be distributed to shareholders. However, if a company sells a property and makes a profit of £3 million on the sale, this is a realised profit and is available for distribution.
- If an asset is re-valued downwards, the loss should be treated as a realised loss, unless the revaluation is a part of a general revaluation of all the assets of the company.

As a rough guide, these rules mean that the profits available for distribution will usually be close in value to the accumulated profits reserves in the company's balance sheet.

Additional restriction on distributions by public companies

Section 831 of the Companies Act imposes an additional rule on **public companies**. This is that any distribution by a public company must not reduce the value of the company's net assets below the total of:

- its called up share capital, plus
- its undistributable reserves.

The consequence of this rule is that a balance sheet approach applies to public companies. Public companies must take into account any changes in the value of their non-current assets (fixed assets). The minimum amount of capital that must be maintained can be calculated by adding the called up share capital and the undistributable reserves (such as the share premium account, revaluation reserve, capital redemption reserve account, and so on).

4.4 Consequences of breaching the rules on distributions

If the rules about distributions are broken, and a company distributes more to shareholders than permitted by law, the consequences are as follows.

- Any shareholders who know that the distribution was paid from non-distributable capital, or who should have known that the distribution was made from non-distributable capital, will be liable to repay to the company the money they have received (s847 CA2006).
- Any directors of the company who break the law on distributions, and **knowingly** pay dividends out of non-distributable capital, should be jointly and severally liable to replace the illegal payments. (This was a decision of the court in **Flitcroft's case** [1882].)

(When a number of individuals are **jointly and severally** liable, each individual could be liable for up to the full amount of the money owed. For example, if director A and director B are jointly and severally liable for illegal dividend payments of £100,000, the repayment can be obtained from them in any way. If director A say he has no money, director B can be called upon to pay the full amount of £100,000, and it is then up to director B to obtain a payment from director A for his contribution.)

Borrowing by companies

- Borrowing to raise capital, as an alternative to issuing shares
- The borrowing powers of a company and its directors
- Debentures
- Comparing the rights of shareholders and debenture holders

5 Borrowing by companies

5.1 Borrowing to raise capital, as an alternative to issuing shares

Share capital represents long-term finance for a company. Shareholders provide long-term capital to a company:

- by paying for the shares allotted to them, and
- through the retention of profits within the company (instead of paying out 100% of profits as dividends).

Companies may also obtain medium-term or long-term finance by borrowing.

- A company might borrow from a specialist lending institution (such as a bank) or from investors. Lenders are paid interest in return for making the loan.
- Borrowing is normally for a defined period of time (term), at the end of which the amount borrowed is **repayable** or **redeemable**. Some borrowing, however, is irredeemable or 'perpetual'.
- Borrowing might be **secured** or **unsecured**. It is fairly usual for borrowing by companies to be secured. When borrowing is secured, the borrower gives the lender some form of security, and the lender is able to make use of this security in the event that the borrower defaults and fails to make the promised interest payments and capital repayments.

5.2 The borrowing powers of a company and its directors

The borrowing powers of a company

A company whose objects are to carry on a trade or business has an implied power to borrow for purposes that are related to its trade or business. It is unusual for the constitution of a company to impose a maximum borrowing limit on the amount that a **company** may borrow.

A public company cannot borrow until it has obtained a trading certificate from the Registrar of Companies.

If there is a power to borrow, there is also a power to create a charge over the company's assets, as security for the debt. Charges are explained later.

Borrowing powers of the directors

The company's powers to borrow are delegated to its directors (in the company's constitution). Although the company itself may have unlimited powers to borrow, the constitution (articles of association) **might** impose a maximum amount that the directors may borrow in the name of the company without first obtaining the approval of the ordinary shareholders in a general meeting of the company.

However, if the directors of a company exceed their borrowing powers, the lender will probably be able to enforce his rights under the lending contract, for example his rights to payment of interest at the agreed rate and repayment of the debt at the end of its term ('at maturity').

5.3 Debentures

Debentures are documents that acknowledge borrowing by a company, although use of the word 'debentures' is commonly applied to the debt itself.

When a company borrows under the terms of a debenture, the debenture holders are lenders to the company, and are therefore **creditors** of the company.

As creditors, they are **entitled to receive interest**. This right to receive interest exists whether or not the company is profitable. In this respect, debentures are very different from preference shares.

Debentures may be created in any of the following ways.

- As a **single debenture**. For example, if a company obtains a secured loan from a bank, the bank will normally insist on a debenture that the company will sign. The debenture will probably create a charge that secures the loan, and will include a number of binding promises (covenants) that the company must keep. If a borrower breaches a covenant, this is an act of default, giving the lender the right to take action to protect its position, for example by demanding immediate repayment of the loan with any arrears of interest.
- **Debentures issued as a series**. Different lenders may lend money to a company at different times. Each transaction is a separate loan, but it might be agreed that all the loans should rank equally with each other in their right to security and repayment. In these circumstances, each separate loan may be transacted with an identical debenture agreement.
- **Debenture securities** or **debenture stock**. A company may raise capital by issuing debentures. In a debenture issue, a number of investors lend money to the company by acquiring debenture securities. These state how much debt the debenture holder owns. The debenture securities are issued under the terms of a debenture agreement and the debenture document will specify the terms of the borrowing, such as how much interest is payable, the interest payment dates and the redemption date for the debentures.

When debenture securities are issued, someone has to be responsible for protecting the interests of the debenture holders, by ensuring that the borrower complies with the terms and covenants in the debenture agreement. A committee is therefore appointed with responsibility for monitoring compliance with the terms of the debenture, and enforcing the rights of the debenture holder in the event of non-compliance. Debentures take the form of a trust deed and trustees are appointed: these are responsible for protecting the interests of the debenture holders.

5.4 Comparing the rights of shareholders and debenture holders

Shareholders and holders of debenture securities both own transferable securities in a company. However, there are important differences between the rights of ordinary shareholders and the rights of debenture holders.

- A shareholder is a member of the company. A debenture holder is a creditor of the company, not a member of the company.
- Ordinary shareholders, as members of the company, have the right to vote on certain matters at general meetings of the company. Debenture holders do not have the right to attend and vote at general meetings (except perhaps in special circumstances specified by the debenture trust deed or the company's constitution).
- A shareholder becomes a member when his name is entered in the register of members (a statutory register). A debenture holder becomes a creditor when the debenture document is completed and the money is lent.
- Debentures may be issued at a discount (as well as a premium) to their nominal value. For example, 4% debentures might be issued at a price of £98 per £100 nominal value of stock, with an undertaking by the company to redeem them at par (£100 per £100 nominal value of stock) at maturity. Shares cannot be issued at a discount to nominal value.
- Interest must be paid on debentures, even if the company is making losses and does not have the money to pay. A company is not obliged to pay dividends on its shares. Failure to make interest payments when due is an act of default, giving the debenture holders a right to take action to protect their interests.
- If the company is wound up and goes into liquidation, debentures (like other debts) must be repaid in full before any capital is distributed to the shareholders. It is usual for a company to provide security for its debentures. Debentures may be provided in the form of a fixed charge, a floating charge or both. A charge gives a lender a prior right to payment, ahead of unsecured creditors, if the company is wound up. Charges are explained in the next section.

Charges

6 Charges

6.1 The nature of a charge: security

When a person borrows money, the lender will often ask for security. The reason for security is that if the borrower is unable to repay the money borrowed, or is unable to meet the interest payments, the lender can use the security to obtain payment.

A charge is a form of security. A charge over a company's assets gives the creditor or lender (called the '**chargee**') a prior claim, ahead of other creditors of the company, to repayment of his debt out of the proceeds from those assets.

A chargee can enforce the charge whenever the borrower commits an act of default. Acts of default are specified in the agreement that creates the charge. For example, the borrower may be late with an interest payment, or may fail to repay some of the loan principal on schedule. The chargee may then be entitled to enforce the charge, and take control of the charged asset (or assets). The asset can then be used, possibly by selling it, to obtain money to pay the debt.

If a company goes into liquidation and is wound up, creditors with a charge over assets of the company have a prior right to repayment of their debt out of the proceeds from selling off the charged assets in the liquidation.

A charge may be:

- fixed, or
- floating.

A company and a limited liability partnership are both permitted to give a floating charge over their assets. Sole traders and ordinary partnerships cannot give a floating charge.

6.2 Fixed charge

A fixed charge is a charge on a specific asset (or assets). It is a charge that applies to the asset from the moment that the charge is created, and it remains attached to the asset until the debt is repaid.

The fixed charge is 'discharged' and ceases to exist when the debt is repaid. As long as the fixed charge exists, however, the borrower cannot dispose of the charged asset (or charged assets) without the consent of the chargee.

Since a fixed charge is attached to specific assets until the debt is repaid, it is suitable for assets that the borrower will expect to hold for a long time. Land and buildings, for example, are suitable assets for a fixed charge. However, a fixed charge can be attached to 'short-term' assets, such as receivables. When there is a fixed charge over a receivable (book debt), the chargee will expect payment out of the proceeds from the money received by the borrower when the charged receivable is paid.

A fixed charge may take several forms, including a **legal mortgage**. For example, the lender might take a legal mortgage over an item of land and buildings, or a legal mortgage over some shares.

6.3 Floating charge

As stated earlier, a company can give a floating charge over its assets.

A floating charge does not attach to specific assets until the charge crystallises. A floating charge has three aspects.

- It is a **charge on a class of assets** (or more than one class of assets). The charge relates to the future assets in that class, as well as the present assets when the charge is created.
- The assets in the class are continually changing over time, in the ordinary course of the company's business.
- Until (and unless) the chargee enforces the charge, the company can carry on its normal business and use the class of assets that is charged, without any requirement for approval from the chargee. Any money that is received from dealing with the assets does not have to be used to repay the loan from the chargee.

The key difference between a fixed charge and a floating charge is that with a fixed charge, the borrower cannot dispose of the charged asset or do anything to affect its value until the debt is paid. In contrast, with a floating charge, the borrower is able to deal with the assets that are subject to the charge, unless and until the charge crystallises.

Assets commonly made subject to a floating charge are:

- stock in trade (inventory) and
- book debts (receivables).

A company giving a floating charge over its stock in trade and book debts is free to use its stock (inventory) as it wishes, and to collect book debts without having to use the proceeds to pay off the debt. However, if the chargee enforces the charge, the floating charge '**crystallises**' and becomes a fixed charge over the present assets of the company that are in the class (or classes) of assets subject to the charge.

A floating charge may also apply more broadly, to the 'undertaking and its assets', not just to a specific class of assets.

It may not be immediately obvious, from the wording of the legal documentation for a charge, whether a charge is fixed or floating. In the case of a charge over book debts, the way to distinguish between the two is as follows:

- If the company is able to collect money from its customers (receivables) and use the money it receives in any way that it wishes, without reference to the chargee, the charge is a floating charge.
- If the company must use the money it obtains from its receivables to reduce the debt (for example, if there is an overdraft with a floating charge over the company's book debts), the charge is a fixed charge.

6.4 Crystallisation of a floating charge

The crystallisation of a floating charge changes the floating charge into a fixed charge over the present assets of the company that are in the class or classes of assets subject to the charge, at the time of crystallisation.

Events causing crystallisation include:

- the start of winding up of the company
- any event specified in the debenture agreement as something that will cause the charge to crystallise.

Example

KLO Limited arranges to borrow £250,000 from its bank. A condition of the loan is that the company should provide security in the form of a floating charge over the inventory and receivables of the business.

The floating charge does not attach to specific inventory or receivables, only to inventory and receivables as classes of assets. Provided that KLO Limited meets the requirements for making the payments on the loan, KLO Limited can trade normally, using and selling inventory, and using the money collected from receivables in its normal day-to-day business.

However, if KLO Limited fails to make a scheduled loan payment and is in default, the bank has the right to make use of its security. If it does this, the floating charge crystallises, and attaches to the inventory and the receivables that the company has at that time. The bank can then seek to obtain payment for the loan from those assets, for example by arranging for the inventory to be sold and the money collected for the receivables, and using the money so collected to repay the loan and any unpaid interest to the bank.

6.5 Advantages and disadvantages of floating charges

A floating charge has some advantages and some disadvantages, compared with a fixed charge.

Advantage

The main advantage of a floating charge is that the company can carry on its normal business without having to refer to the chargee for permission to dispose of assets such as stock in trade or book debts, and to use money that it receives from assets in the charged class to carry on its business.

This can also be a benefit to the chargee, whose only concern is that if the floating charge crystallises at some time in the future, the borrower will have sufficient assets in the charged class or classes to repay the debt.

Disadvantages of a floating charge

The main disadvantages of a floating charge are as follows.

- A company might give a different borrower a fixed charge over assets that are already subject to a floating charge. The holder of a fixed charge will usually have priority over the holder of a floating charge over the same assets, even if the floating charge was created first.
- A supplier might sell goods to a company on credit subject to the condition that the supplier retains the legal title to the assets until the supplier has received payment. (This is sometimes called a 'Romalpa clause', after a test court case on the subject.) Goods sold with a 'retention of title' agreement are not subject to a floating charge. If a floating charge over stock in trade crystallises, the chargee would not have any claim over them.

A lender with a floating charge might seek to protect the charge by including a **negative pledge clause** in the loan agreement. This is a condition of a loan whereby the borrower undertakes not to create a fixed charge over assets that would give the new charge priority over the floating charge.

6.6 Register of charges and registration of charges

Companies may be required by law to keep a record of the charges they have given over their assets.

- Charges **must** be recorded in a register of charges, which is one of the statutory registers that a company must maintain (s876 CA2006).
- Both fixed charges and floating charges must be registered with the Registrar of Companies within 21 days of being created (s860, s870 CA2006). Failure to do so invalidates the charge.

6.7 Priority of charges

Provided that all charges are properly registered by a company with the Registrar, they rank in the following order of priority in the event of a liquidation of the company for non-payment of its debts:

- Legal charges rank in the order (in time) in which they were created. So if a fixed charge over a building is created on 1 June and another fixed charge is created over the same building on 1 December, the charge created on 1 June takes priority over the charge created on 1 December.
- However, if a floating charge is created over an asset or class of assets, and a fixed charge is then created over the same asset or assets, the fixed charge takes priority over the floating charge. This is because a fixed charge attaches to the charged asset from the date that the charge is created, whereas a floating charge does not attach to the asset until the charge crystallises.

6.8 Personal guarantees for a loan to a company

A problem for lenders such as banks is that shareholders of a company are liable for the debts of the company only up to the amount of the share capital they have contributed. Provided that the shares are fully paid, a shareholder is not liable to make any further payment, even if the company goes into liquidation owing money to its creditors. For some creditors, such as banks who are asked to provide loans, this situation might leave them exposed to too much risk in the event of non-payment by the borrower.

A bank often has a considerable amount of influence over companies that want to borrow. In many cases, small companies rely on bank loans to provide them with finance to keep the business going. When a bank is in such a position of power or strength in relation to a borrowing company, it might be able to obtain a personal guarantee.

One or more personal guarantees may be sought by a bank when a company is owned by a small number of shareholders (or even just one shareholder), who also manage the company. The personal guarantee would be a promise to pay personally for any unpaid debts of the company, in the event that the company gets into default on its loan. For example, the owner-manager of a small company might give a personal guarantee for a loan of £50,000 to his company, and provide the equity on his own home as security for the guarantee.

A personal guarantee removes the protection of limited liability from any shareholder. The borrower has a right to claim any unpaid debts from the individual personally.

6.9 Conclusion: loan capital and share capital compared

When a company raises new finance, it has a choice between issuing new share capital and borrowing. Many factors influence the choice, mostly commercial and financial. However, legal factors may also affect the choice, and it may be useful to close this chapter by summarising the main legal differences between lending and 'equity' finance.

Share capital	**Loan/debenture**
Differences for the investor	
A shareholder is a member of the company, with rights such as voting rights.	A debenture holder is a creditor of the company.
Dividends are not an entitlement. Dividends are payable only if recommended by the directors. However, ordinary shareholders receive dividends from the distributable profits of their company after preference shareholders have been paid their dividends. When profits are rising, it is usual for ordinary dividends to be increased too.	Debenture holders are entitled to interest. The interest may be fixed (for example, with most debenture stock) or variable (for example, with bank lending). Entitlement to interest is not dependent on the company making a profit or having distributable profits. Failure by the company to pay interest or repay the loan principal is an act of default.
Share capital is usually permanent, not redeemable. However, some preference shares may be redeemable. A company might also give its directors power to purchase and cancel a quantity of its own shares, of any class.	Debentures are normally repayable at the end of a specified period of time.
Differences for the company	
A company pays dividends out of 'profits after tax'.	Interest is an expense. It is deducted as an expense in calculating profit before tax. Interest is an allowable expense for purposes of calculating the company's tax liability.
A company does not have to pay dividends.	Failure to pay interest within a period of time after the due date is an act of default.
Except in the case of redeemable preference shares, a company does not have to redeem its shares.	Most debt is redeemable.
	A company might be required to allow a lender to take a charge over its assets, as security for the debt. Charges must be registered.

CHAPTER 11

Directors and other officers. Company auditors

Contents

Separation of ownership and control: company directors

- Separation of ownership and control
- What is a company director and a company officer?
- Chairman and managing director
- Executive directors and non-executive directors
- Corporate directors
- Shadow directors

1 Separation of ownership and control: company directors

1.1 Separation of ownership and control

An important feature of a company is the **separation of the ownership from control of a company**. (This was described in a previous chapter.) A company is owned by its equity shareholders (ordinary shareholders) but it is controlled by its board of directors, who direct the company in the interests of the owners. There is a form of agency relationship between the directors and the shareholders, with the directors given powers to act in the interests of the company and its owners.

In some companies, such as many family-owned businesses and small companies, the directors may also be the main shareholders, or even the only shareholders. However, even with these companies, company law recognises the separation of ownership and control. Owner-directors carry out their duties as directors and exercise their powers as directors, even when they are also the company's shareholders.

1.2 What is a company director and a company officer?

A company is an artificial person, and cannot manage itself. Companies therefore have individuals to give it leadership and direction. This is provided by the board of directors. Most of the powers of a company are given to its directors by its articles of association.

Directors

The directors of a company do not have to be shareholders, unless there is a special requirement in the company's articles that they must be shareholders.

For the purpose of company law, a person is a director if he or she carries out functions that can only be done by a director, or attends board meetings of the company's directors. The word 'director' in a job title does not mean that a person is legally a director: for example, a 'human resources director' or an 'IT director' is not a director for the purpose of company law unless, for example, he or she attends meetings of the board of directors and joins in the decision-making processes of the board.

Company officers

A director is an officer of the company, carrying out duties on behalf of the company. The term 'company officer' is sometimes used in the Companies Act 2006 rather than 'director'. A company officer is a person representing the company and might be:

- a director
- the company secretary, or
- a manager who is not a director.

1.3 Chairman and managing director

The board of directors meet as a group (in board meetings) and take decisions as a group. The board is usually given the power by its articles of association to appoint one of their number as **chairman** of the board.

The role of the chairman is to provide leadership to the board, and to be in charge of meetings of the board of directors and general meetings of the company.

The articles of a company usually give the board of directors the power to appoint one or more of their number as **managing director**. (A managing director may be given the title of chief executive officer or CEO.) The managing director is the individual who leads the executive management team. Through the managing director, management powers are delegated to executive management.

The law does not define a managing director, and does not specify what the powers of a managing director should be. This is therefore a matter for negotiation or decision by the board of directors. A managing director is usually both:

- a director of the company, and also
- an executive officer of the company, employed by the company usually on a full-time basis.

The 'old' Table A articles of association included the following article relating to the appointment and dismissal of a managing director or any other executive director: 'Any such appointment … may be made upon such terms as the directors determine and they may remunerate any such director for his services as they think fit. Any appointment of a director to an executive office shall terminate if he ceases to be a director, but without prejudice to any claim for damages for breach of the contract of service between the director and the company.' In other words, if a managing director is removed from his office as a director he also loses his job as an employee of the company, but he is entitled to make a claim against the company for the breach of his contract of service as an employee.

1.4 Executive and non-executive directors

Directors may be executive or non-executive.

- An **executive director** is a director who also has executive management responsibilities in the company. For example, most companies have a finance director, who is an executive director. The managing director is also an executive director.

Most executive directors work full-time for the company, and may have a contract of employment, which makes them employees of the company (with rights as an employee provided by employment law). As employees, they receive a remuneration package that includes a salary. Executive directors report to the managing director in their role as executive manager. They are led by the chairman of the board in their role as company director.

- A **non-executive director** is a director who does not have any executive responsibilities in the company, and so is not a part of the management team. Non-executive directors, unlike most executive directors, are not full-time employees. They should receive a fee for their services, and not a salary or remuneration package. Executive directors and non-executive directors work together as 'colleagues' on the same board. **They have the same duties as directors, they share the same powers and responsibilities as directors**, and they are all involved in decision-making by the board.

Company law does not make any distinction between executive and non-executive directors. They are all directors, with the same duties and responsibilities, and potential liabilities.

Reasons for appointing non-executive directors

Non-executive directors are appointed for several reasons.

- They should be individuals with experience and expertise. Their views, based on their experience and knowledge, should help to improve the quality of decision-making by the board.
- They can act as a check or restraint on the power of the executive directors, particularly the managing director or CEO. For example, they should be able to prevent an all-powerful managing director and a small group of his executive director colleagues from running the company in their own personal interests. In this respect, they act as 'policemen' of the executive directors, and bring a 'balance of power' to the board.
- They might carry out certain tasks that are inappropriate for the executive directors. These may include, for example, acting as members of the audit committee of the board and the remuneration committee of the board (which decides the remuneration packages of the executive directors).

These reasons for appointing non-executive directors are not requirements of company law, but represent 'best practice' in corporate governance. Corporate governance is explained in more detail in a later chapter.

1.5 Corporate directors

A company, as a legal person, may be a director of another company. When this happens, the 'corporate director' is represented at board meetings by one of its officers, such as a director. For example, ABC Limited might be a director of DEF Limited, and ABC Limited might be represented by its chairman at board meetings of DEF Limited.

Company law allows corporate directors, but the Companies Act 2006 (s155) states that every board of directors must include at least one natural person. This means that every company will have in a position of responsibility at least one individual who, as director, can be held to account for the company's actions.

1.6 Shadow directors

Section 251 CA 2006 defines a shadow director. A shadow director is a person who has not been appointed as a director of the company, but who exerts strong influence over the directors. A shadow director is 'a person in accordance with whose directions or instructions the directors of the company are accustomed to act.'

A shadow director is therefore someone who is not 'officially' a director of the company but who in practice has authority over other directors such that he acts as if he were an actual director.

Some aspects of company law relating to directors apply equally to shadow directors. For example, shadow directors are equally liable as 'actual' directors if the company is trading wrongfully, under the provisions of s214 of the Insolvency Act 1986.

The concept of 'shadow director' was introduced into the Companies Act 1985 because it was recognised that a person who actually exercises control over a company may wish to evade their legal responsibilities as a director by 'hiding in the shadows' and avoiding an official appointment as director.

Individuals who work closely with the board of directors of a company, for example as consultants and advisers, need to be aware of the risk that they might be regarded in law as a shadow director if their influence becomes too great.

In normal circumstances, an individual is not a shadow director if he gives advice to the board of directors in a professional capacity, such as a professional solicitor or auditor or banker. Care needs to be taken, however, to avoid stepping outside the normal area of giving professional advice and providing professional services.

C

Case: The Secretary of State for Trade and Industry v Deverell [2001]

This case demonstrated that an individual could be a shadow director when he gives influential advice to a board of directors, even if the advice is not always accepted and acted on. The judge commented that it was not necessary for the influence of an individual to extend across the entire range of a company's affairs before he or she can be a shadow director. In addition, it was not necessary for the existence of a shadow director to prove that either the giver or receiver of advice believed that the advice would always be followed. It would be sufficient if an individual's advice was always considered for that individual to be regarded as a shadow director by the court.

C

Case: Re Tasbian Ltd (no 3) [1992]

In this case, a chartered accountant had acted as a consultant to a company. He assisted the board of directors and was a signatory for the company's bank account, so that the company could not spend any money without his consent.

The court held that it would be possible for a professional person, such as a chartered accountant acting in a consultant's capacity, to be regarded as a shadow director.

The appointment of directors

- First directors
- The number of directors: age requirement
- Appointment of subsequent directors
- Register of directors and secretaries
- Removal of directors: loss of office
- Company Directors Disqualification Act 1986
- Conduct that could lead to the disqualification of a person from acting as a company director

2 The appointment of directors

2.1 First directors

The first director or directors of a company are appointed when a company is formed. Company formation has been explained earlier.

2.2 The number of directors: age requirement

The law specifies a maximum or a minimum number of directors that a company must have.

- A private company must have at least one director.
- A public company must have at least two directors (s154 CA2006).

There is no legal maximum to the number of directors. However, the company's articles of association might specify:

- a minimum number of directors that is higher than the legal minimum, or
- a maximum number of directors.

The Companies Act 2006 introduced a requirement that a director who is a natural person must be at least 16 years of age.

Until April 2007, it was a requirement of the Companies Act 1985 that an individual could not be appointed as director of a **public company** (or as director of a private company that is a subsidiary of a public company) if he was 70 years old or more. This requirement was abolished by the Companies Act 2006.

2.3 Appointment of subsequent directors

After a company has been incorporated, it can appoint new directors, in addition to the existing directors or replace directors who leave the board. The procedures for appointing new directors should be specified in the company's articles of association.

The normal procedure for the appointment of directors by a **public company** (in standard articles of association) is as follows:

- Initially, a new director is appointed by the board of directors. This appointment lasts until the next annual general meeting of the company.
- At the annual general meeting following the director's appointment, the shareholders are asked to vote on a resolution to re-appoint him (or her).
- The articles of association of most public companies require each director to retire by rotation every three years, and each director must stand for re-election at the annual general meeting. This means that one-third of the board retires each year and stands for re-election. If the number of directors is not a multiple of three, the number who must retire and stand for re-election is taken to the nearest one-third. For example, if there are seven directors, two must retire by rotation each year, and if there are eight directors, three must retire by rotation. The directors who must stand retire and stand for re-election are those who have been in office for the longest time since their appointment or their most recent re-election.
- At the annual general meeting, the shareholders vote (by ordinary resolution) on a proposal to re-elect each director. There is a separate vote for each individual director. (The Companies Act 2006 includes a requirement that the appointment of directors in a public company must be voted on individually, s160.)
- The articles of association also normally include a provision that a shareholder can propose a person (or several persons) to be elected as director, by giving notice to the company in advance of the annual general meeting. The proposal will then be subject to a vote at the annual general meeting. This course of action might be taken by a shareholder who is dissatisfied with the current board of directors, and would like to appoint someone else.

Note: the appointment of directors in private companies

The appointment of directors in private companies is subject to the provisions of the articles of the company. In small private companies, there is no requirement for directors to retire by rotation and offer themselves for re-election.

2.4 Register of directors and secretaries

When directors are appointed, the appointment must be recorded. Details of their name, address, date of birth, nationality, and so on, must be entered in the company's statutory register of directors. The appointment must also be notified to the Registrar of Companies.

The requirement for a register of directors was described in an earlier chapter on company formation and constitution.

2.5 Removal of directors: loss of office

A director may resign from office at any time, for example because he wishes to retire.

In public companies, the articles of association usually provide that the directors must also stand for re-election by rotation at the annual general meeting of the company (as explained earlier). However, it is usual practice for directors to be re-elected when they retire by rotation and stand for re-election, and it is unusual for a majority of the shareholders to vote against a director's re-election.

Removal of a director by the shareholders

The articles of association of a company should also include a provision for the removal of a director from office, by a vote of the shareholders in a general meeting of the company.

The Companies Act also states that a director may be removed from office by an ordinary resolution of the members (s168 CA2006). This requires a simple majority vote at a general meeting. This course of action may be taken by shareholders who want the dismissal of a director, but the other directors on the board do not agree.

The shareholders wishing to put the proposal to a general meeting of the company must notify their intention to the company in advance of the meeting, giving notice of at least 28 days. (The director involved should receive a copy of the notice and should have the opportunity to speak at the general meeting.)

Loss of office

In practice, it is fairly common for an executive director to be dismissed from his job, by a decision of the rest of the board. When a director is dismissed, the dismissal is often called '**loss of office**'. The dismissed executive director will usually have a contract of employment and so will have rights under the employment legislation.

In practice, when a director is forced from office, he is asked to resign. If he agrees to resign, this avoids the need to go through the formal process of removing him from office.

It is usual for executive directors to negotiate terms of dismissal, such as compensation for loss of office. As a part of the negotiated settlement, the director will be required to resign from the office as director as well as losing his or her job.

Disqualification

An individual might not be permitted to act as a director of any company through disqualification.

2.6 Company Directors Disqualification Act 1986

The Company Directors Disqualification Act 1986 (CDDA 1986) allows the courts to disqualify certain persons from being a director as follows, for a period of up to 15 years.

The intention of the Act was to prevent individuals from making improper use of the company form.

Phoenix companies

One specific aim, for example, was to try to prevent individuals from setting up 'phoenix companies'. This is a company that is set up to 'rise out of the ashes' of an earlier company that has gone into liquidation, and that is normally given a name very similar to the previous company that had collapsed.

For example, Ted Smith might set up a company of plumbing engineers called Wetwater Limited, with himself as the only director. The company might go into liquidation in 2008 with many customer complaints unsettled and a large amount of unpaid debts. Ted Smith might then set up a new company, Wetwater [2009] Limited, a completely different company but trading as plumbing engineers, and with himself as the only director. If this company gets into trouble and goes out of business, he might then set up another company Wetwater [2010] Limited.

When this happens, it can be argued that the person acting as director of each phoenix company is misusing the company form, by escaping liabilities in the previous company and setting up a new company to carry on in the same kind of business.

2.7 Conduct that could lead to the disqualification of a person from acting as a company director

The CDDA 1986 identifies three categories of misconduct that could lead to the disqualification of a person from acting as a company director **of any company**, for a specified period of time.

- General misconduct in connection with companies
- Unfitness to act as director
- Other reasons.

General misconduct in connection with companies

General misconduct could be any of the following:

- A conviction for an offence in connection with the promotion, formation, management or liquidation of a company (section 2 CDDA 1986). A person convicted on a summary offence (in a magistrates' court) could be disqualified from acting as a director of any company for up to five years, and if he is convicted of a more serious offence on indictment (by a jury) he could be disqualified for up to 15 years.

- Persistent breaches of company law in relation to the requirements for filing returns, accounts or documents with the Registrar of Companies (section 3 CDDA 1986). A person who is proved to be in default of such requirements in three years out of five could be disqualified for up to five years.
- Fraud in connection with the winding up of a company (section 4 CDDA 1986). The court may make a disqualification order **if it appears that** the individual has been guilty of fraud or a party to fraud in a winding up. The maximum period of disqualification on these grounds is 15 years.

Unfitness

The court **must** disqualify someone from acting as the director of any company for a period of between 2 years and 15 years if he is judged 'unfit' to be a director. This may happen when:

- he was the director of a company that became insolvent and the court found him to be unfit to be a director, or
- the court makes a disqualification order following an investigation of the company under companies' legislation (s6 CDDA 1986).

C

Case: Re Uno, Secretary of State for Trade and Industry v Gill [2004]

In this case, the Secretary of State applied to the court for the disqualification of a director on the grounds of unfitness.

A furniture company, Uno, had continued to trade whilst in severe financial difficulties. It had continued to accept deposits from customers, to secure orders that were never met before the company collapsed and went into liquidation.

The directors of the company had been advised that they could protect the deposits of the customers by putting it into a trust fund, but they rejected this advice because they needed the money to keep the business going. It was claimed that this decision showed that the individuals were unfit to act as directors.

The court refused the application for disqualification. It considered that in order to issue a disqualification order, there must be evidence of dishonest behaviour or unethical business behaviour, and this behaviour should also be such as to make the individual unfit to be a director. In this case, the directors had pursued realistic opportunities to keep the company in business, and just because their honest efforts had failed did not mean that they were unfit to be company directors.

Other reasons for disqualification

Other reasons specified by the CDDA 1986 for the disqualification of an individual from acting as a director are:

- the individual was involved in fraudulent or wrongful trading by a company under the Insolvency Act 1986
- the individual is an undischarged bankrupt

- the individual has failed to pay a county court administration order.
- The legislation also applies to undischarged bankrupts and those required to contribute to the company's assets following wrongful or fraudulent trading.

The nature of a disqualification order

When an individual is disqualified under the CDDA 1986, he is prevented (unless the court gives permission otherwise) from acting:

- As a director of a company
- As liquidator or administrator of a company (in a case of insolvency)
- As receiver or manager of a company's property (also in a case of insolvency)
- In any way, directly or indirectly, in connection with the promotion or formation of a company.

Except in the case of unfitness to act, the court has discretion in deciding whether or not to make a disqualification order against an individual.

Breach of a disqualification order is a criminal offence, with a penalty of imprisonment and/or a fine.

The powers and duties of company directors

- Powers of the board of directors
- The authority of individual directors: express, implied and apparent
- Duties of directors
- Duty of care and skill
- Fiduciary duty
- Breach of fiduciary duty
- Material personal interest in contracts with the company
- Statutory general duties of directors in the Companies Act 2006
- Statute law and other duties of directors

3 The powers and duties of company directors

3.1 Powers of the board of directors

The directors are given most of the powers to run their company. These powers are given by the company's articles of association.

- Standard articles of association state that the board of directors may exercise 'all the powers of the company'.
- The default model articles for a public company under CA2006 state that: 'Subject to the Companies Acts and the articles, the directors shall manage the company's business and may exercise all the powers of the company for any purpose connected with the company's business.'

These powers are given to the board of directors as a whole, not to individual directors. Individual directors cannot use powers to bind the company (for example, to commit the company to a contract agreement) unless they have been authorised to do so.

Delegation of powers

The company's articles of association will also usually provide for the board of directors to delegate some of their powers. When a managing director is appointed, the powers necessary for the day-to-day running of the company are delegated to him. The managing director will then delegate powers to other executive directors and to other members of the management team.

It is therefore usual for the powers of management of a company to be exercised as follows:

- Some decisions are reserved for the board of directors, who take decisions collectively, usually in board meetings. Some decisions **must** be taken by the board of directors, such as approving the annual accounts and recommending a dividend to the shareholders.

- Other decisions are taken by managers of the company, including executive directors, who report to the managing director (or chief executive officer). The managing director is accountable to the board of directors for the activities and performance of the managers of the company.

Although the law specifies some decisions that must be taken by the board of directors collectively, it does not provide a comprehensive list of decisions that must be 'reserved for the board'. For example, the law does not specify that the board of directors must agree the major strategies for the company, or should approve major items of capital expenditure. In practice, however, decisions of this nature are usually taken by the board as a collective unit.

It is recommended, as a matter of good corporate governance, that the board of directors should specify a list of matters for which decisions must be taken by the board, and should not allow individual directors or executive managers to make these decisions.

The model articles for a public company under the Companies Act 2006 make fairly specific provisions for delegation of power by the board of directors.

- Subject to the articles of association, the directors may delegate any powers and responsibilities to 'such persons, by such means, to such an extent, in relation to such matters or territories and on such conditions or subject to such restrictions as they think fit.'
- Where the directors have not delegated power to a single director, but have reserved the matter for a board decision, the directors must not take any action in relation to such a matter unless they have taken a collective decision at a board meeting or by a directors' written resolution, in accordance with the articles.

3.2 The authority of individual directors: express, implied and apparent

Actual authority: express and implied

The director of a company might enter an agreement with another person, acting in the name of the company. The company's constitution (articles of association) gives the directors the **express authority** to enter agreements (contracts) that bind the company. A board of directors might take a decision to give an individual director the authority to bind the company in a particular way or for a particular purpose.

Although an individual might not have express authority, **authority might be implied** from the nature of the director's activities, or from the circumstances. For example, it would normally be appropriate for a third party to believe that a managing director has the authority to bind his company to a contract, because this authority can be implied from the role of managing director. Implied authority may exist when express authority has not been given.

Case: Watteau v Fenwick [1893]

This case was described in an earlier chapter on agency (since the directors act as agents for their company).

Fenwick was the owner of a hotel who employed its previous owner as the hotel manager. Fenwick had forbidden the hotel manager to buy cigars on credit, but the manager disobeyed this instruction, and did buy cigars on credit for the hotel, from Watteau.

Watteau sued Fenwick for payment. Fenwick argued in court that he was not bound by the contract, because his manager did not have the actual authority to buy the cigars.

The court disagreed with Fenwick. It decided that it was within the normal authority of a hotel manager to buy cigars on credit. This implied authority should be treated as actual authority. Fenwick was bound by the contract because the limit on the usual authority of the hotel manager had not been communicated to Watteau.

Express authority and implied authority together represent the actual authority of a director or manager.

Directors may therefore have either express or implied authority because of the position they hold in the company. Directors bind the company when they make agreements with other persons, if they act with either express or implied authority.

The standard articles of association allow the board of directors to appoint a managing director and also to delegate powers to the managing director. A managing director may therefore have the actual authority to bind the company to agreements with other persons. However, even if the managing director has not been given the actual authority, outside persons can assume that he does have the authority to bind the company to agreements that are usually within the responsibility of a company's managing director.

For example, suppose that a managing director orders a quantity of computers from a supplier, stating that he is a director of the company. The supplier can assume (unless there is information to the contrary) that the managing director has the authority to order the computers. The company will therefore be bound to accept the computers when they are delivered, and to pay for them. It does not matter whether the managing director had the actual authority to buy the computers, or only apparent authority.

Example

The board of directors might decide that appointments to senior management positions below board level should be agreed by the board. The managing director may, however, offer a senior management job to an individual who accepts it. Even though the managing director did not have the authority to offer the job, his action binds the company because it is a responsibility usually delegated to managing directors. The board of directors must therefore either accept the appointment, or if they decide to cancel the offer, the company will be liable to the appointed individual for a breach of its agreement.

Ostensible authority (apparent authority)

In addition to having actual authority (express or implied), an individual may also have ostensible authority, also called apparent authority. When an individual has ostensible authority, this is wider than (or in addition to) either express or implied authority.

Ostensible authority exists when a company (or its owners or officers) allow a third party to believe that an individual has authority to bind the company, even when actual authority (express or implied) does not exist. The individual appears to have authority in excess of what can normally be implied.

If a company allows a person to behave with ostensible authority, it must be bound by obligations entered into by the individual who uses that authority.

C

Case: Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd [1964]

This case was also described in the earlier chapter on agency.

Two individuals, K and H, owned a property development company in equal shares. They were directors of the company, together with two other individuals they had appointed, making four directors in total. However, H lived abroad.

As a director of the company (and not the managing director) K did not have actual authority (express or implied) to bind the company to certain contracts. However, he made contracts as if he were a managing director. The other directors were aware of what K was doing, but had not authorised his activities.

The plaintiffs brought a case against the company in relation to contracts entered into by K. The company claimed that it could not be held liable for contracts entered into by K without authority.

The court decided that although K had not been given express authority, and though implied authority did not exist either, the company – by its mere acquiescence in allowing K to make the contracts – had led the third parties to believe that K did have actual authority. The court therefore ruled that the company was bound by the contract entered into by K and was forbidden ('estopped') from denying that K was an agent of the company. K did not have actual authority, but he had ostensible authority.

3.3 Duties of directors

Directors have certain duties towards their company. Until the implementation of the Companies Act 2006, the legal duties of directors to their company were defined by common law. The common law duties that directors owe to their company are:

- a duty of care and skill, and
- a fiduciary duty.

Similar general duties of directors have now been introduced into statute law by the Companies Act 2006.

Many of the statutory duties in the Companies Act 2006 are based on the common law concepts of duty of care and fiduciary duty. These common law duties will be explained before going on to consider the statutory duties under CA2006.

3.4 Duty of care and skill

The directors owe a duty of care and skill to the company. This is a duty that is owed in common law and is also a statutory general duty under the Companies Act 2006. A duty of care and skill means that a director must not act negligently in his task of directing the company. However, the test of whether a director has shown sufficient care and skill is not strict, and the law does not place a heavy burden on directors.

The duty is not high, and the standard of care and skill was established in a legal case *Re City Equitable Fire Insurance Co* (1925). The judge in this case stated that:

- The common law did not establish a minimum standard of care and skill. The standard expected should depend on the individual and the situation, and will vary according to circumstances. A director is simply expected to show the degree of skill that might reasonably be expected from a person of his or her experience and knowledge.
- A director is not expected to give continuous attention to the affairs of the company. The duties of a director are of an 'intermittent nature' and performed at board meetings. A director ought to attend board meetings when he or she is able to, but attendance at all board meetings is not a requirement.
- Unless they have reasons for suspicion, directors are entitled to leave the day-to-day management of the company to the managers, and trust them to perform their tasks 'honestly'.

The standard of duty of care and skill is higher when a company is insolvent or is about to become insolvent. In these circumstances, directors could be personally liable to make a contribution to paying the debts of the company if they allow the company to continue trading. Wrongful trading (and fraudulent trading) is explained later.

C

Case: Dorchester Finance Co Ltd v Stebbing [1989]

The company was a money-lending company with three directors. Two of these, Parsons and Hamilton, were chartered accountants but they left the running of the company to the other director, Stebbing. Parsons and Hamilton visited the company occasionally, when they would sign blank cheques drawn on the company's account, for Stebbing to use.

Stebbing made loans for the company, but because he failed to comply with the statutory regulations the loans were unenforceable by the company.

The company brought an action against the directors for negligence. Parsons and Hamilton claimed that as non-executive directors, they could not be held negligent. The judge commented, however, that: 'For a chartered accountant… to put forward the proposition that a non-executive director has no duties to perform I find quite alarming.'

It was held that all three directors were negligent.

3.5 Fiduciary duty

Directors are in a position of trust in their company, because they make contracts as agents of the company and have control over the company's assets. They therefore have a fiduciary duty to the company. This fiduciary duty is owed to the company, not to the company's shareholders.

If a director is acts in breach of his fiduciary duty, legal action can be taken against him, **in the name of the company**, by either the other directors, or by some of the shareholders. If the director is judged by the court to be in breach of his fiduciary duty, he might be required to compensate the company for any loss it has suffered, or account to the company for any profit that he has made.

The fiduciary duty of directors often relates to matters such as:

- the allotment of shares
- borrowing, and giving security for loans
- refusing to register a transfer of shares
- calling (or not calling) a general meeting of the company and failing to circulate information to shareholders
- conflicts of interest.

C

Case: Percival v Wright [1902]

The plaintiffs were shareholders in a company who wanted to sell their shares. They spoke to the board of directors, and three directors bought the shares. The plaintiffs then found that the directors had been negotiating the sale of the company at a much higher price per share.

They brought an action for the sale of the shares to be set aside. One of the arguments was that the directors were in breach of their fiduciary duty.

The court decided against the plaintiffs, who had conceded that the transaction in their shares had not been at an undervalue. The court held that the fiduciary duty of the directors was to the company, not to the shareholders, and the shareholders could not claim that the directors were in breach of their fiduciary duty in their dealings with them.

3.6 Breach of fiduciary duty

There are three main tests of whether a director is in breach of his fiduciary duty:

- Is the action taken by a director honest and sincere ('bona fide' or 'in good faith')? Directors must act in a way that they believe is in the best interests of the company.

- Is the transaction reasonably incidental to the business of the company? Directors must not use their powers for purposes that have nothing to do with the purpose of the business.
- Has the director used his powers for the purpose for which they were given to him?
- Has the director acted in the best interests of the company, or has he allowed a conflict of interests to arise?

Cases involving a claim that directors have not acted in the bona fide interests of the company often relate to the power of the directors to issue new shares in order to prevent or support a takeover of the company.

C

Case: Howard Smith Ltd v Ampol Petroleum Ltd [1974]

One company in this case was expecting to receive a takeover bid from the other. Shareholders owning 55% of the shares in the company that was the target for the bid indicated their intention to vote against the takeover. The directors considered that the bid and the takeover would be in the best interests of the company, because the bidder, if successful, intended to invest more capital in the business. The directors therefore allotted new shares to the prospective bidder, so that the shareholders opposed to the bid would be in a minority, and the takeover bid could succeed.

It was argued in court that the directors were in breach of their fiduciary duty. The court agreed with this view. The court decided that the allotment of the new shares by the directors was void, because the directors were in breach of their fiduciary duty by taking action to turn a majority shareholder group into a minority. They had used their powers for a purpose that was not one for which the powers had been given to them.

(***Note***: There is an overlap between the directors of a company being in breach of their fiduciary duties and the rules on protection of minority shareholders. The protection of minority shareholders is explained in another chapter.)

Conflicts of interest: personal advantage and secret profit

Individual directors owe a fiduciary duty to avoid a conflict of interest between their duty to the company and their personal interests. A director must not obtain any personal advantage or profit from his position as director without the company's consent. (The company's consent should be obtained from the shareholders). In other words, directors must not make a secret profit from their position as a director.

- If a director expects to make a profit or obtain an advantage from his position as a director, he must account to the company for any profit that he makes – in other words, he must hand the profit to the company – **unless** he discloses all the relevant facts to the company's shareholders and obtains their formal approval for his actions. If he obtains the approval of the shareholders for making the personal profit, he can keep it.

- If a director commits the company to a contract, where the director will make a personal profit, and the director has not obtained the shareholders' consent, the contract is voidable but not void. This means that the company can choose to declare the contract void, but it is not automatically void.

C

Case: Industrial Development Consultants Ltd v Cooley [1972]

Cooley was the managing director of a company that provided consultancy services to Gas Boards. One Gas Board decided that it would not use the company for consultancy services. Cooley learned, however, that if he acted personally, the Gas Board might be willing to give the consultancy work to him. He informed his fellow directors that he was ill, and persuaded the company to release him from his contract of employment. On ceasing to be a director of the company, Cooley applied for the consultancy work with the Gas Board, and was given the work. His former company sued him to recover the profits from the contract.

The court decided that Cooley was accountable to his former company for the secret profit that he had made. The profit had arisen from his former position as managing director of the company.

C

Case: Regal (Hastings) Ltd v Gulliver [1967]

In this case, the company owned a cinema and had an opportunity to acquire two more cinemas for £5,000, through a subsidiary company that would be formed with £5,000 of share capital. However, the company had just £2,000 to invest. The directors and their friends therefore subscribed for £3,000 shares in the subsidiary, to make up the £5,000 needed.

The chairman of the company did not subscribe for any of the shares in the subsidiary for himself, but did subscribe on behalf of other beneficiaries (as a nominee). The company's solicitor also subscribed for some of the shares.

The company and its subsidiary now owned three cinemas, which were then sold to another buyer. The sale resulted in a profit of £2.80 per share on each of the shares in the subsidiary company. The directors had therefore made a personal profit by subscribing for the shares.

The new owner of the companies brought a legal action against the directors and the solicitor, claiming payment to the companies of the personal profit they had made on the sale.

The court reached the following decision.

- The directors who had made a personal profit had done so without permission of the shareholders. The opportunity to make the profit had come to them in their position as directors of their company. They were in breach of their duty, and had to account to the company for the profit they had made.
- It did not matter that if they had not subscribed the £3,000, the company would have been unable to acquire the two cinemas.

- The directors would have been able to keep their profit if they had obtained the approval of their shareholders, but they had not done so.
- The chairman, however, was not accountable to the company for the profit on the shares that he had obtained, because he was not the beneficial owner of the shares and so had not made a personal profit.
- The solicitor was not accountable to the company for the profit on his shares, because he was not a director of the company. The rule that directors should account to the company for secret profits does not apply to a company's solicitors.

3.7 Material personal interest in contracts with the company

In the previous examples, the directors made a secret profit from transactions in which the company was not directly involved. A different situation arises when a director has a material (significant) personal interest in a **transaction with the company**.

Requirement to disclose interests in contracts

Section 182 CA2006 states that if a director has any interest in a contract or proposed contract with the company, he has a duty to disclose this interest to the other directors. Failure to notify the other directors will make him liable for a fine.

A declaration of interest may relate to a specific contract, but it is sufficient for a director to give a general notice about his interest in another company. The other directors are then expected to remember this interest in the future.

The interest must be disclosed at the board meeting where the contract is considered by the board, or at the first board meeting following the date when the director acquired his interest. Alternatively, the disclosure can be given by:

- notice in writing to the board about the interest, or
- or as a general notice to the board about an interest in another company or a connection with another person

A director who fails to disclose an interest to the board is liable to prosecution for breach of the criminal law, and a fine if found guilty.

This Companies Act requirement is a requirement to **disclose** an interest. It does not prohibit a director from having any such interest.

Directors' interests in contracts with the company: articles of association

Standard articles of association allow a director to have a material personal interest in a transaction **provided that** he discloses this interest to the **other directors** and they give their consent. If a director has disclosed his personal interest in a transaction with the other directors, and the other directors have approved:

- he may be a party to a contract with the company, or

- he may be a director or employed by another company that is a party to a contract with the company, and
- he will not be required to account to the company for any profit or benefit that he makes from the transaction.

Failure to disclose an interest in a contract with the company makes the contract voidable, which means that the company can choose to declare the contract void (but it is not automatically void). The company can also seek to hold the individual director to account for any profit that he or she has made on the contract.

Example

As a consequence of this rule, an individual director can enter into a contract of employment with the company (as a party to the contract of employment) with the consent of the other directors, and:

- without the need to obtain the shareholders' approval in a general meeting of the company and
- without having to account to the company for his salary and other remuneration benefits.

The standard articles of association include a rule that a director cannot vote at a board meeting on a matter in which he has a personal interest.

3.8 Statutory general duties of directors in the Companies Act 2006

The duty of care and fiduciary duty of directors in common law and equity have been introduced into statute law by the Companies Act 2006 (sections 171 – 177). These statutory general duties consist of a duty:

- to act within their powers (s171)
- to promote the success of the company for the benefit of its members (shareholders) (s172)
- to exercise independent judgement (s173)
- to exercise reasonable care, skill and diligence (s174)
- to avoid conflicts of interest, unless permission is given by the company (s175)
- not to accept benefits from third parties (s176)
- to declare any personal interest in a proposed transaction with the company (s177).

The consequences of any breach of these rules will be to make the director liable in civil law in the same way as for breaches of the common law.

Duty to act within powers

A director must act within his powers in accordance with the company's constitution, and should only exercise his powers for the purpose for which they were granted. However the legal position remains that if a director acts outside his powers in making a contractual agreement with a third party, the company is bound by the action of its agent and is liable for any contractual obligation to the third party, provided that the third party has acted in good faith.

Duty to promote the success of the company

A director, in good faith, must act in the way he considers would be most likely to 'promote the success of the company for the benefit of its members as a whole'. The Companies Act does not define 'success', but the term is likely to be interpreted as meaning 'increasing value for shareholders'. However, the Act also states that in acting to promote the success of the company, a director must also have regard, amongst other matters, to:

- the likely long-term consequences of any decision
- the interests of the company's employees
- the need to foster the company's relationships with its customers, suppliers and others
- the impact of the company's operations on the community and the environment
- the desirability of the company maintaining its reputation for high standards of business conduct, and
- the need to act fairly as between members of the company.

The Act does not create a duty of directors to anyone other than the shareholders (members) of the company, but directors are required to give consideration to interests of others, such as employees, customers, suppliers and the community.

Section 172(3) of the Act states that this duty to promote the success of the company is subject to any legal requirement of the law that requires directors, in certain circumstances, to consider or act in the interests of the creditors of the company.

This aspect of directors' duties has given rise to some concerns that directors will need to create a 'paper trail' to provide evidence if required in a court of law to show that they have given due consideration to the interests of other stakeholders in their decision-making, although the government has denied that this is intended by the Act.

It has also been suggested that this statutory duty may be fulfilled for quoted companies by the legal requirement to include a narrative business review in the annual report and accounts, which should discuss the company's policies (and their effectiveness) with regard to employees, the environment and social and community issues.

Duty to exercise independent judgement

A director must exercise independent judgement. However, this requirement does not prevent a director from acting in a way authorised by the company's constitution (for example, accepting resolutions passed by the shareholders in general meeting) or from acting in accordance with an agreement already entered into by the company that prevents the director from using discretion.

Duty to exercise reasonable care, skill and diligence

This is similar to the common law duty of care.

Duty to avoid conflicts of interest

A director has a duty to avoid conflicts of interest. However, this duty is not breached if the director declares the interest to the board of directors and the interest is authorised by the rest of the board.
The Companies Act 2006 recognises three situations in which a conflict of interests may arise.

(1) A conflict of interest may arise in a situation where the company is not a party to an arrangement or transaction, but where the director might be able to gain personally from 'the exploitation of any property, information or opportunity.' For example, a director might pursue an opportunity for his personal benefit that the company might have pursued itself.

(2) A conflict of interest may arise in connection with a proposed transaction or arrangement to which the company will be a party. If a director has a personal interest in any such transaction or arrangement, he must disclose his interest to the board of directors before it is entered into by the company. An example would be a proposal to acquire a target company in which a director owns shares.

(3) A third type of conflict of interest arises in relation to existing transactions or arrangements in which the company is already a party. It can be a criminal offence for a director not to make or update his declaration of interest in an arrangement or transaction to which the company is a party.

Duty not to accept benefits from third parties

A director must not accept benefits from a third party unless they have been authorised by the shareholders or unless they cannot reasonably be regarded as giving rise to a potential conflict of interest. In practice many listed companies already have strict internal policies on the acceptance of gifts and corporate hospitality, especially from other companies that are or might be about to tender for business with the company. An internal policy might include a requirement for a director to obtain clearance from another director before accepting any such benefits.

Duty to declare interests in proposed transactions with the company

This duty is linked to the duty relating to conflicts of interest. A director must declare the nature and extent of his interest to the other directors, who may then authorise it.

Consequences of a breach of the general duties

A director owes his duties to the company, and if the director is in breach of his duties only the company can bring a legal claim against him. In practice, this has usually meant that the rest of the board of directors might bring an action against a fellow director in the name of the company.

The 2006 Act states that the consequences of a breach of a director's general duties are the same as if the corresponding common law rule or equitable principle applied, but it does not set out in detail what these consequences should be.

Derivative claims for breach of general duties

In addition the Act also introduced a procedure whereby individual members of the company can bring a legal action for a **'derivative claim'** against a director. A derivative action may be brought in respect of 'an actual or proposed act or mission involving negligence, default, breach of duty or breach of trust by a director of the company.' A shareholder would have to bring the action against a director in the name of the company, and if the action is successful the company and not the individual shareholder would benefit.

The procedures for bringing a derivative action are set out in sections 260–269 CA2006. They include safeguards designed to prevent individual shareholders from bringing actions that are not reasonable on the basis of the *prima facie* evidence. Even so, there is a possibility that in future legal actions against directors might be brought by shareholders under the derivatives claims procedure for breach of their general duties.

3.9 Statute law and other duties of directors

Apart from the rules dealing with disclosure of interests in contracts, the Companies Act includes other regulations relating to directors and their dealings with the company. Some of these regulations are listed below.

- **Substantial property transactions involving directors** (s190 CA2006). A company must not enter into a substantial property transaction with a director or a shadow director unless it has been approved by the shareholders, by passing an ordinary resolution at a general meeting of the company. Any substantial property transaction with a director that is made without shareholder approval can normally be made voidable by the company. A substantial property transaction is defined as any transaction of a value in excess of £100,000 or 10% of the company's net assets, whichever is lower. (Transactions of less than £5,000 are ignored.)
- A **company cannot make a loan to a director** or shadow director (or to a connected person of the director, such as a husband/wife or a child). There are a number of exceptions to the general rule.
  - One of these is that loans below £10,000 are permitted, which means for example that a company can give a loan to a director to buy a season ticket for travelling to and from work each day (provided that the ticket costs less than £10,000).
  - A company may lend money to a director to assist him in the performance of his or her duties. For example, if the director has to move home from one part of the country to another, the company can assist with a bridging loan. However, such financial assistance cannot exceed a certain limit (£50,000).
  - Another exception is that loans may be made by the company on proper commercial terms in the ordinary course of its business. For example, a bank can lend money to a director in a normal lending transaction. (There is no ceiling on the size of such loans.)

Company secretary

- Requirement to have a company secretary
- Duties of a company secretary
- Appointment of a company secretary
- Powers of a company secretary

4 Company secretary

4.1 Requirement to have a company secretary

A company secretary is an officer of the company (together with the directors).

Under the provisions of the Companies Act 1985, every company was required to have a company secretary. However, the Companies Act 2006 abolished the requirement for **private companies** to appoint a company secretary. 'A private company is not required to have a secretary' (s270 CA2006). Private companies are able to choose whether or not to have a company secretary.

If a private company chooses not to have a company secretary, the directors must ensure that the duties that a company secretary would have performed are properly carried out by someone else.

The requirement for a **public company** to have a company secretary continues. 'A public company must have a secretary' (s271 CA2006).

4.2 Duties of a company secretary

The duties of a company secretary are decided by the board of directors, and vary from one company to another. In general terms, a company secretary usually has:

- some administrative responsibilities
- responsibilities for assisting the chairman of the board
- responsibilities for ensuring compliance with some aspects of company law, such as the requirements to provide information to the Registrar of Companies and to maintain the company's statutory registers
- responsibilities associated with corporate governance practices.

The list of the duties of a company secretary will usually include the following:

- Assisting the chairman of the board to arrange board meetings, for example by sending papers to the directors in advance of meetings, attending these meetings and preparing the minutes of the meetings
- Assisting the chairman of the board to arrange general meetings of the company, attending these meetings and preparing the minutes of the meetings.
- Helping to ensure that the committees of the board function properly.

- Maintaining the statutory registers.
- Providing statutory information to the Registrar of Companies.
- Signing official documents on behalf of the company, if permitted to do so by company law.
- Keeping under review all legal and regulatory developments that might affect the company's operations, and making sure that the directors are informed about them
- For listed companies, ensuring that the company complies with the regulations of the financial services regulator (which in the UK is the Financial Services Authority).

In practice, the duties of the company secretary include some important executive tasks. For example, the company secretary might have the responsibility for arranging all the company's insurance policies.

4.3 Appointment of a company secretary

It is usual for the company's articles of association to give the board of directors the power to appoint and dismiss the company secretary, and fix his or her term of office and remuneration. The company secretary is therefore normally appointed by the board of directors.

The directors of a **public** company must ensure that the company secretary has the necessary knowledge and experience to carry out his or her functions properly (s273 CA2006). The law specifies what should be considered evidence of necessary qualifications and experience. This includes:

- membership of an appropriate professional body, such as the ACCA, or
- qualification as a barrister in the UK, or
- having held the position of company secretary in a public company for at least three of the past five years before his or her appointment.

A director may combine the roles of director and company secretary, provided that he has the qualifications to be company secretary. (However, it is considered poor corporate governance for the role of company secretary in a listed company to be an executive director with other executive responsibilities.)

4.4 Powers of a company secretary

The law recognises that a company secretary has the power to enter certain contracts on behalf of the company, and the company will therefore be bound to honour its obligations under these contracts. However, the contracts must relate to matters that would seem to be within the area of responsibility for a company secretary.

In the case *Panorama Developments Ltd v Fidelis Furnishing Fabrics Ltd* (1971) the court decided that a company secretary is 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 secretary.'

A company secretary cannot enter contracts on behalf of the company where the matter is clearly outside his or her area of responsibility. For example, without the authority of the board of directors, a company secretary should not be able to borrow money on behalf of the company, or start litigation in the name of the company.

Case: Panorama (Developments) Guildford Ltd v Fidelis Furnishing Fabrics Ltd [1971]

In this case, the court held that a company was bound to pay for the hire of cars by the company secretary, apparently for use by the company, even though the cars were actually hired by the secretary for his own personal use.

Auditors and company audits

- The purpose of the annual audit
- The appointment of auditors
- Qualification of auditors
- The auditors' report
- Duties of auditors
- Rights of auditors
- Remuneration of auditors
- Offences in connection with the auditor's report
- Removal of auditors
- Resignation of auditors
- Statement by a person ceasing to be auditor
- Rights of resigning auditors

5 Auditors and company audits

5.1 The purpose of the annual audit

The purpose of the annual audit of a company's financial statements by external auditors is to provide reassurance about the reliability of the information contained in the company's annual financial statements.

The external auditors prepare a report for the company's shareholders, which is included in the annual report and accounts. The audit report states whether, in the opinion of the auditors, the financial statements provide a fair representation (or give a 'true and fair view') of the financial performance of the company during the year and of the financial position of the company at the end of the year.

In addition to providing reassurance to the company's shareholders, the audit report may also be of some assistance to creditors of the company and potential investors in the company.

5.2 The appointment of auditors

Companies are required to appoint auditors for each financial year (s485 and s489 CA2006). An exception to this rule is that private companies do not need to appoint auditors for each financial year if the directors consider that audited accounts are unlikely to be required for that year.

The first auditors will be appointed by the directors. The appointment of the auditors lasts from the end of the general meeting to the end of the next general meeting at which the report and accounts for the next financial year are laid. In other words, the appointment is for one year. The auditors should therefore be appointed or re-appointed annually.

There are some exceptions to this general rule.

- Dormant companies are not required to appoint auditors. Dormant companies are companies that have not traded at all, and meet the regulatory requirements for recognition as a dormant company.
- Some small private companies are exempt from the requirement to have an annual audit, so they do not have to appoint auditors.

Re-appointment of private company auditors: Companies Act 2006

Under the provisions of the Companies Act 2006 private companies are not required to hold an annual general meeting (AGM).

The appointment of the auditors for a private company that does not hold an AGM will run from the end of a 28-day period following the circulation of the annual accounts to shareholders and last until the end of the corresponding period the next year.

If no auditor has been appointed by the end of this period, the current auditors are deemed to be re-appointed for the next financial year (without the need for a formal re-appointment), unless the articles of the company actually require formal re-appointment or the members vote to prevent a deemed re-appointment of the auditors.

There is an exception to this rule. The shareholders of a private company may vote to dispense with the requirement to appoint auditors annually, in which case the auditors are deemed to be re-appointed each year.

(***Note***: The legislation sometimes uses the word 'auditor' in the singular form and sometimes the plural 'auditors'. It will probably help to think in terms of the legislation applying to a firm of auditors.)

5.3 Qualification of auditors

An auditor must be a member of a recognised supervisory body (RSB) and authorised by that body to carry out audits. In the UK, RSBs are:

- the Institute of Chartered Accountants in England and Wales (ICAEW)
- the Institute of Chartered Accountants of Scotland (ICAS)
- the Institute of Chartered Accountants in Ireland (ICAI)
- the Association of Chartered Certified Accountants (ACCA)
- the Association of Authorised Public Accountants.

These bodies may authorise their members to carry out audits.

Certain people are specifically excluded from being able to carry out an audit of a company, notably an officer or employee of the company or another company in the same group.

5.4 The auditors' report

The auditors are required to make a report to the company's shareholders on the annual accounts that are laid before the company in general meeting during the term of their appointment. The auditors' report **to the shareholders** is included in the company's annual report and accounts.

The auditors' report must state whether, in their opinion, the financial statements give a fair representation (or a 'true and fair view') of the company's financial performance during the period and its financial position as at the end of the period (s495 CA2006).

The auditors should also consider whether the information contained in the directors' report to the shareholders is consistent with the accounts.

In the case of quoted companies, which are required to include a directors' remuneration report in their annual report and accounts, the auditors must also consider whether the part of the directors' remuneration report that is subject to audit has been prepared properly.

The auditors' report must state the name of the auditor, and must be signed by him. Where the auditor is a firm, the report must be signed by an auditor of the firm. The Companies Act requires that the audit report must be signed by the 'senior statutory auditor' of the firm in his own name for and on behalf of the audit firm (s503 CA2006).

5.5 Duties of auditors

Duties of auditors relating to the preparation of the audit report

When preparing their report, the auditors are required to carry out investigations that will enable them to form an opinion about the following matters:

- whether the company has kept proper accounting records
- whether the financial statements of the company are consistent with the accounting records.

If they reach the opinion that the company has not kept accounting records, or that the financial statements are not consistent with the accounting records, the auditors must state this in their report.

If the auditors fail to obtain the information or explanations they need to form an opinion, they must state this in their report.

Other duties of auditors

Company law places some other duties on the auditors. For example:

- When a public company intends to issue shares in return for a non-cash consideration (consideration in kind) , a valuation report must be prepared by a person who is qualified to be an auditor of the company (s596 CA2006). This will often mean in practice getting the company's auditors to carry out the valuation.

- When a private company proposes to purchase its own shares out of capital, there is a requirement for a statement on the company's financial postion by the directors and a report on the statement by an auditor of the company (s714 CA2006).

5.6 Rights of auditors

The auditors have the right of access to the company's accounting records and documents, and are entitled to ask officers of the company for any information or explanations that they consider necessary for carrying out their audit tasks.

It is a **criminal offence** for an officer of the company (a director, the company secretary or a manager) to give misleading, false or deceptive information to an auditor. A person found guilty of this offence is liable to imprisonment, a fine, or both.

A company's auditors also have the right to:

- receive a copy of all notices and other communications relating to any general meeting of the company
- attend the general meetings, and
- speak at any general meeting that they attend, on matters of concern to them as auditors.

5.7 Remuneration of auditors

The remuneration of the auditors (the annual audit fee) is fixed for each year. In the UK, the remuneration of the auditors is:

- fixed by the shareholders in general meeting, or
- fixed in any other way that the shareholders might decide (by ordinary resolution).

In practice, it is usual for the shareholders to agree to delegate to the directors the power to fix the audit fee by agreement with the auditors.

The amount of remuneration of the auditors for their audit work (including expenses) should be shown in the annual report and accounts.

5.8 Offences in connection with the auditor's report

The Companies Act 2006 (section 507) introduced two new criminal offences for auditors. It becomes an offence for an auditor to:

- knowingly or recklessly cause an audit report to include 'any matter that is misleading, false or deceptive' in a material way, or
- knowingly or recklessly cause a report to omit a statement that is required under certain provisions of the Companies Act.

An auditor found guilty of such an offence will be liable to a fine.

The Companies Act introduces a criminal offence for auditors, but the potential civil liability of auditors for professional negligence remains. Professional negligence and the limitation of auditors' liability under the provisions of the Companies Act 2006 has been explained in the earlier chapter on the law of tort.

5.9 Removal of auditors

Auditors may be removed from office. One way of removing them is to appoint a different firm of auditors at the next annual general meeting.

Section 510 CA2006) states that the shareholders can vote at any time, by ordinary resolution, to remove the auditors, regardless of any agreement with the audit firm. However, the dismissed auditors have the right to claim compensation or damages as a consequence of their removal from office before the end of the period of appointment.

When auditors are removed in this way, the Registrar of Companies must be notified.

If a company plans to put a resolution to a general meeting of the company for the removal of the auditors from office, before their term of appointment has expired:

- the company must issue a **special notice** of the resolution, and give a copy to the auditors
- the auditors have the right to make a representation (in writing) to the company about their removal, and ask for a copy of their representation to be given to the shareholders.

If the auditors are removed from office before the expiry of their term of appointment, they also have the right to attend the general meeting of the company:

- at which the auditors' term of office would have expired, or
- at which it is proposed to appoint new auditors.

5.10 Resignation of auditors

A company's auditors may decide to decline re-appointment.

The auditors of a company may also formally resign at any time (s516 CA2006). The auditors may resign by depositing a notice in writing at the company's registered office. This notice must be accompanied by a statement (which is explained below); otherwise the resignation is not effective.

5.11 Statement by a person ceasing to be auditor

When an auditor ceases to hold office for any reason, he is required to deposit a statement at the company's registered office, if there are any circumstances or reasons connected to the cessation of office that should be brought to the attention of the members or anyone else entitled to receive a copy of the annual report and accounts of the company. The statement should specify what those matters are.

This statement might be required, for example, when the auditor:

- is removed by the company's shareholders
- chooses to resign, or
- decides not to seek re-appointment at then next AGM.

The Companies Act 2006 (s519) extends the requirement in the case of quoted companies. When an auditor of a **quoted company** ceases to hold office, he **must** provide a statement.

- The statement must explain any circumstances connected with the auditor ceasing to hold office that the auditor considers should be brought to the attention of the shareholders or creditors of the company.
- If the auditor considers that there are no such circumstances, there should be a statement that there are none.

If the statement specifies circumstances connected with the auditor ceasing to hold office that the auditor considers should be brought to the attention of the shareholders or creditors of the company, the company must send a copy of the statement to every shareholder and debenture holder of the company.

An auditor who fails to make a statement on ceasing to hold office is guilty of an offence and liable to a fine.

5.12 Rights of resigning auditors

Certain rights are given to auditors who resign and deposit a statement with the company that there are circumstances relating to the resignation that should be brought to the attention of the shareholders or creditors of the company (as explained above).

In these circumstances, the auditors may also deposit with the company a demand for the company to hold an extraordinary general meeting of the company, for the purpose of considering the auditors' statement.

They may also request the company to circulate to its members, before this meeting, a written statement of the circumstances surrounding their resignation.

If the directors fail to call a general meeting in these circumstances, they are guilty of a criminal offence and liable to a fine.

Summary: removal from office and resignation of auditors

Removal from office	**Resignation**
Where the company proposes to vote on a resolution to remove the auditors from office, the auditors have the right to make a written representation to the company.	The auditors must deposit at the company's registered office a notice of resignation and a statement of circumstances.

Summary: removal from office and resignation of auditors

Removal from office	Resignation
The company must send a copy of the auditors' representation to the shareholders, with the notice of the general meeting at which the vote will be taken.	The statement of circumstances explains the circumstances relating to the resignation that ought to be brought to the attention of the shareholders, or a statement that there are no such circumstances.
If removed from office before the end of their term of appointment, the auditors may attend the general meeting where their term of office would have expired or where the new auditors are to be appointed.	A statement of circumstances should be sent by the company to every shareholder and debenture holder.
On ceasing to hold office, the auditor must deposit at the company's registered office a statement of circumstances connected with ceasing to hold office (or a statement that there are no such circumstances).	Where the auditors have deposited a statement of circumstances, they may also write a statement for distribution to the company's shareholders, and require the company to call an extraordinary general meeting to consider the reasons for the auditors' resignation. The auditors have the right to speak at any such meeting.

When auditors resign or are removed from office, the company must notify the Registrar of Companies.

CHAPTER 12

Company meetings and resolutions

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Company meetings

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- Annual general meetings (AGMs): private companies
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1 Company meetings

1.1 Types of company meeting

Company meetings may be:

- class meetings, or
- general meetings.

General meetings may be:

- an annual general meeting or
- an extraordinary general meeting.

1.2 Class meetings

If a company has more than one class of shareholders, it may occasionally be necessary to call a meeting of a particular class of shareholders. A class meeting is called to ask the class of shareholders to vote on a matter that affects them, for which their approval is required.

For example, a class meeting of preference shareholders may be necessary:

- when the company wants to ask the shareholders to approve an alteration to the rights attached to their shares (their 'class rights'), or
- when the company is in financial difficulty and it wants to reach a compromise arrangement with its creditors and shareholders (and the arrangement will affect the class rights of the shareholders).

1.3 General meetings

A general meeting is a meeting of the shareholders ('members') of the company who are entitled by the company's constitution to attend and vote at such meetings.

Usually, the ordinary shareholders of a company have the right to attend and vote at general meetings, but preference shareholders do not (provided that their dividend payments are not in arrears).

In theory, general meetings allow the members to make decisions on matters of importance, and restrict the powers of the directors. For example, the members in general meeting may:

- hold the directors to account
- remove directors from office
- restrict the powers of the directors by altering articles of association of the company
- resolve any differences between the shareholders themselves.

In practice, however, the power of the shareholders in general meeting is often fairly limited.

- Resolutions at general meetings are usually proposed by the directors. Individual shareholders, or a number of shareholders acting together, may have the right to propose resolutions that all the members will vote on, but it is unusual for shareholders to exercise this right.
- Many of the resolutions voted on by the members, particularly at annual general meetings, are routine. The approval of resolutions is therefore often a formality, where the company is simply complying with procedures required by law.

General meetings are usually chaired by the chairman of the board of directors, and other directors also attend. However, the directors do not have a right to vote at a general meeting unless they are also a member of the company. They can then vote at the meeting as a member.

Quorum for a general meeting

The articles of association may specify the minimum number of members who must attend a general meeting in order to have a quorum. Unless a quorum is obtained, the meeting cannot be held.

In the absence of any other specification in the articles, a quorum consists of two members (or individuals representing a member at the meeting as a proxy). However, there are situations where a general meeting or a class meeting can be held with a quorum of just one member. These include situations where:

- there is just one shareholder in the class of shares for which the meeting is held; for example when there is a company with just one member.
- The court makes an order that a general meeting should be held with a quorum of one (an example is given later).

1.4 The right to call general meetings

Various persons may have the right to call a general meeting. The right to call a general meeting is normally exercised by the board of directors. However, in certain circumstances, a general meeting may be called by:

- a shareholder or group of shareholders
- the company's auditors
- the court.

The **directors** are given the power to call general meetings by the articles of association of the company. The Companies Act (s656 CA2006) requires the directors of a **public** company to call a general meeting if the net assets fall below half the called up share capital, so that the members can discuss the state of affairs of the company.

The **members of the company** can require the directors to call a general meeting, provided that the shareholders who requisition the meeting own at least 10% of the voting shares in the company (s303 CA2006). If the directors fail to hold a meeting that shareholders have demanded in this way, the shareholders themselves then have the right to call the meeting (and recover any related expenses from the company).

The **auditors** of the company have a right to require the directors call a general meeting of the company, if they resign as auditors. At this meeting, they can explain to the members the reasons for their resignation (s518 CA2006).

In some cases, the **court** may order the company to hold a general meeting when it is impracticable for anyone else to call a meeting in any other way.

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Case: Re El Sombrero Ltd [1958]

There were three shareholders in a private company. One of them held 90% of the shares but was not a director. The other two held 5% of the shares each, and were the only two directors of the company. The articles of the company included a rule that the quorum for a general meeting was two people, and unless a quorum existed, a general meeting could not be held.

The majority shareholder requisitioned an extraordinary general meeting of the company, to consider a resolution to remove the two directors from office and replace them with new directors. The directors did not comply with this requisition. The majority shareholder therefore called a general meeting himself, but the other two directors, as shareholders, deliberately failed to attend. Since a quorum of two people did not exist for the general meeting, the meeting could not be held and the directors could not be removed from office.

The majority shareholder therefore applied to the court. The court decided that since a general meeting of the company could not be held under the articles of the company (since the two other shareholders would refuse to attend) it would use its power to call an extraordinary general meeting of the company, at which the quorum should be just one person.

The court's decision enables the majority shareholder to vote to remove the two directors from office and replace them with new directors.

1.5 Annual general meetings (AGMs): public companies

A company is required by law to hold an annual general meeting (AGM), at which the members should be entitled to vote on certain resolutions. In normal circumstances, the meeting is called by the board of directors.

An AGM gives the members an opportunity to assess and discuss the company's performance and situation. Without a meeting of this kind, the members of a large company who are remote from the directors would be deprived of the opportunity to hear the directors give an account of themselves and the company's achievements.

An AGM is also used to obtain shareholder approval for certain matters such as:

- the election or re-election of directors
- the declaration of a final dividend
- the appointment or re-appointment of the auditors.

At the AGM the members will also consider the annual report and accounts. The AGM is therefore normally used to consider routine business. Most of the resolutions at an AGM are ordinary resolutions, but there may also be some special resolutions.

Members should be given written notice of the AGM, and the notice should comply with the company's articles of association. The notice will specify the date, time and place of the meeting and the resolutions that will be proposed.

Timing of AGM for public companies

The Companies Act 1985 and companies Act 2006 differ slightly in the rules about giving notice to members of an AGM and the timing of the AGM each year.

Public companies	**Companies Act 2006**
Minimum notice required for AGM	21 days
	Combined Code requirement for listed companies that minimum notice period should be 20 working days
Minimum notice period can be waived with agreement of:	95% of members
First AGM of the company must be held	N/A
Holding AGMs each year:	AGM must be held within 6 months of the end of the financial year (s336).

1.6 Annual general meetings (AGMs): private companies

The Companies Act 2006 introduced new rules for annual general meetings of **private** companies.

- If a private company holds an AGM, the minimum notice period required is 14 days (the same as for extraordinary general meetings).
- A rule in the Companies Act 1985 that allowed private companies to 'opt out' of holding an AGM by passing an elective resolution of its members was replaced by an 'opt in' rule that a private company only needs to hold an AGM if it wishes to do so.

Private companies are therefore no longer required to hold an AGM unless they wish to do so. This removal of the requirement for an AGM has two important consequences:

- **Report and accounts**. Private companies are no longer required to lay the annual report and accounts before the members. However, it must send a copy of the report and accounts to its members within 9 months of the end of the financial year, or by the date that it files its accounts with the Registrar if this is earlier.
- **Appointment of auditors**. The appointment of the auditors for a private company will run from the end of a 28 day period following the circulation of the accounts until the corresponding period the next year.

1.7 Members' resolutions at AGMs: public companies

The resolutions at an annual general meeting are usually proposed by the board of directors and voted on by the members (or their proxies).

However, members of **public** companies are entitled to submit resolutions of their own, to be proposed and voted on at an AGM (provided it is not defamatory of any person, frivolous, vexatious or would be ineffective if passed).

- The members asking for the resolution to be proposed must represent at least 5% of the total voting rights, or must consist of at least 100 members holding an average of at least £100 each in paid-up shares.
- The request may be in writing or in electronic form, and must be given no later than six weeks before the AGM or the date that notice of the AGM is sent out by the company (if this is a later date).
- The company is then required to include the proposed members' resolution in the notice for the AGM that is sent out to the members.

1.8 Extraordinary general meetings (EGMs)

An extraordinary general meeting (EGM) is any general meeting of the company that is not an annual general meeting.

An EGM may be called, for a public or private company:

- by the directors, when the approval of the members is required for a certain proposal

- by shareholders of the company, provided that they hold a sufficient proportion of the voting shares of the company
- by the auditors or by the court, in circumstances described earlier.

An EGM requires at least 14 days written notice. This notice requirement can be waived if 90% of the members entitled to attend and vote agree (or a higher percentage figure not exceeding 95% if the articles of association specify otherwise).

The requirement remains that at least 28 days notice should be given to the company by the shareholders concerned when a **special notice** is required for a resolution.

Resolutions

- Chairman of a general meeting
- Resolutions
- Ordinary resolutions
- Special resolutions
- Written resolutions in private companies
- Methods of voting at general meetings
- Voting by a show of hands
- Voting by poll
- Proxies
- Poll votes or show of hands?

2 Resolutions

2.1 Chairman of a general meeting

The chairman of a general meeting is usually the chairman of the board of directors. In his absence, another member of the board usually acts as the chairman. If necessary, the members can appoint any member to act as chairman.

The chairman is therefore responsible for the conduct of the meeting. Each item on the agenda is taken in turn and discussed. Where appropriate, a vote is taken on a resolution when the matter has been discussed.

2.2 Resolutions

Decisions are taken by members in a general meeting by making proposals for a resolution and voting on them. Each resolution is voted on separately. Depending on the type of resolution, a minimum size of majority is required for the resolution to be passed (and the proposal accepted).

Under the provisions of the Companies Act 1985, the main types of resolution were

- ordinary resolution
- special resolution
- extraordinary resolution.

There were also written resolutions and elective resolutions, which were somewhat different in nature.

The Companies Act 2006 abolished extraordinary resolutions and elective resolutions, so now there are ordinary resolutions, special resolutions and written resolutions.

2.3 Ordinary resolutions

An ordinary resolution is passed if it receives the support of a simple majority. This is a majority of the members attending the meeting or who are represented at the meeting by a proxy.

The articles of association of the company should specify matters for which an ordinary resolution of members is required. As a general rule, ordinary resolutions are sufficient for fairly 'routine' decisions and relatively unimportant decisions.

Some ordinary resolutions require '**special notice**'. This requirement may arise when one or more shareholders wish to propose a resolution at a general meeting. Special notice must be given by the members concerned to the company 28 days before the meeting. This is to give the directors and the auditors sufficient warning of the proposed resolution. Two areas that require special notice are as follows:

- a proposal by members for the removal of a director
- a proposal by members to remove the auditors before their term of office has expired, or to re-elect at the AGM any auditor other than the retiring auditor.

2.4 Special resolutions

A special resolution is passed if it receives the support of at least 75% of the members who attend and vote (in person or by proxy).

The law specifies situations where a special resolution of the members is required. Examples where the approval of the members of a company is required by special resolution are special resolutions to:

- alter the company's articles of association
- change the company's name
- reduce the company's share capital
- re-register a private company as a public company
- re-register a public company as a private company
- authorise an off-market purchase of the company's shares.

2.5 Written resolutions in private companies

Private companies are permitted to pass resolutions by written agreement, without the need to call a general meeting of the shareholders. Written resolutions can be used, instead of resolutions at general meetings, for making any decisions except the removal of a director or the removal of the auditors.

When a private company wishes to pass a written resolution:

- there is no need to call a general meeting of the company, and
- there is no need to give any notice of the intention to pass a written resolution.

The Companies Act 2006 made it much easier than before for private companies to use written resolutions and dispense with the need for general meetings entirely except in special circumstances (such as when there is a proposal to dismiss a director or dismiss the auditors before expiry of their term of office, for which written resolutions cannot be made).

There are two types of written resolution:

- An **ordinary written resolution**. This is like an ordinary resolution at a general meeting, and requires a simple majority of the members who are eligible to vote.
- A **special written resolution**. This is like a special resolution at a general meeting, and requires a majority of at least 75% of the members who are eligible to vote.

The key elements of the new written resolution procedure are as follows:

- A written resolution can be proposed by the directors, or by members holding at least 5% of the voting rights.
- A written resolution can be communicated to members in either hard copy or electronic form, depending on the arrangements that it has made for electronic communications with its members.
- A written resolution does not have to be physically signed by each member. A member is treated as signifying his agreement to a written resolution when the company receives from him an authenticated document (which may be in hard copy form or electronic form) indicating his agreement to the resolution.
- A proposed written resolution lapses if it does not obtain the required majority before the end of a period specified for its acceptance (which ought to be specified in the articles, or is otherwise 28 days after its initial circulation to members).
- When members propose a written resolution, a statement of up to 1,000 words may be sent out with the proposed resolution when it is circulated.

The reduction in the required majority for a written resolution and the ability to circulate resolutions and acceptances electronically mean that private companies should in future use written resolutions for most members' decisions, and avoid the need for general meetings entirely (including AGMs) except in special circumstances.

2.6 Methods of voting at general meetings

Resolutions are passed at a general meeting by means of a vote on each resolution individually. There are two methods that may be used to vote on resolutions at general meetings:

- by a show of hands of the members present at the meeting
- by a poll vote.

It is for the chairman to decide how the business of the meeting should be conducted. Normal procedure is for the chairman to take a vote on a show of hands. If the vote is divided, the chairman will then go on to take a poll vote. However, poll votes may be time-consuming, especially when there are many shareholders, and the chairman will usually want to avoid these if possible.

2.7 Voting by a show of hands

When a vote is taken by a show of hands, each member present at the meeting has one vote. The chairman of the company (who chairs the general meeting) calls for a show of hands to vote on a resolution, and declares the result of the vote.

Voting by a show of hands is quick and simple when there only a small number of members are present at the meeting. It is also a convenient method of voting for non-controversial resolutions where unanimous agreement is expected.

The disadvantages of voting by a show of hands are as follows:

- A member owning 100,000 shares has only the same voting power as a member with 1 share.
- A small group of members acting together can attend a meeting and win a vote on a share of hands, against the recommendation of the board of directors.

2.8 Voting by poll

In a poll vote, each member usually has one vote for each share that he or she holds. This means, for example, that a member with 100,000 shares has 100,000 votes, whereas a member with one share has just one vote.

In addition, the member does not have to attend the meeting personally in order to vote. Members can nominate a proxy, who is authorised to vote on their behalf.

2.9 Proxies

A member of a company who is entitled to attend and vote at a general meeting has the right to appoint an agent, called a 'proxy', to attend and vote for him.

- Proxies can vote on a show of hands as well as vote in a poll vote on behalf of the member.
- A proxy does not have to be a member of the company.
- A proxy might be a specially-appointed person who attends the meeting in place of the member. Under the provisions of the Companies Act 2006 proxies can speak at general meetings on behalf of the absent member.
- In practice, members often appoint the chairman of the board of directors to act as their proxy.

The articles of a company allow members, if they wish, to instruct their proxy how to vote in a poll on each individual resolution. The instruction to the proxy will be to vote in favour of the resolution or against. A third option is to instruct the proxy to abstain from voting on a particular resolution, and the 'abstain' option is now included in the proxy voting forms of UK listed companies as a 'positive' voting option.

Where the members appoint the chairman of the board of directors, or any other director of the company, to act as their proxy, the instructions on how to vote on each resolution may be submitted to the company before the meeting:

- in writing, on 'proxy cards' that are sent to shareholders before the general meeting: a proxy card lists the resolutions that will be voted on at the meeting, and provides space for the member to indicate how he wishes to vote on each resolution; or
- electronically: nearly all quoted companies now allow shareholders to submit proxy votes electronically using the company's website.

An advantage of submitting proxy votes in advance of a general meeting is that this gives the company time to count the proxy votes before the meeting is held. This saves time at the meeting. It also allows the chairman to judge the opinion of the shareholders in advance of the meeting, and make a decision about whether to call for a poll vote or a vote by a show of hands.

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Example

A company meets in a general meeting, and one of the resolutions is a special resolution to alter the company's name. The company has 1,000 members and 10 million shares in issue.

The meeting is attended by 21 members, and three more individuals attending as specially-appointed proxies of some of the members. Most members have submitted a proxy vote, nominating the chairman to vote for them at the meeting, and indicating their voting requirement, for or against the resolution.

The voting may be conducted as follows.

- Under the provisions of the Companies Act 2006 the 21 members and 3 proxies are all able to vote. A decision to change the company name requires a special resolution which means at least 75% of the vote; therefore on a show of hands at least 18 of the 24 people voting must vote in favour to pass the resolution.
- The chairman might decide that a poll vote should be taken, either instead of or after the vote on a show of hands. The decision in a poll vote will be decisive, regardless of the decision indicated by a show of hands.
- In a poll vote, the proxies attending the meeting and the 21 members all cast their votes, one vote per share. The chairman will also include the votes of all the other members who have submitted proxy votes, nominating him as the proxy.
- The vote is decided on a count of all the votes. A majority of at least 75% is required amongst all the votes cast. For example, if votes are received from members holding 8 million shares in the company, the majority required to pass the resolution must be at least 6 million.

2.10 Poll votes or show of hands?

There are no rules about whether resolutions should be decided on a show of hands or by a poll vote. This is something for the chairman of the meeting to decide. However in listed companies and quoted companies more generally, there is growing pressure from institutional investors for resolutions to be decided by poll vote, so that institutional shareholders can make a considered use of their votes even if they are unable to attend a general meeting.

- Quoted companies are required to publish on their website the result of polls at their general meetings 'as soon as reasonably practical' after the meeting. The published results should show the number of votes cast for and against the resolution.
- The Combined Code on corporate governance, which applies to listed companies, recommends that companies should also publish on their website details of the proxy votes submitted for resolutions where the decision was taken by a show of hands.

CHAPTER 13

Company insolvency

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- Circumstances leading to a winding up
- Role of the liquidator
- Distribution of the company's assets in a liquidation
- Receivership

1 Winding up and liquidation

1.1 The meaning of winding up, liquidation, dissolution and insolvency

A company is a legal person, and it exists separately from its member shareholders. It also has a perpetual existence. Shareholders may sell or transfer their shares and cease to be members, and the company may get new shareholder members: although the members may change, the company remains the same.

The existence of a company can be brought to an end. This is achieved through a process of winding up and liquidation.

- **Winding up** means that the affairs of a company are brought to an end.
- The company is put into **liquidation**, which means that its assets are 'realised' (usually, disposed of through sale) and the company's creditors are paid from the proceeds of the liquidation. Any money remaining after the creditors have been paid is distributed to the shareholders.
- Liquidation leads to the **dissolution** of the company, when its name is removed from the official register of companies, and the company ceases to exist.

When the winding up of a company begins, the company may be:

- **solvent**, which means that it is able to pay its creditors in full out of the proceeds from the disposal of its assets
- **insolvent**, which means that it is unable to pay its creditors in full.

The procedures for winding up differ according to whether the company is solvent or insolvent.

The main UK statute on insolvency and winding up is the Insolvency Act 1986.

1.2 Circumstances leading to a winding up

Voluntary winding up and compulsory winding up

The winding up of a company may be either voluntary or compulsory:

- In a voluntary winding up, the company is wound up without any intervention by the court.

- A compulsory winding up is made as a result of a court order, following a petition to the court that the company should be wound up.

Circumstances in which a company may be wound up by the court

The circumstances in which a company may be wound up by the court are listed in section 122 Insolvency Act 1986 (IA 86). These occur when:

- The company's members have decided by special resolution that the company should be wound up by the court. (This does not apply to a voluntary winding up.)
- The company is unable to pay its debts.
- On application from a minority shareholder, the court decides that it is just and equitable that the company should be wound up.

Section 122 also specifies other circumstances in which the court may wind up a company, but these are less common than the three reasons listed above.

- It is a public company that has failed, within 12 months of its registration, to obtain a certificate of compliance with the minimum share capital requirements for a public company.
- The company has not commenced business within a year of its incorporation, or has suspended its business for a whole year.
- Except in the case of a private company, the number of members falls below two (which is the minimum number of members for a public company).

1.3 Role of the liquidator

When a company is wound up, a liquidator is appointed to liquidate the assets of the company, pay the creditors and distribute the surplus money (if there is any) to the shareholders. In order to act as a liquidator it is necessary to be qualified as an insolvency practitioner.

1.4 Distribution of the company's assets in a liquidation

When a company is put into liquidation, the liquidator has the task of 'realising' (selling off) the assets of the company. He must also seek to swell the assets of the company where possible, for example by requiring shareholders to pay up any unpaid capital on their shares, or applying to the court for directors to be held personally liable for some of the liabilities of the company (for wrongful trading or for breach of fiduciary duty).

The money obtained is then used to settle the liabilities of the company, in the following order of priority:

- Fixed charge holders. These are creditors who have security for their debt in the form of a fixed charge on a specific asset or specific assets
- The liquidator's remuneration and expenses
- Preferential creditors: these are liabilities that are given preference in the priority for payment. The most important preferential creditors are unpaid holiday pay

of employees and (up to a limit of £800 per employee) unpaid salaries and wages of employees.

- Floating charge holders. These are creditors who have security for their debt in the form of a floating charge (that has now crystallised) over the undertaking or business of the company or over one or more categories of assets.
- Unsecured creditors.
- Members' dividends that have been declared payable but are not yet paid (which may be relevant for preference shareholders).

If there is still some cash after making all these payments, capital is returned to the shareholders. The priority for making payments to shareholders out of capital should be specified in the articles of association, but preference shareholders are repaid in full before any capital payment is made to ordinary shareholders.

1.5 Receivership

Receivership is commonly associated with the winding up of a company, but a winding up is not necessary for a receiver to be appointed.

A receiver is a person appointed by a creditor, or by the court on behalf of a creditor, to realised secured assets and use these to obtain payment of a secured debt.

A receiver is someone appointed when there is a fixed charge, to take control of a fixed asset (or several fixed assets) to which the charge applies. He is usually appointed under the terms of the debenture that created the charge, typically when the company is in default on the payment of interest or capital on the secured debt. The powers of the receiver are set out in the debenture.

The function of a receiver is to realise the charged asset and use the proceeds to pay the debt to the creditor who is the fixed charge holder. Any surplus should be paid to the company or its liquidator.

A receiver acts only in the interests of the creditor with the security. Once the creditor has been paid in full from the charged assets, a receiver will:

- allow the directors to resume full control of the company, or
- if the company is being wound up, hand over the company's affairs to the liquidator.

Voluntary winding up

- The nature of a voluntary winding up
- Members' voluntary winding up
- Creditors' voluntary winding up
- Members' and creditors' voluntary winding up compared

2 Voluntary winding up

2.1 The nature of a voluntary winding up

A voluntary winding up of a company is a winding up that is made without a court order and without court intervention. There are two types of voluntary winding up:

- a members' voluntary winding up
- a creditors' voluntary winding up.

These two methods of winding up have some similarities, apart from the fact that they do not involve the courts:

- They are initiated by a decision of the board of directors
- They require approval from the shareholders (members) in general meeting
- They involve the appointment of a liquidator to liquidate the assets.

The main difference between a members' voluntary winding up and a creditors' voluntary winding up is that:

- In a members' voluntary winding up, the assets of the company are sufficient to pay its liabilities in full, so that some capital will be returned to the shareholders in the liquidation.
- In a creditors' voluntary winding up, the assets of the company are not sufficient to pay its liabilities in full, or might not be sufficient. If the company is wound up, the creditors will therefore not be paid what they are owed in full, or might not be paid in full.

The beginning and end of the voluntary winding up process

A company may be wound up voluntarily, by means of a resolution of its shareholder members. The **voluntary winding up process begins** from the moment that the members pass the resolution to wind up.

In a voluntary winding up, the company must cease to carry on business from the moment that the winding up process begins, except to the extent that carrying on some business may be beneficial for the winding up.

However, the company remains in existence until the winding up process is completed and the company is eventually dissolved.

Type of members' resolution required for a voluntary winding up

The Insolvency Act 1986 (section 84) states that the type of resolution required for winding up depends on the circumstances.

Circumstances	Type of resolution required for a voluntary winding up
A company may be wound up because its articles of association specify that it should exist only for a fixed period of time, and that period of time has come to an end. Similarly, a company may be set up for a specific purpose, and the reason for its existence ends when that purpose has been accomplished.	Ordinary resolution
A company may be wound up when it cannot continue in business because of its liabilities, so that it is advisable to wind up.	Extraordinary resolution. This applies to a creditors' voluntary winding up.
In all other circumstances	Special resolution. This normally applies to a members' voluntary winding up.

2.2 Members' voluntary winding up

A members' voluntary winding up may occur if the directors of the company consider that the company is solvent, and is able to pay its creditors in full. The winding up process is therefore initiated by the board of directors.

Statutory declaration by the directors in a member's voluntary winding up

The Insolvency Act 1986 requires the directors to make a statutory declaration that:

- they have made a full inquiry into the company's affairs, and
- have reached the opinion that the company will be able to pay its debts in full within a specified period of time from the beginning of the winding up process. This specified period of time cannot exceed 12 months.

It is a criminal offence, punishable by imprisonment or a fine, for a director to make a statutory declaration without having reasonable grounds for the opinion that the company will be able to pay its creditors in full.

This statutory declaration must be prepared before the general meeting at which the shareholders vote on the resolution for a voluntary winding up.

After the general meeting, a copy of the shareholders' resolution, together with a copy of the directors' statement, must be delivered to the Registrar of Companies.

The procedure in a members' voluntary winding up

When the members pass the resolution to wind up the company, they should also **appoint a liquidator** to wind up the company's affairs and liquidate and distribute its assets.

The appointment should be made by the members in general meeting, and an ordinary resolution is sufficient for making the appointment.

On being appointed, the liquidator sets about the task of liquidating the company's assets and paying off the company's liabilities. On completion of his task, when the affairs of the company have been wound up, the liquidator must:

- prepare a report of the liquidation, showing how the winding up has been conducted and how the assets have been liquidated and distributed, and
- call a final general meeting of the members (ordinary shareholders) to present the report to them and explain it. The meeting will also confirm how much capital should be returned to the shareholders.

After the meeting, the liquidator must send a copy of the account and details of the meeting to the Registrar of Companies. The Registrar registers the report from the liquidator, and the company is dissolved three months later.

Members' voluntary winding up: if the company is insolvent

If the liquidator reaches the view during the liquidation process that the company cannot pay its creditors in full, he must call a meeting of the creditors, for the purpose of converting the members' voluntary winding up into a creditors' voluntary winding up.

2.3 Creditors' voluntary winding up

When the members of a company wish to wind it up, but the directors are unable to make a statutory declaration of solvency, a voluntary winding up must be a creditors' voluntary winding up.

In these circumstances, the directors consider the company to be insolvent, so that the creditors cannot be paid in full. The creditors are therefore given a more active role to play in the winding up process. They are invited to agree to a winding up of the company on a voluntary basis, without the intervention of the court.

The aims of a creditors' voluntary winding up are therefore:

- to bring the existence of the company to an end
- to avoid intervention by the court
- to pay as much to the creditors as is possible, and
- to involve the creditors in the winding up process.

The procedure in a creditors' voluntary winding up

The Insolvency Act 1986 specifies the following procedure for a creditors' voluntary winding up.

- The directors decide that the company should be wound up and decide to seek shareholder approval.
- They are unable to make a statutory declaration of solvency, which means that the winding up will need to be a creditors' voluntary winding up.
- A general meeting of the company is held where the shareholders approve a creditors' voluntary winding up by means of an extraordinary resolution.
- The company must call a meeting of its creditors within 14 days of the resolution to wind up the company. It should also nominate a liquidator.
- At this meeting, the directors must present to the creditors a statement of the affairs of the company. This should give details of the assets of the company, and its debts and other liabilities of the company, together with the names and addresses of its creditors, and details of any security they have been given.
- At the meeting of creditors, the creditors may nominate a liquidator. If the person nominated by the creditors differs from the person nominated by the company's members, the person nominated by the creditors should be appointed.
- Also at the meeting of the creditors (or at any subsequent meeting of creditors), the creditors may appoint a **liquidation committee** to work with the liquidator. This committee consists of representatives of the creditors.

The liquidator liquidates the assets of the company. On completion of the winding up process, the liquidator must call a:

- final general meeting of the company prior to dissolution, and
- a final meeting of the creditors.

The purpose of these meetings is to present a report from the liquidator, and to provide an explanation of it.

The liquidator must then send his report and details of the two meetings to the Registrar of Companies. The Registrar registers the liquidator's report, and the company is dissolved three months later.

2.4 Members' and creditors' voluntary winding up compared

The following flowcharts compare a members' voluntary winding up and a creditors' voluntary winding up.

Members' voluntary winding up	**Creditors' voluntary winding up**
The directors decide to propose a winding up.	The directors decide to propose a winding up.
The directors find that they can make a statutory declaration of insolvency.	The directors find that they cannot make a statutory declaration of insolvency.
General meeting held. Members agree by special resolution to a members' voluntary winding up.	General meeting held. Members agree by extraordinary resolution to a creditors' voluntary winding up.
A liquidator is appointed.	The directors call a meeting of creditors. They prepare a statement of affairs for the meeting.
	Creditors meeting held. Liquidator appointed. A creditors' committee may also be appointed.
Assets of the company are liquidated. Creditors are paid in full.	Assets of the company are liquidated.
Liquidator prepares a report of the liquidation, for presentation to the shareholders.	Liquidator prepares a final account for presentation to separate meetings of the shareholders and creditors.
Copy of the final account sent to the Registrar.	Copy of the final account sent to the Registrar.
After 3 months the Registrar dissolves the company.	After 3 months the Registrar dissolves the company.

Compulsory winding up

- The nature of a compulsory winding up
- The procedure in a compulsory winding up

3 Compulsory winding up

3.1 The nature of a compulsory winding up

In a compulsory winding up, the decision to wind up the company is taken by the court (under section 122 of the Insolvency Act 1986). An application must be made to the court for a winding up order to be made.

The reasons why the court may order the winding up of a company were described earlier.

- The main reason why a court may order a winding up is that the company cannot pay its debts (and has not voluntarily wound itself up by means of a creditors' winding up).
- An unpaid creditor may apply to the court, asking for the court to order a compulsory winding up. (The Act also provides for the company, its directors or a member to apply to the court for a compulsory winding up.)

Inability to pay debts

A company is deemed 'unable to pay its debts' in any of the following circumstances.

- A creditor has served a written notice at the company's registered office demanding payment of a debt (which must be more than £750), and the company has failed to pay it within three weeks of the notice being served.
- The creditor has obtained a court judgement for the company to pay a debt and has tried but failed to collect the debt.
- It is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities.

3.2 The procedure in a compulsory winding up

When the court makes an order for a company to be wound up, the winding up is deemed to have begun when the petition to wind up the company was presented to the court.

The court approves the application for a winding up, and makes a winding up order. The **company** must notify the Registrar of Companies of the winding up order.

Role of the Official Receiver in a compulsory winding up

The court appoints the Official Receiver as a provisional liquidator, to act until another liquidator has been appointed.

When a winding up order has been made, no legal action can be started or may continue against the company or its property without the approval of the court.

The company's directors are required to prepare a statement of affairs of the company, and give this to the Official Receiver. Acting as provisional liquidator, the Official Receiver calls:

- a meeting of the company's creditors, and
- a meeting of the members.

The purpose of these meetings is to appoint a liquidator, to take over from the Official Receiver. At each meeting, the members or creditors may nominate a person to act as the liquidator of the company. The person selected will be the person nominated by the creditors (but if the creditors do not nominate anyone, the liquidator will be the person nominated by the members).

The creditors and members may also choose to appoint a **liquidation committee** to work with the liquidator and monitor the winding up process.

Role of the liquidator in a compulsory winding up

The liquidator has the job of taking control of all the assets of the company, realising them (liquidating the assets) and distributing the proceeds to the company's creditors.

On completion of the liquidation and distribution of the assets, the liquidator must summon a final general meeting of the company's creditors. At the meeting, he must:

- present a report to the creditors, and
- obtain their agreement for his release from office (so that he will no longer be liquidator).

The liquidator must then inform the Registrar of Companies that the final meeting of creditors has been held. This information is registered, and the company is dissolved three months later.

Alternatives to winding up and liquidation: administration order

- The reason for wanting an alternative to winding up
- Administrator
- Administration order
- The administration process
- Functions of the administrator
- End of administration
- Advantages of administration

4 Alternatives to winding up and liquidation: administration order

4.1 The reason for wanting an alternative to winding up

When a company is wound up, the end of the process is the dissolution of the company by the Registrar of companies. In many cases, this is an appropriate outcome.

In some cases, however, a company might be in financial difficulties, but if it is given a 'reprieve' and time to sort out its difficulties, it might be able to recover and become a profitable company.

Many countries provide for an alternative process to winding up and liquidation when a company becomes insolvent. The purpose of the alternative process is to give the company an opportunity to 'trade its way out of its difficulties', so that it can eventually:

- pay its creditors in full, and
- continue in business.

In the UK, this alternative process is called **administration**. (In the US, an alternative process is available under Chapter 11 of the Bankruptcy Code, and the process is known as 'Chapter 11 bankruptcy'. You will often hear on the news about American companies seeking Chapter 11 protection.)

4.2 Administrator

An administrator is a person appointed under the terms of the Insolvency Act 1986 to manage the company's affairs, business and property.

A company 'enters administration' when an administrator is appointed and is said to be 'in administration' when the appointment of the administrator has effect.

The administrator must perform his functions in the interests of the creditors of the company as a whole, with the objective of:

- rescuing the company from its financial difficulties, so that it can continue in business as a going concern, or
- achieving a better result for the creditors of the company than would be possible if the company were to be wound up (without going into administration), or
- to realise assets of the company in order to make a distribution (payment) to one or more secured creditors of the company.

An administrator may be appointed:

- by order of the court
- by the holder of a floating charge, or
- by the company and its directors.

In all cases, the administrator is an officer of the court, which means that the court has supervisory jurisdiction over the administration.

4.3 Administration order

An administration order is made **by a court**, under the provisions of the **Enterprise Act 2002**, following an application by:

- the company
- the company's directors, or
- a creditor.

An administration order places an insolvent company, or a company that is likely to become insolvent, under the control of an administrator. The purpose of such an order is to:

- give the company some time to implement a reorganisation, or ensure that its assets will be realised in the best way possible,
- by protecting it from its creditors whilst the administration order is in force.

The court will not make an administration order unless it believes that administration will achieve one of the objectives listed above (in particular, rescue the company as a going concern or achieve a better result for the company's creditors).

A company in administration cannot go into liquidation (except in limited circumstances). When a company is in administration, there is a moratorium on legal proceedings against the company, except with the court's permission or the administrator's agreement. The effect of the moratorium is that, during administration:

- no one can make an application to the court for the company to be wound up
- the company cannot pass a resolution for a voluntary winding up

- legal steps cannot be taken to enforce security over the company's property, except with permission of the court
- no other legal proceedings can be started against the company, except with permission of the court.

An administration order lasts for 12 months, but may be extend a further six months with the approval of the creditors or with a court order.

4.4 The administration process

The administrator is required to notify the company's creditors and the Registrar of Companies about his appointment.

He must then obtain from the company a 'statement of affairs' of the company. This should give details of the company's assets, debts and other liabilities, the names and addresses of its creditors, and details of the security held by any of the creditors.

The administrator must then make some **proposals for achieving the purpose of the administration**, such as finding a way to enable the company to continue in existence as a going concern. These proposals may include a compromise with the company's creditors or members. A copy of the proposals should then be sent to every creditor and member of the company, and to the Registrar of Companies.

Having issued his proposals, the administrator must call an **initial meeting of the company's creditors**. At this meeting, the administrator presents his proposals, and the meeting may:

- agree to them without modification
- agree to them, with modifications that the administrator agrees to.

The creditors may establish a creditors' committee at any of their meetings, to represent their interests in negotiations with the administrator.

Following the initial creditors' meeting, if the administrator decides to make a substantial revision to his proposals, he must call **another creditors' meeting**, to consider the revised proposals. At his meeting, the creditors may again:

- agree to the proposals without modification
- agree to them, with modifications that the administrator agrees to.

Further creditors' meetings may be held at the request of some of the creditors, if agreement is not reached.

If the administrator is unable to obtain the consent of the creditors to any of his proposals, the matter will be referred back to the court. (The court may remove the administrator from office and order the winding up of the company.)

4.5 Functions of the administrator

The administrator is a '**company doctor**'. He may do anything necessary for the management of the business and assets of the company, and should take custody of or control over all the assets of the company. He can remove directors from office or appoint new directors, and directors and officers cannot exercise any management power' without the consent of the administrator.

The administrator also has the power to make payments to creditors of the company, although payments to unsecured creditors usually require permission from the court.

4.6 End of administration

The period of administration ends:

- when the administration has been successful, or
- 12 months after the date of the administrator's appointment (although the court may agree to extend his period in office)
- when the administrator applies to the court for an end to administration, or
- when a creditor applies to the court for an end to administration.

The administrator may apply to the court for an end to administration when:

- he reaches the conclusion that the objectives of the administration cannot be achieved, or
- he reaches the conclusion that the company should not have been put into liquidation, or
- the administrator was appointed by the court and the objectives of the administration have been achieved.

When the court orders the end of administration, the administrator ceases to hold his office.

4.7 Advantages of administration

There are several advantages of administration, compared with winding up the company.

	Advantages
For the company	It provides an opportunity to reorganise the company so that it can survive in business as a going concern.
	It provides temporary relief from creditors, who are unable to bring legal proceedings against the company whilst it is in administration.
For the shareholders	If the company survives, the shareholders may retain some interest in the company (although the agreement formulated by the administrator may provide for creditors to take a major shareholding by accepting new shares in the company).
For the creditors	They may eventually receive payment of their debt in full, or may receive a better settlement than if the company is wound up immediately without going into liquidation.
	A floating charge holder may appoint an administrator to enforce his security, without the need to apply to the court

CHAPTER 14

Corporate governance

Contents

The nature of corporate governance

1 The nature of corporate governance

1.1 Introduction to corporate governance

Corporate governance is concerned with how a company is governed. It is concerned mainly with the relationship between the directors of a company and its shareholders, particularly in large companies. To some extent it is also about the relationship between the directors, shareholders and other 'stakeholder groups' in a company, such as its employees, customers and suppliers.

Problems with the governance of companies arise largely from the separation of ownership of a company from its control. Powers to make decisions for the company are delegated to the board of directors, who:

- should try to ensure that the company is governed and managed in the best interests of the shareholders, and
- should be accountable to the shareholders for the way in which they have exercised their powers and for the performance of the company.

In practice, companies are not always governed in the best interests of the shareholders, and there is a risk that companies might be governed in the interests of other individuals or groups, particularly in the interests of powerful executive directors themselves. Accountability of the board of directors to the shareholders might also be unsatisfactory, and other important issues in corporate governance are:

- the communication between a company's directors and its shareholders and the extent to which shareholders should be kept informed about the company's performance, and
- whether the shareholders should perhaps have some say in how some decisions by the company are reached.

The way in which a company is governed therefore depends largely on:

- the powers and duties of directors, both collectively (as the board of directors) and individually
- how the directors use their powers

- whether they carry out their duties properly
- the extent to which they are accountable to the shareholders for the way in which they have used their powers.

Accountability of the directors to the shareholders has 'traditionally' been based on laying the audited annual report and accounts before the shareholders at the annual general meeting, but there have been concerns about lack of transparency in the financial statements of some companies and about the independence of the external auditors of companies.

Codes of corporate governance and statutory provisions relating to corporate governance have developed over the past twenty years or so. In the UK, the need for better corporate governance was first recognised by financial institutions, including investors, following the spectacular financial collapse of several major UK listed companies. Two of the more notorious examples in the 1980s were:

- the collapse of the business empire of Sir Robert Maxwell (Maxwell Communications Corporation) and the financial crisis in its subsidiary Mirror Group Newspapers
- the financial collapse of Polly Peck International, with its leader Asil Nadir leaving the UK in order to avoid prosecution.

Examples such as these in the UK, and the more recent collapse of major US corporations such as Enron and WorldCom in 2002 and Lehman Brothers in 2008, explain the need to ensure high standards of corporate governance, particularly in large public companies.

1.2 Governance and management

The distinction between corporate governance and the management of companies is sometimes blurred and unclear. However, there is a difference between governance and management.

- Management is concerned with the task of running the business of a company. The executive managers of a company have the responsibility for management, and they use the powers that are delegated to them to carry out their tasks.
- Governance is concerned with giving leadership and guidance to the company. This includes setting its objectives and providing strategic direction for the company. It also includes the general oversight of management and accountability to the shareholders (and possibly also other stakeholder groups). Governance is provided largely through occasional meetings of the board of directors and board committees, and through dialogue with shareholders. Unlike management, it is not a day-to-day activity.

However, governance and management overlap. The board of directors provides strategic direction for the company (governance), but management formulate and implement specific strategic plans. Management is responsible for activities such as financial reporting and internal controls, but the board of directors is responsible for the oversight of these issues.

1.3 Key issues in corporate governance

There are several key issues in corporate governance, but all of them are related to ensuring that a company is governed in the interests of its shareholders (and to some extent its other stakeholders). These factors may be grouped into four broad categories:

- ensuring that the directors act in the interests of shareholders and not in their own self-interest and that the board (not management) provides strategic direction for the company
- the remuneration of directors, particularly executive directors, and senior executives
- the accountability of the directors to the shareholders and the audit of information provided to shareholders
- the relationship between the board of directors and the shareholders.

To a large extent, matters of corporate governance are closely linked to issues in company law, particularly the law relating to directors, financial reporting and auditing.

The board of directors: acting in the interests of shareholders

The board of directors should act in the best interests of the shareholders. Past experience has shown, however, that companies are often run in the interests of powerful executive directors (such as the chief executive officer) or possibly the company chairman. This risk has been particularly high when the same individual has been both company chairman and CEO, and so an all-powerful leader of the board of directors.

Some provisions of good corporate governance are designed to prevent the board from being dominated by one individual or by a small group of executive directors, and run for their personal interests rather than those of the shareholders.

- An important measure is to achieve a balance of power on the board, and ensure that the interests of the shareholders are properly represented. This can possibly be achieved by appointing **independent non-executive directors** to the board, preferably also by having a strong independent chairman to lead the board.
- The role of the independent non-executive directors should include ensuring that the executive directors do not make decisions that promote their self-interest. In particular, independent non-executive directors should make the decisions about the remuneration of executive directors and senior managers.
- Independent non-executive should also have some oversight over financial reporting and risk management systems, and they should be involved in the appointment of new individuals to the board of directors (so that the senior executive directors are not able to appoint 'yes men' to board positions.

The involvement of non-executive directors in deciding the remuneration of executive directors, in oversight over financial reporting, audit and risk management and in the nomination of new directors to the board can be achieved by establishing committees of the board of directors. It is accepted good corporate governance in large companies that there should be a remuneration committee and audit committee of the board, each consisting entirely of independent non-executive directors. Similarly, it is recognised good practice that appointments to the board should be recommended by a nominations committee, consisting largely of independent non-executive directors.

Providing strategic direction

The board of directors should provide strategic direction for the company and is also responsible for the governance of the company. There are certain decision-making powers that should therefore be reserved for the board of directors as a collective group that should not be delegated to an individual director or to management.

The articles of association might specify some decisions that must be reserved for the board, such as decisions about dividends (or proposed dividends) and the appointment of new directors. To achieve good corporate governance, however, other decisions should be reserved for the board, such as setting strategic targets, deciding the broad strategic direction for the company and approving major capital expenditure projects and raising large amounts of new finance.

Accountability to shareholders and the relationship with shareholders

The board of directors should be accountable to shareholders, and corporate governance is concerned with how a suitable standard of accountability can be achieved. Governance is therefore concerned with reporting to shareholders and the reliability and transparency of reports. This involves issues such as the reliability of financial reporting.

Shareholders need reassurance that financial statements provide a true and fair view of the financial performance and financial position of the company. The external audit and report of te external auditors is an important element in the provision of this reassurance.

Shareholders and other stakeholders in a company will also benefit from information about future prospects, the main risks to the business and other non-financial aspects of performance, including information about the social and environmental effects of the company's operations. Information to supplement the annual financial statements is provided by other reports such as the business review, the directors' remuneration report and the directors' report.

Relations with shareholders

A board of directors should seek to maintain constructive dialogue and continual communications with its shareholders, particularly its larger shareholders. The main shareholders in listed companies are usually institutional investors – such as pension funds, insurance and life assurance companies and unit trust companies.

One aspect of the relationship between the board and the shareholders is the extent to which the shareholders should use their rights to influence decision-making by the board. 'Activist' shareholders might try to organise opposition to decisions by the board of directors, by voting collectively against specific resolutions at general meetings of the company, or calling an extraordinary general meeting to vote on a proposal put forward by the activist shareholders themselves.

1.4 Executive directors and non-executive directors

Executive directors are individuals who have delegated management responsibilities for aspects of the company's business operations, who are also directors of the company. They are both governor (director) and senior executive manager. They are employees of the company, spend most or all of their working time with the company and receive most or all of their remuneration from the company.

Non-executive directors (NEDs) are individuals who are directors of the company, but do not have any executive responsibilities. Their contribution to the company is made largely through meetings of the board of directors and board committees (the remuneration, audit and nomination committees). They work part-time for the company for a fee, and are not employees. Typically, an NED for a large listed company might spend about 20–30 days each year on the company's affairs.

Some NEDs are not independent, because connections that they have with the company or a major shareholder means that they will not have a fully independent outlook when deliberating on the company's affairs. Examples of NEDs who are not independent include directors who are appointed to represent the interests of a major shareholder, and directors who until fairly recently were full-time employees of the company.

In corporate governance, independent NEDs fulfil two roles: policeman and colleague for the executive directors.

- They should create a balance of power on the board, to prevent the board from being dominated by a powerful executive director or group of executive directors. They should ensure that the interests of the shareholders are properly considered and that decisions are not taken for the personal benefit of executive directors. As members of the audit committee and remuneration committee, independent NEDs fulfil a role of 'policeman' or 'supervisor' for the executive directors.
- As members of the board, they work constructively with their executive colleagues in making major decisions such as major strategy decisions. They are expected to bring external experience, skill and knowledge to the discussions of the board, and thereby help to improve the quality of decision-making by the board. In this respect, NEDs are colleagues of the executive directors, working towards a common goal.

It is important to remember that although independent NEDs have a special role in good corporate governance, company law makes no distinction between executive and non-executive directors. In law all directors have the same duties to their company, and as directors both NEDs and executive directors are potentially liable to the company for any breach of those duties.

1.5 Large companies and smaller companies: the relevance of good corporate governance practice

The basic concepts of good corporate governance are relevant to companies of all sizes, and to private as well as public companies. Companies should be governed in the interests of the shareholders and the directors should be accountable to the shareholders for the way in which the company has been governed and the way it has performed.

Some aspects of company law, which have relevance for corporate governance, apply to all companies. These include the statutory general duties of directors to their company.

Rules of good corporate governance, however, are intended to apply mainly to large companies whose shares are traded on a stock market. It should not be expected that 'rules' of corporate governance for a major listed company should be the same as those for a small private company with one member and one director.

- In the UK, the main voluntary code of corporate governance applies to listed companies, although large public companies whose shares are traded on the Alternative Investment Market (AIM) are encouraged to comply with the same voluntary code.
- It is recognised that 'best practice' in corporate governance is not the same for smaller public companies, or even large private companies.
- It is debatable whether many of the concepts of good corporate governance have any practical relevance to smaller private companies. For the purpose of your examination, it is sufficient to recognise that voluntary 'best practice' in corporate governance does not apply to private companies, and some statutory rules on corporate governance apply only to quoted companies, not to other types of company.

It should also be remembered that for any type of company, shareholders might be able to exercise their statutory rights to influence decision-making by the board of directors, or possibly to reject proposals by the board (by voting against them at a general meeting).

1.6 Best practice in corporate governance: voluntary code or statutory rules?

If it is accepted that there should be guidelines or rules on best practice in corporate governance, that large public companies in particular should observe and comply with, the next question is whether best practice should be:

- voluntary, through compliance with a voluntary code of behaviour, or
- compulsory, through the introduction of laws and regulations.

In the UK much corporate governance of listed companies is based on compliance with a voluntary code, although there are statutory regulations for some aspects of governance that apply to all companies or to all larger companies.

Voluntary codes of corporate governance

- The Combined Code on Corporate Governance
- The regulatory status of the Combined Code: comply or explain
- The Combined Code: principles and provisions
- Voluntary codes for smaller companies

2 Voluntary codes of corporate governance

2.1 The Combined Code on Corporate Governance

In the UK, there has been a voluntary code of best practice in corporate governance since 1992. This now takes the form of the Combined Code on Corporate Governance. The Financial Reporting Council (FRC) is responsible for the Combined Code and reviews the content of the Code regularly. The most recent review and (small) revision of the Combined Code was in 2008, although at the time of updating this text another review of the Code is in progress.

The Combined Code consists of a number of principles and provisions.

- There are main principles and associated supporting principles.
- For each main principle and associated supporting principles, there are Code Provisions, which indicate how the principles should normally be applied in practice.

Because the Code consists largely of principles, with some practical provisions, it is said to be a form of 'principles-based regulation'.

The Combined Code is intended primarily for **listed companies**, although the principles and provisions might be used by other companies.

- Listed companies are expected to apply all the principles of the Code.
- They are also expected to apply all the provisions in the Code; however, it is recognised that there might be situations where the most appropriate corporate governance arrangement might differ from the requirements of a Code Provision.

The preamble to the Combined Code states although it is expected that listed companies will usually comply with the Code's provisions, it realises that in certain circumstances departing from this can be justified. Companies should review each provision, giving explanations as necessary if it doesn't comply with the Code provisions.

2.2 The regulatory status of the Combined Code: comply or explain

All listed companies in the UK, as a condition of their listing, must comply with rules established the Financial Services Authority (FSA), which is the regulator of the UK financial markets. The FSA publishes rules of conduct for listed companies, known collectively as the UK Listing Authority Rules. Compliance with these rules is a requirement for keeping the status of listed company. Only the shares of listed companies are accepted for trading by the London Stock Exchange. Compliance with the UK Listing Authority Rules is therefore essential for listed companies.

The UK Listing Authority Rules are divided into three sets of rules, the Listing Rules, the Prospectus Rules and the Disclosure and Transparency Rules. The Listing Rules include two rules on compliance with the Combined Code.

- In the annual report and accounts, a company must provide 'a statement of how the listed company has applied the **principles** set out in … the Combined Code, in a manner that would enable shareholders to evaluate how the principles have been applied.'
- Also in the annual report and accounts, a company must provide 'a statement of whether the listed company has:
  (a) complied throughout the accounting period with all the relevant **provisions** set out in … the Combined Code, or
  (b) not complied with all the relevant **provisions** … and if so setting out those provisions … it has not complied with and … the company's reasons for non-compliance.'

Listed companies must therefore comply with all the principles in the Combined Code. They must also either comply with all the provisions of the Code or explain the reasons for non-compliance with any particular provision. This is known as '**comply or explain**' and all listed companies are required to do this by the Listing Rules.

(***Note***: The Listing Rules also include requirements for the disclosure of certain information about directors' remuneration which go beyond the requirements of UK law. The details of these regulations are not explained in this text.)

2.3 The Combined Code: principles and provisions

It is useful to look at the principles and provisions of the Combined Code. In particular, it is useful to compare the provisions of the Combined Code with company law, to understand by how much the required 'best practice' in corporate governance goes beyond the requirements of the law.

The principles and provisions of the Combined Code for companies are presented under four headings:

- The board
- Remuneration
- Accountability and audit
- Relations with shareholders.

Principles	**Some Code Provisions**
The board	
Main principle: Every company should be headed by an effective board which is collectively responsible for the success of the company.	There should be a formal schedule of matters reserved for decision by the board of directors. The annual report should include a statement of how the board operates.
Supporting principles include: (a) The board must set the company's strategic aims. (b) All directors must take decisions objectively in the interests of the company. (c) The role of non-executive directors (NEDs) should include (1) satisfying themselves on the integrity of financial information (2) deciding the levels of remuneration of executive directors and (3) having a prime role in appointing and where necessary removing executive directors.	The annual report should set out the number of meetings of the board and the board committees and provide information about attendance at meetings by individual directors. A NED on resignation should, if he or she has concerns about the running of the company, provide a written statement about such concerns to the chairman, for circulation to the other board members.
Chairman and chief executive	
Main principle: There should be a clear division of responsibilities at the head of the company between running the board and running the company's business. No individual should have unfettered powers of decision.	The roles of chairman and chief executive officer should not be exercised by the same individual. On appointment, the chairman should meet the criteria for being independent. The CEO of the company should not subsequently become chairman of the company after retiring as CEO.
Board balance and independence	
Main principle: The board should have a balance of executive and non-executive directors (particularly independent NEDs) so that no individual or small group can dominate the board's decision-making.	In the annual report the board should identify each NED it considers to be independent. Except for smaller listed companies at least half the board (excluding the chairman) of a listed company should consist of independent NEDs. In smaller companies (outside the FTSE 350) there should be at least two independent NEDs. The board should appoint one independent NED as the Senior Independent Director (SID).

Principles	Some Code Provisions
Appointments to the board	
Main principle: There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.	The process for making board appointments should be led by a **nominations committee** of the board. A majority of members of this committee should be independent NEDs.
Information and professional development	
Main principle: The board should be supplied in a timely manner with the information its needs to discharge its duties properly. All directors should be given induction and training.	The board should ensure that all directors, especially NEDs, should have access to independent professional advice at the company's expense, where they consider that such advice is necessary to discharge their duties properly.
Performance evaluation	
Main principle: There should be a formal evaluation each year of the performance of the board, its committees and individual directors.	
Re-election	
Main principle: All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance.	All directors should be subject to election by shareholders at the first AGM after their appointment and to re-election after that at intervals of no more than three years. NEDs should be appointed for specified terms subject to re-election. (The typical appointment is for three years, after which the NED might be invited to continue for a further three years subject to re-election.)
Remuneration	
Main principles: (1) Levels of remuneration should be sufficient to attract, retain and motivate directors of the required quality, but a company should avoid paying more than is necessary for this purpose.	A significant proportion of the remuneration of an executive director should be linked to corporate and individual performance. Service contracts for directors should have a notice period of one year or less.
(2) There should be a formal procedure for developing policy on executive remuneration and deciding the remuneration packages of individual directors. No director should be involved in deciding his own remuneration.	The board should establish a **remuneration committee** consisting entirely of independent NEDs, with responsibility for setting the remuneration of the executive directors and chairman, and recommending/monitoring the level of remuneration for other senior managers. Shareholders should be invited specifically to approve all new long-term incentive schemes.

Principles	Some Code Provisions
Accountability and audit: financial reporting	
Main principle: The board should present a balanced and understandable assessment of the company's position and prospects.	The board should state in the report and accounts its responsibility for preparing the accounts. The board should report that the business is a going concern, with supporting assumptions or qualifications as necessary.
Accountability and audit: audit committee and auditors	
Main principle: The board should establish formal arrangements for considering how it should apply the financial reporting principle and maintaining an appropriate relationship with the company's auditors.	The board should establish an **audit committee** consisting entirely of independent NEDs. The Code Provisions set out the main roles of the audit committee which include (1) monitoring the integrity of the financial statements, (2) monitoring and reviewing the auditor's independence, objectivity and effectiveness, (3) making recommendations to the board (for the board to put to the shareholders at the AGM) about the re-appointment or removal of the auditors and the remuneration of the auditors, and (4) deciding the policy on giving non-audit work to the company's auditors. The audit committee 'should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors'.
Relations with shareholders	
Main principles: (1) There should be a dialogue with shareholders based on the mutual understanding of objectives. Most of the contact between the shareholders and the company will be with the chairman or CEO.	The chairman should ensure that the views of shareholders are communicated to the board as a whole.
(2) The board should use the AGM to communicate with investors and encourage their participation.	The company should propose a separate resolution at the AGM relating to the report and accounts. (This will normally mean a proposal to approve the report and accounts for the year.) For each resolution where a decision is made on a show of hands the company should make available to the meeting, and as soon as possible afterwards on its website, the number of proxy votes that were received for the resolution, and the number of proxy votes for and against the resolution, and the number of 'votes withheld'.

The main reason why corporate governance became an issue of concern for the financial establishment was the collapse of major companies in the UK and (later) in the US. The need for faithful representation in the annual report and accounts of the financial performance and financial position of the company is a vitally important issue. In this respect, key issues include matters such as the independence and competence of the external auditors and reassurance about the going concern status of the company.

The other major concern about poor corporate governance is the risk of domination of the board by a powerful chief executive or chairman, or a group of powerful executive directors. In this respect, the role of the non-executive directors should be important. In practice, it may be argued that NEDs have so far failed to fulfil adequately their role of 'supervising' the executive directors and management.

2.4 Voluntary codes for smaller companies

The Combined Code does not apply to quoted public companies whose shares are traded on the Alternative Investment Market (AIM). However, there are many similarities between listed companies and AIM companies. In most cases, there is a separation of ownership from control, with a substantial number of shareholders who are not involved in the management of the company.

In 2005 the Quoted Companies Alliance (QCA), a body representing smaller quoted companies, issued *Corporate Governance Guidelines for AIM Companies.* The Guidelines are intended to help companies whose shares are traded on AIM to develop good corporate governance practices. These *Guidelines* are consistent with the Combined Code for listed companies, but are not as detailed or rigorous. Although the Combined Code does not apply to AIM companies, the QCA comments that: 'Compliance with the Combined Code should continue to be an aspiration for AIM companies as they grow.'

Corporate governance and private companies

In theory, good principles of corporate governance should also be applicable to private companies, especially companies where a significant proportion of shares are held by members who are not involved in the running of the company. However, in practice it may be difficult to argue in favour of a formal corporate governance regime for private companies, beyond the minimum requirements set out in the law.

Legal regulation of corporate governance

- The need for legal regulation of corporate governance
- Examples of UK law on aspects of corporate governance
- The directors' remuneration report
- Legislation and corporate governance: the future

3 Legal regulation of corporate governance

3.1 The need for legal regulation of corporate governance

As explained in the previous chapter, the UK has a voluntary code for corporate governance which applies to listed companies, although listed companies must comply with the provisions of the Code or explain their non-compliance.

Legal regulation could be used instead of a voluntary code, and in the US there is a much stronger legal framework of corporate governance than in the UK. This was introduced by the Sarbanes-Oxley Act 2002.

Within the UK, there is some legal regulation of corporate governance. There might be several reasons why legal regulation is required.

- There might be a requirement that a particular provision of corporate governance should apply to quoted companies in general, not just to listed companies. Alternatively, there might be a requirement for a law to apply to all companies or most companies, such as the general statutory duties of directors in the Companies Act 2006, which apply to all companies. The Combined Code applies to listed companies only, not to all quoted companies.
- There might be a requirement for regulation that goes into much more detail than a voluntary code on corporate governance would provide. The legal requirement for quoted companies to produce a detailed directors' remuneration report (described later) is an example.
- A requirement for statutory provisions might be imposed by a European Union Directive, such as the requirement for all companies except small and dormant companies to produce a business review each year as part of the directors' report.
- In some cases, legislation might be necessary when voluntary self-regulation fails.
- The government might take the view that some aspects of corporate governance should be included in statute law. An example is the introduction of statutory directors' duties in the Companies Act 2006, largely replacing common law and equity law (the directors' duty of skill and care, and fiduciary duties).

3.2 Examples of UK law on aspects of corporate governance

In the UK, several items of legislation have been introduced since a voluntary code of corporate governance was first introduced in 1992. These are:

- the directors' remuneration report regulations
- the requirement for companies to produce a business review as part of the directors' report: this has been described in an earlier chapter
- the statutory duties of directors in the Companies Act 2006. These have also been described in an earlier chapter.

3.3 The directors' remuneration report

Directors' remuneration became a major issue in corporate governance in the UK in the mid-1990s, when there was a public outcry against the high level of remuneration paid to 'fat cat' directors in the newly-privatised utility companies.

The reasons why directors' remuneration is a corporate governance matter are as follows.

- As a general principle, the remuneration paid to directors should be sufficient to attract people of the right quality and to retain them.
- The directors provide leadership to the company. A remuneration package should therefore be sufficient to motivate directors to want the company to achieve its objectives. A remuneration package should include a basic salary, short-term incentives and long-term incentives (in the form of share options or a share incentive scheme), and there should be a suitable balance between short-term and long-term incentives, and between fixed pay and pay that relies on achieving incentive targets.
- On the other hand, directors' remuneration should not be too high.
- Unsuccessful directors should not be rewarded for failure, by receiving a large pay-off in the event of his dismissal.
- Shareholders should have an opportunity to review and assess the remuneration paid to directors, so that they can decide whether remuneration policy is successful in achieving its aims of attracting talented individuals, and retaining and incentivising them.

The need for legislation arises from the reluctance of companies to publish details of directors' remuneration, so that shareholders can make their assessment. Prior to a change in the Companies Act 1985, listed companies were required by the Listing Rules to provide details of directors' remuneration. The amendment to the Companies Act extended the requirement for remuneration disclosures to all quoted companies.

Disclosures of directors' remuneration: requirements

The Companies Act 2006 (ss 420 - 422) requires quoted companies to disclose details about directors' remuneration in an annual directors' remuneration report, which is included in the annual report and accounts.

The Secretary of State has the power to make regulations about the contents of this report. The current regulations require the report to be divided into two parts:

- a section that is not subject to audit
- a section that is subject to audit by the company's auditors.

The Act also requires that quoted companies should ask its shareholders to approve the directors' remuneration report each year at the annual general meeting. This vote is **advisory only**, and the shareholders do not have the power to reject the report or alter the remuneration packages of individual directors.

The section of the report that is not subject to audit should include:

- A statement of the company's policy on directors' remuneration.
- For each individual director, information about the performance conditions that are used to judge the performance of the director and his or her entitlement to share options or shares under a long-term incentive scheme.
- For each director, this section of the report should also give information about the relative importance of the portion of the remuneration package that is fixed and not dependent on meeting an incentive target, and the portion that is incentive-based.

The section of the directors' remuneration report that is subject to audit should shown for each individual director, details of his other remuneration, including salaries and fees paid, payments towards the director's pension, bonuses, compensation for loss of office, and non-cash benefits such as share options or share awards under a share incentive scheme.

3.4 Legislation and corporate governance: the future

It is likely that in the future company law or other regulations will be altered in a way that introduces new laws to aspects of a company's affairs that might be described as 'corporate governance'. For example, it is probable that the existence of an audit committee will become a statutory requirement for some types of company.

At the moment, however, it does not seem likely that there will be a major enactment of corporate governance requirements in English law. The approach of the government appears to be that a voluntary code is more flexible than detailed regulations and so is likely to be more adaptable and successful. Extra legislation is only likely to occur for one or more of the reasons suggested earlier.

CHAPTER 15

Fraudulent behaviour

Contents

Insider dealing

- The nature of insider dealing
- Part V of the Criminal Justice Act 1993 and the crime of insider dealing
- Definition of inside information
- Definition of an insider
- Penalty on conviction for insider dealing
- Defences against a charge of insider dealing
- Note on directors buying and selling shares in their company

1 Insider dealing

This chapter deals with two specific aspects of criminal law that are commonly associated with business activities, and that might have a direct impact on accountants in the course of their professional work. These are:

- Insider dealing and Part V of the Criminal Justice Act 1993
- Money laundering and the Proceeds of Crime Act 2002.

1.1 The nature of insider dealing

Insider dealing relates to dealing in 'price-affected securities' on a stock market. The most common types of price-affected securities are shares in quoted companies and, to a lesser extent, debentures (bonds).

To understand the nature of insider dealing, it is important to remember that the prices of shares and debentures traded on the stock market continually change. A stock market is a secondary market, where shares already in issue are bought and sold by investors. When there is a strong demand from investors to buy shares, the price of the shares is likely to go up. When there are more shareholders wanting to sell shares in a company than there are investors wanting to buy them, the price will go down.

Investors can make money or lose money by buying and selling shares.

The price of shares in any company (and the willingness of investors to buy them) often depends on the view of investors about the future profitability of the company.

- If there is new information suggesting that profits (and dividends) will be higher than expected, the share price will go up because more investors will want to buy the shares.
- If there is new information suggesting that profits will be lower than expected, the share price is likely to fall.

- Other new information will often lead to changes in the share price. For example, when Company X announces its intention to take over Company Y (by purchasing all or most of its shares), the price of shares in Company Y is likely to rise, because a takeover bid is always at a price higher than the current market price of the target company's shares.

The key point to note is that new information about the future prospects of a company will often send the share price up or down.

An individual in possession of information about the future prospects of a company, such as its future profitability or prospects, that is not yet available to other investors in the stock market, could make a large profit by dealing in the shares before the information is released and made public. For example, if a person knows that Company X will soon make a takeover bid for Company Y, but this information is not yet public, he might buy shares in Company Y. When the news is made public, the shares in Company Y will go up in price and the individual can sell his shares at a profit.

The person would be an 'insider' and buying and selling the shares in Company Y would be insider dealing, a criminal offence.

1.2 Part V of the Criminal Justice Act 1993 and the crime of insider dealing

In broad terms, insider dealing involves the use of 'inside information' by an 'insider' to deal or encourage someone else to deal in price-affected securities. Price-affected securities are shares (or debentures) whose price will be affected by the release of the inside information to the general public. (Note: Inside information will become public information eventually, but it remains 'inside' information until it becomes public.)

Part V of the Criminal Justice Act 1993 sets out **three criminal offences of insider dealing**.

- An individual is guilty of insider dealing if he is in possession of inside information as an 'insider', and uses that information to deal in price-affected securities.
- An individual is also guilty of insider dealing if he is in possession of inside information as an 'insider', and uses that information to encourage someone else to deal in price-affected securities.
- An individual is also guilty of insider dealing if he is in possession of inside information as an 'insider', and discloses the information to any other person other than in the proper performance of their employment, office or profession.

Reasons why insider dealing is a criminal offence

It might be asked why insider dealing should be a criminal offence. It can be argued that people are free to buy and sell shares as they wish, and they deal at a price they are willing to accept for buying or selling.

However, there are several reasons why insider dealing is made a criminal offence.

- Individuals with inside information could possibly make very large profits by making use of the information to buy or sell shares. It is unreasonable that they should be allowed to do this.
- If directors use inside information to make a personal profit, this would be a breach of their duty as a director. Similarly, if professional advisers such as solicitors or auditors of a company acted in the same way, this would be a breach of their professional ethics.
- Institutional investors are major investors in many countries. For example, US and UK investment funds buy shares in stock markets around the world. They do not expect to deal in shares when individuals are allowed to make use of inside information to make personal profits, at the expense of other investors. Countries therefore need to have laws against insider dealing if they want to encourage foreign investment through their stock markets.

1.3 Definition of inside information

Information is 'inside' information when all the following conditions are met:

- It is information that relates to **particular securities** or the **issuer of particular securities** and not to securities generally. For example, information may be 'inside information' when it relates to shares in ABC plc or to ABC plc itself, but it is not inside information if it relates more generally, say to shares in all oil companies or to the general level of share prices in the stock market.
- The information must be **specific** or **precise**.
- The information has **not been made public**.
- If it were made public, it would be likely to have a **significant effect on the price** of the securities to which the information relates.

This means for example that if you are told (in a private conversation) by a director of XYZ plc that the company will announce an increase of 50% in its profits and annual dividends next week, you will have received inside information. The director will be guilty of insider dealing, because he has disclosed the inside information, as an insider, and the disclosure is not in the proper performance of his job or office. You will be guilty of insider dealing if you then use the information to buy shares in the company, whilst it is still 'inside' information and has not been made public.

On the other hand, if a friend tells you that there will be an announcement soon of one of the biggest takeovers in stock market history, this would not be inside information because it does not relate to particular securities (it does not specify which companies are involved).

1.4 Definition of an insider

A person is an insider if the following conditions are met:

- the information comes from an inside source, and
- the person knows that it is inside information.

There can be two types of insider, and the criminal law applies to both types:

- **Primary insiders**. These are individuals who obtain the inside information in the direct course of their work or professional involvement with the company. Primary insiders include directors, certain employees and possibly also some shareholders of a company to which the information relates. Primary insiders also include individuals who obtain the information by virtue of their employment or profession, and could include investment banks advising the company, and solicitors or auditors to the company.
- **Secondary insiders**. This is not a term used in the Act itself, but it refers to individuals who receive inside information from an insider, second hand or third hand (and so on). A person receiving inside information from an insider himself becomes an insider, until the information is made public.

Example

A director of BNM plc, a listed company, knows about the probability of a takeover bid for the company by a foreign company, but this information is confidential and has not yet been announced to the public. The current price of BNM plc shares is £6 and the foreign company is likely to offer £7.20 per share.

The director uses his inside knowledge to buy 50,000 shares in BNM plc at £6. Not long afterwards, the foreign company eventually makes a takeover offer at £7.20 per share, which is announced to the stock market. Shares in BNM rise to £7.50.

This is an example of insider dealing. The director has used his inside knowledge to profit from the rise in the share price by dealing in the shares of his company.

Example

The finance director of CVB plc, a listed company, is aware from his work that the company will have to issue a profit warning in the near future, and he expects the share price to fall when the profit warning is announced to the stock market.

He knows that his brother owns a large number of shares in CVB. He tells his brother that he is extremely worried about the CVB share price, because the company will be announcing an unexpected 20% fall in its annual profits, and he encourages the brother to sell his shares. The brother follows the advice and sells all his shares in CVB.

This is another example of insider dealing by a company director. He was guilty of insider dealing in giving the inside information to his brother. It is also insider dealing by the brother, who became an insider when he received the information and was guilty of insider dealing when he sold his shares.

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Example

Wendy is a girlfriend of John. John is the director of a listed company, Trout plc. He tells Wendy that his company is about to be taken over by another company, and that he will be attending a board meeting in a few days' time when the directors will give their support for the bid. He is very excited about the takeover, because he thinks it will be good for his company and also for the company making the takeover bid.

After hearing this news from John, Wendy buys shares in Trout plc.

She then tells her friend Poppy about the likelihood of a takeover, and Poppy buys shares in Trout plc.

Poppy then tells her friend William about the takeover, and William also buys shares in Trout plc.

Wendy visited her parents and told her father to buy shares in Trout plc as soon as he could, but without telling him the reasons for her advice. Her father bought shares in Trout plc.

All of these share dealings occurred before any public announcement is made about the takeover.

Required

Who, if anyone, has committed an offence of insider dealing?

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Answer

- **John**. John is guilty of disclosing information otherwise than in the proper performance of his job. He told Wendy about the takeover, but did not need to. It is specific information about a particular company (Trout) that has not been made public. It is price-sensitive, because the takeover bid will be expected to result in a rise in the share price of Trout.
- **Wendy**. Wendy is guilty in three ways.
  (1) She is an insider because she received inside information from a director of the company. As an insider, she dealt in shares of the company, no doubt expecting to make a profit.
  (2) She disclosed the information to another person, Poppy.
  (3) She encouraged her father to deal in the shares.
- **Poppy**. Poppy is guilty in two ways.
  (1) On receiving the specific information from Wendy, she became an insider. As an insider, she then dealt in shares of the company.
  (2) As an insider, she disclosed the information to William.
- **William**. William became an insider on receiving the specific information from Poppy. As an insider, he dealt in shares in the company.
- **Wendy's father**. Wendy's father is not guilty of insider dealing. He was encouraged to deal by Wendy, but did not receive any specific information and so is not an insider.

1.5 Penalty on conviction for insider dealing

On summary conviction (without a jury trial) an individual found guilty of insider dealing is liable to imprisonment up to six months and/or a fine up to a specified maximum amount.

On indictment (in a jury trial) an individual found guilty of insider dealing is liable to imprisonment up to seven years and/or a fine up to a (higher) specified maximum amount.

1.6 Defences against a charge of insider dealing

A criminal charge of insider dealing may be very difficult to prove in a criminal court. The guilt of an accused person must be established beyond reasonable doubt. There are several defences against a charge of insider dealing that might be used.

The Criminal Justice Act 1993 allows the following defences against a charge of insider dealing.

- Defences against the offence of dealing in securities, or encouraging someone else to deal:
  - The individual did not realise that the information was price-sensitive, and did not expect to make a profit from dealing or to avoid a loss.
  - The individual believed on reasonable grounds that the information had been disclosed widely, so that no one involved in the dealing would be at a disadvantage.
  - The individual would have dealt in the way that he did even if he did not have the information.
- Defences against the offence of disclosing price-sensitive information
  - The individual did not expect any person to deal in the securities as a result of the disclosure of the information
  - The individual did expect someone to deal in the securities as a result of the disclosure of the information, but did not expect that person to make a profit.

These valid defences against a charge of insider dealing might help to suggest why it is very difficult to obtain a conviction in a court of law.

1.7 Note on directors buying and selling shares in their company

Directors are free to buy or sell shares in their company if they want to do so. Dealing by a director is not insider dealing, provided that the director does not have inside information at the time of dealing. Directors of listed companies are required by the London Stock Exchange to avoid dealing at times when they might be expected to have access to information that is not yet public (such as in a period before a takeover bid or a period before the announcement of financial results by the company).

Money laundering

- The nature of money laundering
- Money laundering as a criminal offence
- Proceeds of Crime Act 2002: three categories of money laundering offences
- Laundering
- Failue to report
- Tipping off
- Money Laundering Regulations 2007
- Prevention of Terrorism Act 2005

2 Money laundering

2.1 The nature of money laundering

Money laundering is the process of changing the identity of money or other property that has been obtained from serious crime ('dirty money'), so that it appears to come from a legitimate source ('clean money'). Money laundering also applies to funds that are obtained and used to finance terrorist activities.

The process of money laundering can be very complex. It may involve three stages:

- **Placement**: Placement is the process of getting the money obtained from criminal activities (often in the form of cash) into the banking system. A bank might accept money from a new customer in cash, and open up a bank account for the customer: strict controls over money laundering internationally, especially for banks, should mean that this is quite difficult to accomplish. Criminals might operate businesses where cash is handled regularly in large quantities, such as gambling casinos.
- **Layering**: Layering is a process of transferring the money between bank accounts so that the 'trail' that the money has taken becomes difficult to follow. This process may involve the use of 'shell companies' (whose directors may be professional advisers) and using bank accounts in countries with strict banking secrecy laws. Money might be transferred many times between such companies, until its original source is difficult to trace.
- **Integration**: Integration is the final stage in the process. Eventually, the money is made to seem as if it has come from a legitimate business and a legitimate source.

2.2 Money laundering as a criminal offence

Money laundering is a criminal offence, because it is not acceptable that individuals found guilty of serious criminal offences should be allowed to retain the money or their property they have acquired from their criminal activities.

There is international recognition of the need to act against money laundering, and of the need for close international co-operation in order for any such action to be successful.
In the UK, the criminal law on money laundering is now contained in the Proceeds of Crime Act 2002.

2.3 Proceeds of Crime Act 2002: three categories of money laundering offences

The Proceeds of Crime Act 2002 specifies three categories of criminal offence relating to money laundering:

- laundering
- failure to report
- tipping off.

2.4 Laundering

It is a criminal offence for anyone in the UK to launder money that is the proceeds of crime, or to assist in the process of laundering such money. without making a disclosure to the authorities, to:

- conceal or disguise the nature, source, location, movement or ownership of criminal property
- convert criminal property from one form to another (for example, from cash to real estate)
- transfer criminal property
- remove criminal property from the UK or Northern Ireland.

A person also commits a criminal offence if he acquires, uses or has possession of criminal property.

Criminal property is property that the alleged offender knows (or suspects) has been obtained from or represents the benefit from any criminal conduct.

These laundering offences are punishable by up to 14 years imprisonment and/or a fine.

Defences against a charge of money laundering

An individual is not guilty of laundering in certain circumstances, which provide a possible defence against a criminal charge. Money laundering has not been committed, for example if:

- the individual has made an authorised disclosure as soon as possible after the transaction has taken place (see 'failure to report', later)
- a disclosure was made before the transaction took place, and the person making the disclosure was given consent to proceed with the transaction
- there was a reasonable excuse for not making such a disclosure.

2.5 Failure to report

A person working in the 'regulated sector' has a duty to report suspicions of money laundering activity. It is a criminal offence for such a person to fail to report his knowledge or reasonable suspicion of money laundering by another person. He must report his knowledge or suspicion of money laundering to the appropriate authority.

To be guilty of this offence, an individual is not involved in the process of laundering. He simply has knowledge of it or a suspicion that money laundering is happening in relation to a transaction in which he is involved.

The 'regulated sector' includes banking in particular. In a bank, employees will normally be expected to report their suspicions to a Money Laundering Reporting Officer, who will then report reasonable suspicions to the authorities on behalf of the bank. The authorities are the Serious Organised Crime Agency (SOCA).

The regulated sector also includes accountants and solicitors acting in the course of their professional business. Accountants may be required to report their suspicions of money laundering by a client to a 'nominated officer' in his firm, who must then notify SOCA.

A Money Laundering Reporting Officer or other nominated officer is guilty of failure to disclose if he fails to notify the NCIS of suspicions reported to them by other employees.

This offence of 'failure to report' is punishable by up to 5 years imprisonment and/or a fine.

2.6 Tipping off

It is a criminal offence for any person to put an investigation into suspected money laundering at risk by telling a suspected person or a third party that:

- a disclosure has been made to the authorities, or
- the authorities are acting or proposing to act on their suspicions of money laundering.

Tipping off is illegal because it gives the person under suspicion an opportunity to do something to reduce the risk from an official investigation.

A defence against an accusation of tipping off is that the individual did not know or suspect that the disclosure to the suspected person would prejudice an investigation into the money laundering activity.

This offence of 'tipping off' is punishable by up to 5 years imprisonment and/or a fine.

Confiscation orders

The Proceeds of Crime Act gives the court the power to issue confiscation orders. A confiscation order is an order for the seizure of property from a person convicted of a serious criminal offence, or an order requiring a convicted person to pay a specified amount of money. A confiscation order may be made when the court believes that the person has acquired the property as a result of his criminal activities or has obtained financial benefit from his criminal activities.

Example

Dan is a drug trafficker who uses proceeds from his criminal activities to buy a business, intending to disguise future income from drug trafficking as legitimate revenue of the business. He employs Frank, an accountant, to maintain false accounting records so that this can be done. He also employs Harry to manage the business.

In this example, all three men are guilty of money laundering.

- Dan is guilty of laundering. (He is also guilty of drug trafficking, but that is another matter.) In the UK, the maximum sentence for this crime is 14 years in prison and a fine.
- Frank is also guilty of laundering, because he is disguising and concealing criminal property by producing false accounts. (Even if Frank did not know that the money has been obtained by crime, he would be guilty of failing to report his suspicions to the authorities.)
- Harry is also probably guilty of laundering, since by acting as the managing director of the 'legitimate' business, he is helping Dan to conceal the nature and source of the money coming into the business.

2.7 Money Laundering Regulations 2007

The more general requirements of the Proceeds of Crime Act 2002 are reinforced by the Money Laundering Regulations 2007. These Regulations implement the requirements of the EC Third Money Laundering Directive.

The Regulations apply specifically to certain types of relevant business, which are required to have systems in place to prevent anyone using their business for money laundering and so report suspicious activities to the authorities (SOCA).

The relevant businesses that are subject to the Regulations include:

- Credit institutions and financial institutions, including banks, building societies and bureaux de change
- Legal professionals (in relation to certain types of transactions with clients)
- Accountants, auditors, tax advisers, insolvency specialists
- Estate agents
- High value dealers
- Casinos.

Each of these organisations must be registered with a relevant supervisory authority (such as the Financial Services Authority for banks), and this supervisory body is responsible for monitoring all registered organisations to ensure compliance with the Regulations.

Each registered organisation must have a nominated person responsible for implementation of the Regulations. In banks, this person may be called the Money Laundering Regulations Officer.

Each organisation is required to put in place and implement policies and procedures for:

- Assessment of risks of money laundering
- Customer identification ('know your customer' procedures)
- Monitoring suspicious activity and reporting this to the authorities (SOCA)
- Retaining records
- Establishing and maintaining effective internal controls.

2.8 Prevention of Terrorism Act 2005

Money laundering activities may be carried out by many different types of individual or organisation. Major concerns about the scale and nature of money laundering are focused on the activities of organised criminals and also terrorists.

It is therefore useful to note that in the UK, there are additional measures that the authorities may take against individuals suspected of terrorist activities, both foreigners in the UK and UK nationals. The Prevention of Terrorism Act 2005 allows the authorities to impose control orders on individuals suspected of terrorist activities. A control order may provide for a number of restrictions on the individual, including:

- placing the individual under house arrest
- restricting access to mobile phones and the internet
- restricting or preventing other forms of communication, with either specified individuals or in general
- restricting work and business arrangements.

Control orders may be issued for individuals who are suspected of money laundering activities for terrorist purposes.

Fraudulent and wrongful trading
■ Fraudulent trading: section 213 Insolvency Act 1986 ■ Wrongful trading: section 214 Insolvency Act 1986

3 Fraudulent and wrongful trading

3.1 Fraudulent trading: section 213 Insolvency Act 1986

Fraudulent trading occurs when the business of a company is carried on with the **intent to defraud creditors**, or for any other fraudulent purpose. Fraudulent trading may occur whether or not the company is in the course of being wound up.

- **Fraudulent trading is a criminal offence**, punishable by imprisonment, a fine or both. A criminal offence is an offence against the State and society as a whole. Individuals accused of the crime of fraudulent trading are prosecuted in the criminal courts.
- **Fraudulent trading is also a civil offence**. A civil offence is not a crime. Instead, it involves a dispute between citizens. Where one citizen accuses another of a civil offence, the matter is judged by a civil court. If a civil court decides that a civil offence has occurred, it will make the offender liable to the person who has suffered a loss as a result of the offence.

Civil liability for fraudulent trading

If fraudulent trading occurs and the company is wound up, the directors may also be made liable, in a civil action, for some or all of the company's debts. Only the individual directors who take a decision that involves fraudulent trading will be held liable by the civil court.

The liquidator of a company that is being wound up may apply to the court for named directors to be held personally liable for some or all of the company's debts.

When a liquidator applies to the court, he must also report the matter to the criminal law authorities (the Director of Public Prosecutions).

Fraudulent trading: the burden of proof

In practice, it may be difficult to obtain a decision by a court that fraudulent trading has occurred. This is because fraudulent trading is a crime as well as a civil offence. The criminal courts should require sufficient evidence of guilt to decide that an accused person is a criminal, and could be sent to prison. A person cannot be found guilty of a criminal offence unless the prosecution can prove the guilt of the accused person 'beyond reasonable doubt'.

The 'burden of proof' is not as heavy in civil cases, where the penalty for committing an offence is usually financial, and so not as serious as in criminal cases.

Since there may be difficulty in obtaining a conviction for fraudulent trading, there is also a lesser civil offence of wrongful trading, where a decision about whether or not an offence has occurred is decided on the balance of probabilities.

e

Example

A director of a company ordered goods from a supplier at a time that he **knew** that the company was unable to pay its debts. This could be considered fraudulent trading, with the deliberate intention of defrauding the supplier.

If the director is prosecuted in the criminal courts and found guilty of fraudulent trading, he could also be held liable in the civil court for the company's debt.

However, it might be difficult to prove a charge of fraudulent trading, and when the company goes into liquidation, the liquidator may choose to make a claim in the civil court for wrongful trading.

C

Case: Morphites v Bernasconi [2001]

A company was formed as a part of a road haulage franchise. It acquired an onerous lease through its managing director, who was subsequently removed from office.

The company was in financial difficulties, but the directors of the company gave their assurance to the landlord that the company would pay its rent under the terms of the lease. The company didn't pay the rent and the company went into liquidation.

The liquidator applied to the court for the directors to be held personally liable for the unpaid rent, on the grounds that they had been guilty of fraudulent trading.

The court decided that the directors were liable. They had been closely involved in running the business and the assurances they had given to the landlord were clearly false. They were required personally to pay the unpaid rent on the lease and were also fined £17,500 for their dishonesty.

The case shows that directors should not make representations to a creditor that the company will pay its debt when they have no reason to suppose that the company will be able to do so. In proving fraudulent trading, **it is not necessary to show** that the directors did not intend to pay the creditor or **actually knew** that the money would not be available to pay the creditor.

3.2 Wrongful trading: section 214 Insolvency Act 1986

Wrongful trading occurs when:

- the directors of a company decided to keep the company in business when they knew, **or should have known**, that there was no reasonable prospect of the company avoiding becoming insolvent and going into insolvent liquidation, or

- the directors knew that the company would have to go into insolvent liquidation, but did not do enough to minimise the potential loss for the company's creditors.

The court will assume that a director should have known that the company would have to go into insolvent liquidation:

- if this would have been the opinion of a reasonably diligent person
- with the general knowledge, skill and experience that the director might reasonably be expected to have.

Unlike fraudulent trading, **wrongful trading is not a criminal offence. It is a civil offence**.

However, if the liquidator of the company is able to show that directors were responsible for wrongful trading, the court may decide that the directors should be personally liable to make a contribution to the company's assets. Any such payment to the company by a director will be used towards paying the company's creditors in the winding up process.

The extent of a director's liability for wrongful trading depends on the circumstances of the case.

- The extent of liability will depend on the losses that were actually incurred by the company from the time that the directors ought to have realised that the company could not avoid going into insolvent liquidation.
- The directors can also reduce their liability if they can show that from the time they knew, or ought to have known, that the company could not avoid going into insolvent liquidation, they took every step possible to minimise the losses.

C

Case: Re Produce Marketing Consortium Ltd [1989]

This case provides an example of wrongful trading, and deciding the liability of the directors.

The liquidator of Produce Marketing Consortium Ltd applied to the court, asking that two directors of the insolvent company should personally contribute to the company's assets in the winding up.

This followed a decision by the court that the directors were liable for wrongful trading, because they had allowed the company to continue in business in the belief – wrong and unrealistic – that the company could trade its way out of its financial difficulties. The court decided that the directors were liable for wrongful trading, but were not potentially guilty of fraudulent trading, because they had not acted dishonestly or with the intention to defraud the company's creditors. However, it should have been clear that the company would have to go into insolvent liquidation, and the directors had ignored a warning from the company's auditors about the company's situation.

The court therefore decided that the two named directors should be personally liable (jointly and severally) to contribute £75,000 plus interest to the company. This payment would be available to the liquidator of the company, as a contribution towards paying the company's creditors in the winding up process.

The judge in the case said that although the directors had not acted fraudulently, this was no reason for making their liability only a small amount. The liability of any director in cases involving wrongful trading should be judged by the circumstances of the case.

Q&A

Practice questions

Contents

Fraudulent behaviour

1 Legislation

(a) In the English legal system, what is the difference between primary legislation and delegated legislation?

(b) What are the main advantages of delegated legislation?

(c) Explain the powers that the courts have to alter or control each of these types of legislation.

2 Case law

Explain the doctrine of precedent and how precedent is established in case law.

3 Precedent and the court hierarchy

Explain the court hierarchy on which the doctrine of binding precedent is based for civil cases.

4 Consideration

(a) Explain the meaning of consideration in contract law.

(b) Explain the comment, in relation to contract law, that 'past consideration is not good consideration'.

(c) Explain the comment, in relation to contract law, that 'consideration must be sufficient but need not be adequate.'

5 Promissory estoppel

What is the doctrine of promissory estoppel, in the context of contract law, and how does it operate?

6 Pablo

Pablo is a professional artist. Rob and Pablo agreed that Pablo should paint a picture of his mother's house, and Rob paid £2,000 in advance for the work. He also instructed Pablo to deliver the picture, when finished, to his mother, since he would be out of the country for a few weeks on business.

A picture was eventually delivered to Rob's mother, but Pablo had painted the house next door by mistake. The mother was furious. She demanded repayment from Pablo of the money that had been given to him by Rob. If he did not pay back the money, she would call in a lawyer.

Pablo refused to pay back any of the money, on the grounds that the instructions from Rob had been misleading. As far as he was concerned, he had done his work in accordance with the instructions from Rob.

Required

(a) Explain the legal position in this situation, and state whether the mother can take legal action against Pablo to recover the money he had received.

(b) If the dispute goes to court and the court finds that Pablo was at fault and in breach of contract, suggest the likely remedy that the court will apply.

7 Paintings

Mel owns an art gallery in London, where he exhibits and sells original paintings. He specialises in selling works by the Italian painter Paniani. He saw an advertisement in a local newspaper for the sale of a 'second hand' Paniani painting for £2,000. This advertisement had been placed by Sam.

Mel telephoned Sam and offered to buy the painting for £1,600. Sam said he would sell it for £1,800. Mel asked for time to think about it. Sam agreed not to sell the painting to anyone else for the next three days, until Mel had telephoned back with his decision.

Later the same day, Tom came into Mel's gallery and asked if he had any Paniani paintings for sale. He was willing to pay £2,500 for one. Mel said that he would be able sell a Paniani painting to Tom for that price, provided he could obtain it from a 'supplier'. He then telephoned Sam to say that he wanted to buy the painting at the offer price of £1,800. However, Sam said that he had already sold the painting to Val for £2,000.

Also during the same day, Mel wrote a letter to Ben, a regular customer, saying that he had available for sale a painting by Penni, another Italian artist. He supplied details of the painting and said that its price was £1,500. Ben posted back a reply the next day, saying that he would buy the painting at the asking price of £1,500. However, Ben then telephoned Mel soon after posting the letter, and said that he had changed his mind and did not want the painting. Mel should therefore ignore the letter of acceptance when it arrived.

Required

Explain the situation described here in relation to the law of contract.

8 Part payment

Ali provides tax advice to clients, but has been having difficulty in collecting the money owed by some of them.

(a) Russell is an electrician. He owes Ali £900. Without any discussion or correspondence with Ali, Russell sends in a cheque for £400 by post. A covering note states that this is all that he is willing to pay and the cheque is therefore in full settlement of his debt to Ali.

(b) Sam is an actor. He owes £1,200 but is currently out of work and is unable to pay more than £600. Ali reluctantly agrees to accept the £600. Sam subsequently gets a part in a television drama series, and earns a substantial amount of money from his new work.

(c) Tina is a self-employed person whose income is obtained from doing word processing work for clients. She owes £800, but can only afford £300. She offers to do two days' secretarial work for Ali in settlement of the remaining debt. Reluctantly Ali agrees, although he is not convinced that two days' of secretarial work is worth £500.

(d) Uri is designer. He owes Ali £750 but cannot afford to pay. Uri's father offers £550 in full settlement of Uri's debt. Reluctantly, Ali agrees.

Required

In each case, explain the legal position with regard to the part-payment of the amount owed, and explain whether in each case Ali has the legal right to pursue the client for full payment of the remaining money owed.

9 Exclusion

(a) What is an exemption clause or an exclusion clause in a contract?

(b) In which three ways might the courts establish the existence of an exemption clause in a contract?

(c) How will the courts decide whether a particular exemption clause in a contract is valid and enforceable?

10 Terms, conditions and warranties

Explain the difference between terms, conditions and warranties in a contract.

11 Implied and innominate

Explain the meaning of:

(a) implied terms in a contract, and

(b) innominate terms.

12 Grand Pearl

Shiruti runs a business selling watches and jewellery. He placed an advertisement in the Thursday edition of the local newspaper. The advertisement offered one Grand Pearl watch for sale for £800 **in cash** on the following Monday morning to the first person wanting it. The offer would be valid on the Monday only.

(a) Angus read the advertisement on Thursday and immediately posted a letter to Shiruti, together with a cheque for £800, stating that he wanted to buy the watch. Shiruti read the letter before he opened his shop for business on the Monday morning. However, there was something he disliked in the tone of the letter from Angus, and he decided that he did not want to sell the watch to him.

(b) Brenda was the first person to enter Shiruti's shop on the Monday morning. She said that she wanted to buy the watch and that she would pay by cheque.

Shiruti said that he wanted paying in cash, not by cheque, and refused to sell the watch to her.

(c) Colin visited the shop later in the morning and said he wanted to buy the watch. On being told that payment had to be in cash, he said that he would go to his bank to obtain the cash, but would not be able to get back to the shop until the next day. He asked Shiruti to keep the offer open until Tuesday morning. As a gesture of intent to buy, he offered a cash deposit of £40. Shiruti agreed and promised to hold the watch until then.

(d) Donna visited the shop on Monday afternoon. She said she wanted to buy the watch, and on being told that it was being reserved for someone else, she offered to pay £1,000. She would get the cash from her bank first thing on Tuesday morning. Shiruti agreed to sell her the watch on those terms.

(e) Colin came back to the shop on Tuesday morning with the £760 in cash to buy the watch. Shiruti said that the watch had now been sold to someone else, and he gave back the £40 deposit to Colin.

(f) Colin was desperate to obtain a Grand Pearl watch, and he did so by going to another shop in the town and paying £1,250 for it.

(g) Later on the Tuesday morning, Donna telephoned to say that she had changed her mind about the watch and no longer wanted it.

Required

(a) Explain the nature of Shiruti's advertisement. Is it an invitation to treat or an offer to sell?

(b) Explain whether there is a binding contract between Angus and Shiruti.

(c) Explain whether Brenda has a right of legal action against Shiruti.

(d) Explain whether Colin has a right of legal action against Shiruti.

(e) Explain whether Shiruti has a right of legal action against Donna.

13 Pool

Carter Goff decided to build a swimming pool in his garden, and he entered into an agreement with Coral Diving Pools Limited (CDP) to construct the pool. The specifications were that the pool should be 25 metres long by 11 metres wide, and should have a depth ranging from one and a half metres at the shallow end to two and a quarter metres at the deep end.

After agreeing the main construction contract with CDP, Carter Goff arranged another contract for CDP to surrounds the pool with floor tiles. The contract specified that the pool should be surrounded by stone floor tiles.

Carter Goff contracted with another supplier, John Fox, to install a diving board at the deep end of the pool, with construction work to begin on 1 September, after it was expected that CDP would have finished construction of the pool.

CDP began construction of the pool and completed the work on 20 July. However, on checking the pool Carter Goff found that the pool was only two metres deep at the deep end, not the two and a quarter metres that had been specified.

In addition, CDP had used plastic tiles to surround the pool. Carter Goff had slipped on one of these and had injured himself badly in the fall, with the result that he had taken a week off work and had lost a contract with a potential new client because of his absence from work.

On 1 August, John Fox notified Carter Goff that he would not be installing the diving board as agreed from 1 September. As a result Carter Goff had to arrange for another firm from a different area to install a diving board, at a cost of £400 more than the price that had been agreed with John Fox.

Carter Goff has obtained quotations from other swimming pool construction companies for the cost of altering the pool so that it is two and a quarter metres at the deep end. The cheapest quotation for the work is £24,000. The original cost of constructing the pool was £90,000.

Required

(a) Advise Carter Goff, with reasons, whether he can take legal action to require CDP to rebuild the swimming pool to the specified depth of two and a quarter metres at the deep end. If not, suggest what the probable legal remedy will be.

(b) Advise Carter Goff whether he can take legal action against CDP for its failure to supply the required floor tiles to surround the pool, and whether he can claim for the loss of revenue arising as a consequence of his injury and absence from work.

(c) Advise whether Carter Goff can require John Fox to install the diving board, and if not what legal remedy (if any) is available to him.

14 Damages

(a) Explain the difference between:

  (i) unliquidated damages

  (ii) liquidated damages

  (iii) a penalty in a contract

(b) Explain how unliquidated damages are assessed.

15 Tortious liability

Explain how the liability of a person is established in a claim for damages for negligence by the defendant.

16 Daisycutters

Gordon has been employed for five years by Daisycutters Limited, a provider of domestic garden services. He is paid monthly, and the company deducts income tax and National Insurance contributions from its weekly payments to him.

Gordon thinks that he would pay less tax if he were self-employed. He therefore asks the company to treat him as self-employed and the company agrees. They draw up and sign a contract. This provides for Gordon to do the same work as before, and for the same hours, in return for the same amount of payment as before. In the contract, Gordon agrees not to do any work on his own account for any other customer as long as he is doing work for Daisycutters.

The tax authorities challenge Gordon's claim that he is self-employed.

Required

(a) Explain the main differences between a contract of service and a contract for services.

(b) Explain the factors that the court will consider when deciding whether an individual is an employee or a self-employed person.

(c) Suggest in this case whether Gordon is an employee of Daisycutters or a self-employed person, when they sign the new agreement.

17 Dismissal

(a) List the circumstances in which the dismissal of an employee might be fair.

(b) List the circumstances in which dismissal of an employee is automatically unfair.

(c) List the remedies that might be used by an employment tribunal in a case of unfair dismissal.

18 Air Fair

Air Fair Limited is a private airline company, owned and managed by Ginger. The company employs 20 pilots, but following the loss of two major contracts Ginger has decided that the number of pilots should be reduced by five, to 15.

Douglas has been a pilot with the company for six years. Two years ago, he reported the company to the authorities for breaches of the health and safety regulations. Since then the relationship between Ginger and Douglas has been professional, but unfriendly.

Neil has been a pilot with the company for eight years and has been a trade union representative for the pilots of Air Fair for the past four years. Last year he had an argument with Ginger about the working hours for pilots, and secured a reduction in their maximum flying hours per week.

Donna has been a pilot with the company for five years. Two years ago she took maternity leave, much to Ginger's annoyance, and she announced a month ago that she was pregnant again.

Douglas, Neil and Donna are three of the pilots who have received notice of dismissal. The other two are Ronnie, who has been with the company for 18 months and Chris, who has been with the company for eight months.

Required

Advise the five pilots about their rights in this situation.

19 Redundant

Wallows Limited runs a retail store selling the goods that it produces, but most of its sales are to the 'trade'. It has decided to close down the retail store and concentrate on trade sales. It has therefore given three months' notice to Hattie, the 44-year old manager of the retail store, and has told her that her job will terminated after the notice period has ended.

Required

Suggest whether Hattie is entitled to either redundancy pay or compensation for unfair dismissal.

20 Agency

Explain the nature of the following types of agency arrangement:

(a) agency by agreement

(b) agency by ratification

(c) agency by estoppel

(d) agency by necessity.

21 Implied authority

Describe the nature of implied authority and explain whether a company secretary has implied authority to act on behalf of his or her company.

22 Duties of partners

(a) What fiduciary duties are owed by each partner in a general partnership to the other partners?

(b) Ten years ago, Ron, Sam and Tim formed a partnership. Last year, Ron sold his share to the other two partners. Since selling his share in the business, Ron has found out that Sam and Tim have entered into a very profitable contract with a new customer. Sam and Tim knew about this when they negotiated a purchase price with Ron, but did not tell Ron. Ron thinks that if he had known about the contract, his valuation of his share of the business would have been much higher, and he would have negotiated a much higher price from the other two partners.

Last year, before Ron sold his share of the business, Fairland Company sold a building to the partnership. Unknown to Ron and Tim, Fairland Company was owned by Sam. Fairland Company made a large profit on the deal, out of which Sam has paid himself a large dividend.

Tim owns and is running another business in direct competition to the partnership, and has been doing so for several years.

Required

Explain the legal position, and advise each partner of the rights and liabilities that he may have.

23 Authority of partners

Is the firm bound by the actions of its partner in each of the following circumstances?

Case 1
The partners of the firm of solicitors Evelyn Donkin Lee have an agreement that any capital expenditure or development expenditure of more than £200,000 should require the prior formal approval of a majority of the partners at a partnership meeting.

The firm's managing partner commissions a software company to carry out extensive work to upgrade the firm's website, e-mail and intranet systems, at a cost of £250,000. The other partners were not consulted beforehand. The software company was unaware of the firm's restriction on development spending without the partners' approval.

The software company began work and some weeks later submitted an invoice for £50,000 for the first phase of the project.

Case 2
Would the situation in Case 1 be any different if one of the partners in Evelyn Donkin Lee had telephoned the managing director of the software company before it had begun to do any of the work, and told him that the managing partner did not have the authority to commit the firm to such a large amount of development expenditure without the partners' permission?

Case 3
The organisers of an international furniture exhibition in Frankfurt sent some marketing material about the exhibition to a partner in Clough & Partners, a furniture design business in South London. The partner, Tim Sorenson, decides to pay for an exhibition stand at for the firm, and places a booking with the exhibition organisers. He also arranges for an international carrier to transport display items of furniture to the exhibition centre in Frankfurt.

On learning about his decision, Tim Sorenson's partners are annoyed. They do not think that he had the proper authority to arrange the exhibition stand and spend money on transporting the items of furniture.

Case 4
Manson Giles, a firm of independent financial advisers, is expanding and the partners are looking for larger and more prestigious premises near St Paul's in the City of London.

A senior partner in the firm has a contact in a firm of property consultants, who shows him some property currently under construction that appears ideally suited to the firm's requirements, although the rental cost would be very high.

The senior partner agrees on behalf of the firm to take a ten-year lease on the property, starting in six months when the property will be ready for occupation.

He then tells the other partners what he has done.

Case 5
Sonombrera is a wine bar in Central London, run by a partnership of four people, W, X, Y and Z. One of the partners, Z, orders a range of new kitchen equipment from a supply company, for delivery to an address in Oxford. Without telling the other partners, Z has promised the owner of a new wine bar that the Sonombrera partnership will provide capital support to his new business.

The equipment supplier delivers the equipment as ordered to the address in Oxford, and submits its invoice to Sonombrera in London.

24 Partnership dissolution

Bruno, Carlos and Didier are in partnership as chartered surveyors. The partnership was formed three years ago. Bruno introduced capital of £20,000 and Carlos and Didier each introduced capital of £10,000.

The firm operates from a small building that is owned by Bruno, for which the firm pays a monthly rental of £1,000. It was agreed that it should remain the personal property of Bruno.

A year ago, Carlos made a loan of £5,000 to the firm which was having cash flow difficulties. However, the business continued to struggle and lost money. The partners therefore agreed to dissolve the partnership. At the time of the dissolution the partnership assets had a disposal value of £29,000 and the external liabilities of the firm were £6,000. The firm also owed Bruno £2,000 for unpaid rent, and the loan to Carlos had not been repaid. The building was valued at £200,000.

Required

How should the assets of the partnership be distributed in the dissolution?

25 LLP

What are the main features of a limited liability partnership?

26 Sole trader and limited company

List the advantages for the owner of a sole trader business in registering the business as a private limited company.

27 Partnerships and limited liability companies

What are the main advantages of a limited company structure for a business in comparison with a traditional partnership structure?

What is the main disadvantage of a limited company structure in comparison with a traditional partnership?

28 Corporate personality

(a) What is meant by the doctrine of corporate personality?

(b) In what circumstances might the courts **not apply** this doctrine?

29 Registration of a company

What documents and procedures are required for a company to register as:

- a private limited company, or
- a public limited company?

30 Articles

Explain the nature of the articles of association of a company.

31 Shareholder's liability

Eighteen months ago, Kara invested £30,000 in 40,000 ordinary £1 shares of Lam Limited, a new company that was just being formed. The shares were issued partly paid, and there has been no further call on the shares since that time. Lam Limited has now gone into insolvent liquidation, owing a large amount to its creditors.

Twelve months ago, Kara was having a conversation with a friend who was the sole shareholder and director of Jam Limited. Jam Limited was in serious financial difficulties, and needed more capital to trade its way out of trouble. Kara showed an interest in the company, and the friends offered to sell to Kara 20,000 new shares of £1 each. The friend was willing to issue the shares at a discount to nominal value of 40 pence, which meant that Kara would acquire the shares for £12,000.

Kara also purchased 5,000 shares in Stamm plc. These have a nominal value of £5,000 but are trading at a price of £3 per share.

Kara has no other money or assets except the shares in these three companies.

Required

Advise Kara about her potential liabilities in relation to the debts of (a) Lam Limited and (b) Jam Limited, and suggest what she might do to deal with any difficulties that might arise.

32 Names

(a) What laws might apply to the selection of its name by a company?

(b) What is meant by 'passing off' in relation to business names?

33 Objects

Farid, Gordon and Henry set up a company in the UK a few years ago, under the provisions of the Companies Act 1985. Farid and Gordon each own 40% of the shares and Henry owns the other 20%. The objects of the company were stated in its memorandum of association as providing taxi services.

Farid and Gordon have now decided that there is more money to be made from providing security services, and they have therefore given up taxi work to act instead as security guards. All their income from this work goes to the company.

Henry has been left to provide taxi services on his own, and he has complained to Farid and Gordon that what they are doing is wrong, and against the objects of the company.

Farid and Gordon have said that they intend to continue doing security work, and that Henry can continue with the taxi work if he likes.

Required

State with reasons whether Henry has the right or the power to make Farid and Gordon return to taxi work, so that the company will comply with its stated objects.

Explain whether the introduction of the provisions of the Companies Act 2006 changes the situation.

34 Boom Limited

Boom Limited is a company that acts as managers to a number of musicians and recording artistes. It has three directors, Ann, Betty and Carol.

Carol discovers a talented new musician, and instead of signing him up for the company, she arranges to become his personal manager. In this capacity, she arranges a lucrative recording contract for him.

Ann and Betty then discover has Carol has done.

Do Ann and Betty have any course of action against Carol?

35 Promoter

Tom was a promoter of Slope plc, a UK public limited company that received its trading certificate in September. After the company received its trading certificate, a meeting of the board of directors was held, where the following information was brought to the attention of the directors.

(1) **Transaction 1**. Tom had entered into a contract in August, in the name of Slope plc, with A Supplies Limited for the purchase of office furniture. The board of Slope plc wants to honour this contract.

(2) **Transaction 2**. Tom had entered into another contract in August, in the name of Slope plc, with B Supplies Limited for the purchase of a motor van. The board of Slope plc does not want to honour this contract.

(3) **Transaction 3**. Tom had sold office premises to Slope plc before the company was incorporated. The company intends to use these premises as its

headquarters. Tom did not reveal his personal interest in the contract at the time the contract was made.

(4) **Transaction 4**. Tom had entered into another contract in August, in the name of Slope plc, with JV Limited. The contract is an agreement for the two companies to work together on the development of a new product. Slope Limited has already incurred some preliminary costs in relation to this venture. JV Limited has now informed Slope Limited that it does not wish to continue with the agreement.

(5) **Transaction 5**. Tom had entered into another contract in August, in the name of Slope plc, with C Supplies Limited for the purchase of shelving equipment. The agreement was made by Tom 'subject to adoption by Slope plc'. The board of Slope plc does not want to honour this contract.

Required

What is the legal position of Tom, Slope plc and any third party in relation to each of these five transactions?

36 Shares and charges

(a) What is the meaning of each of the following terms?

- (i) 50,000 ordinary shares in A Limited of £1 each, fully paid
- (ii) 50,000 ordinary shares in A Limited of £1 each, 75% paid up
- (iii) 10,000 5% cumulative preference shares of £1 each in C Limited.

(b) What is the difference between a fixed charge and a floating charge on assets of a company?

37 Issuing shares

(a) What is the nominal share capital of a company?

(b) What are the legal rules relating to:

- (i) the issue of shares at a premium
- (ii) the issue of shares at a discount?

38 Class rights

(a) In company law, what is meant by 'class rights'?

(b) Explain briefly how class rights may be altered.

39 Dividend payments

In relation to the law relating to dividend payments by companies:

(a) state how dividend payments must be funded

(b) state the rules that apply to dividend payments by public limited companies

(c) state the consequences of a company breaching these rules on dividend payments.

40 Capital maintenance

Explain the concept of capital maintenance in company law.

41 Purchase of own shares

Tract Limited is a UK private limited company, owned and managed by three friends, Alan, Barry and Charles. The company has issued share capital of 100,000 ordinary shares of £1 each. Alan and Barry own 40,000 shares each and Charles owns 20,000 shares.

The company has made small annual profits since it was established six years ago, and last year made a profit of £15,000 after tax.

Charles has informed Alan and Barry that he will be leaving the company in order to emigrate to Australia. The three friends discuss the possibility that Alan and Barry might buy the shares of Charles, who wants to receive their nominal value as a sales price.

However, neither Alan nor Barry has enough money to buy the shares. It is also unlikely that they can find an outsider willing to buy the shares at the required price.

Required

State whether Tract Limited might be able to buy the shares itself. If it is possible, state how it should be done.

42 Directors

(a) Explain the difference between executive directors and non-executive directors of companies in a unitary board system.

(b) Explain the roles of:

(i) the chairman of a company's board of directors

(ii) a managing director of a company.

43 Directors' authority

The authority of a director may be:

(a) express

(b) implied

(c) apparent (ostensible).

Explain the difference between each type of authority.

State the extent to which each type of authority may bind the company.

44 Duties of directors

What duties does a company director have towards the company?

45 Capacity

What is the capacity of each of the following to enter their company into binding contracts with third parties?

(a) The company itself

(b) The board of directors of a company

(c) Individual directors of the company.

46 Small shareholder

Ravi is a small shareholder in Thin Limited. The company has four directors, but three of them appear to have very little to do with the day-today affairs of the company, and control over the company's operations appears to be in the hands of Gil, the chairman of the company.

Ravi does not approve if this state of affairs, especially as he has been told by a friend that Gil regularly takes a commission from suppliers for placing orders with them.

Ravi would like to remove Gil from the board.

Required

(a) Explain whether individual directors have the authority to make binding contracts on behalf of their company, and in particular whether or not Thin Limited is bound by the contracts that Gil has made.

(b) Explain with reasons whether you think any of the directors are in breach of their duty of care and skill to the company.

(c) Explain with reasons whether you think any of the directors are in breach of their fiduciary duty to the company.

(d) Explain how Gil might be removed from the board.

47 Interest in a contract

Lee is a director of ABC plc, a UK public limited company. He also owns 90% of the shares in DF Limited, a private company specialising in the supply of electronic components.

ABC plc entered into a contract with DF Limited to purchase a large quantity of components. The contract was approved at a meeting of the board of directors of ABC plc, that Lee attended. However, Lee did not reveal his interest in the contract to his fellow-directors.

The contract price for the components was higher than available market prices for similar components and DF Limited made a large profit on the transaction.

Required

Explain the legal position in relation to Lee's position as director of ABC plc and his interest in the contract with DF Limited.

48 More interest in a contract

Hans is a director of Imp plc, but he also carries out his own business as a wholesale supplier of specialist paper under the name of Jam Limited. Last year Imp plc entered into a contract to buy a large consignment of paper from Jam Limited. Hans attended the board meeting that approved the contract and voted in favour of it, without revealing any link with Jam Limited. The contract price was considerably above the market price and Jam Limited and Hans made a considerable profit from it.

Required

Analyse the situation explaining any potential liability that Hans may have under English law in relation to the sale of the paper to Imp plc by Jam Limited.

49 Pesos

Pesos Limited is a subsidiary of FX plc.

(a) The managing director of FX plc, Dan Frost, makes an agreement for the sale to Pesos Limited for £5 million of an office property that he owns through his one-member private company. His colleagues suggest that he should obtain shareholder approval for the transaction. He therefore arranges for a general meeting of Pesos Limited to be held, at which its two members (both nominees of FX plc) give their approval to the property transaction. Has Dan Frost obtained shareholder approval correctly?

(b) FX plc makes a loan of £80,000 to Michael Hudson, a director of Pesos Limited. Michael Hudson is married to Jenny Hudson, the finance director of FX plc. The shareholders were not informed about the loan. Is the loan permissible?

(c) Pesos Limited specialises in software systems development for major corporate clients and government departments. A contract for developing a new system is about to be awarded by a company. George Travis, a director of Pesos Limited, has been told informally by the IT director in the company that the price asked by Pesos Limited was too high, but the company was very keen for George personally to do much of the development work, because of his skills and experience. George tells his board colleagues at Pesos Limited that he is thinking of a career change, and asks to be allowed to retire as director, and give up his job with the company. His board colleagues are surprised and disappointed, but agree that he should leave if he had made up his mind. George then approaches the company with a tender to carry out the development work on the new system, and he is awarded the contract. His former colleagues at Pesos Limited find out. What should they do?

50 Disqualification

List the grounds on which an individual may be disqualified from acting as a director, under the provisions of the Company Directors Disqualification Act 1986.

51 Company secretary

(a) What are the rules relating to the appointment of a company secretary?

(b) What are the duties and powers of a company secretary?

52 Auditors

Count and Tickem is a firm of auditors. Its partners are having a bad day.

Count has come back from a meeting with a client, Blade Limited. There has been an argument between the shareholders and the directors of the company, and the shareholders have expressed doubts about the reliability of the company's accounts. Count understands that there is an intention by shareholders to dismiss Count and Tickem as the company's auditors.

Tickem has come back from a meeting with the directors of Slick Limited, another audit client. The audit has been very difficult and the directors of the company have been unfriendly and uncooperative. Tickem feels that he is unable to carryout the audit properly, to his own satisfaction, and he intends to resign as the company's auditor.

Required

(a) Explain how the auditors of a company might be dismissed.

(b) Explain the actions that should be taken and might be taken by the auditors, on resigning from the position as a company's auditors.

53 General meetings

What is the difference between an annual general meeting of a public company and an extraordinary general meeting?

How do the annual general meeting and extraordinary general meetings of a private company differ from those of a public company?

54 Meetings

Who might have the authority or ability to call a general meeting of the company? Explain the circumstances in which they may do so.

55 Votes at general meetings

(a) State who has the authority to call a general meeting of a company, and who might have this authority under certain circumstances.

(b) Explain how votes are taken at a general meeting of a company.

56 Resolutions

(a) Some decisions are made by companies in the form of resolutions by the members. Explain the different types of resolution, and how they are passed.

(b) Explain how a company would amend its articles of association.

57 Winding up

(a) Explain what is meant by 'winding up' in company law.

(b) Distinguish between:

(i) voluntary winding up

(ii) compulsory winding up.

58 Kevin and Kim

Kevin and Kim are the sole directors of Big Twang Limited, a company that puts on rock concerts in the UK to promote bands from Central and Eastern Europe. The company was established three years ago, with issued share capital of £50,000.

At 1 July 2009 the company had accumulated losses of £30,000 and it was using a bank overdraft facility of £25,000 to carry on in business.

In October 2009 the company organised a number of concerts for a band from Slovakia, but these resulted in a loss for the company of £90,000. The company had now exceeded its overdraft limit, but the bank had not yet taken any action.

Kevin and Kim decided that the company must have a success soon, and decided to go ahead with a London concert for a band from Bulgaria. This too was a failure, and the company lost a further £20,000.

In a last gamble, Kevin and Kim decided that the company would put on a concert in May for a Russian band, but this too was a failure and the company lost another £40,000.

Kevin and Kim decided after this that they should apply to the court for a compulsory winding up order for the company. The company's assets on winding up have a disposal value of £10,000 and its total creditors were £175,000.

Required

Explain the potential liability of Kevin and Kim for fraudulent or wrongful trading under the Insolvency Act 1986, and explain their potential liability to the creditors of the company.

59 Combined Code

(a) The Combined Code on Corporate Governance is a voluntary code of practice. Explain why and to what extent companies are required to comply with its provisions.

(b) Describe the main issues of corporate governance covered by the Combined Code.

60 Stick plc

Stick plc is a large UK listed company. Its board of directors has nine directors, including the chairman. Explain the composition of the board and its committees, in terms of executive and non-executive directors, that the company should have.

61 Legislation on corporate governance

Explain the reasons why the UK government might introduce legislation relating to certain aspects of corporate governance, rather than rely on voluntary compliance with a code of best practice. Give examples of legislation on corporate governance to illustrate your answer.

62 Inside information

Define inside information.

(Hint: In UK law, information must meet four conditions before it is regarded as inside information.)

63 Dealing

In June, the board of directors of Giant plc decided to make a takeover bid for Gross plc. Representatives of the boards of directors of Giant plc and Gross plc have discussed the terms of a bid, and the directors of Gross plc have indicated that they will recommend its acceptance to their shareholders when the bid is announced.

After the boards of directors have agreed terms, but before public announcement of the takeover bid, the following events occur.

(1) **Event 1**. Chancer, a director of Gross plc, buys some shares in Gross plc.

(2) **Event 2**. Chancer tells his friend Bent about the probability of a takeover of Gross plc by Giant plc, and Bent then buys some shares in Gross plc.

(3) **Event 3**. Bent tells his friend Moll about the probability of the takeover, and Moll then buys some shares in Gross plc.

(4) **Event 4**. Moll tells her friend Kat about the probability of the takeover, and Kat then buys some shares in Gross plc.

(5) **Event 5**. At a family lunch, Chancer strongly advises his father to buy shares in Gross plc, but without giving a reason for his recommendation. His father follows the advice and buys shares in Gross plc.

Required

State the position of each of these individuals in relation to the law on insider dealing.

64 Money laundering

(a) Define money laundering and explain the nature of money laundering activities.

(b) Explain the activities related to money laundering that are criminal offences under the Proceeds of Crime Act 2002.

65 Using information

Don is a director of a listed UK company, Coaster plc. The company has ended a financial year and is in the period before any public announcement of the annual results for the year. Don is aware that the company will be declaring profits (and probably dividends) that are much higher than the stock market is expecting.

He therefore decides to buy as many shares as he can in Coaster plc. To disguise the share purchase, he buys the shares through a company that he owns with his wife, although all the shares are held on their behalf by a firm of solicitors, in a nominee account. This company is called Grab Limited.

After the declaration by Coaster plc of its annual results, Grab was able to sell the shares for a substantial profit. Don wanted to disguise the source of his money, so he arranged for Grab Limited to pay out the profits to himself personally as a fee for 'consultancy services' that he claimed to have provided.

Required

Explain the legal position from the viewpoint of UK criminal law.

66 Drug dealing

Kim is a dealer in illegal drugs from which activity he makes a considerable amount of money. In order to conceal his gain from his drug dealing, he bought a laundry intending to pass off his drug money as profits from the legitimate laundry business. Kim employs Los to act as the manager of the laundry and Mel as his accountant to produce the false business accounts for the laundry business.

Required

Analyse this scenario from the perspective of the law relating to money laundering.

67 Fraudulent and wrongful

The directors of a company may be accused of either:

(1) fraudulent trading or

(2) wrongful trading.

Required

(a) Explain the meaning of these terms, and the difference between them.

(b) Explain how the law deals with fraudulent trading by directors.

(c) Explain how the law deals with wrongful trading by directors.

Q&A

Answers to practice questions

Contents

Capital and financing of companies

Directors and company officers. Company auditors

Company meetings and resolutions

Insolvency

Corporate governance

Fraudulent behaviour

1 Legislation

(a) **Primary legislation** is statute law passed by Parliament, in the form of Acts of Parliament. Parliament can also delegate the authority to create new legislation to other bodies. **Delegated legislation** is used widely, to simplify the process of law-making. Instead of passing Acts of Parliament that contain lengthy and detailed regulations, Parliament can pass an 'enabling law' containing the general aims and principles of the legislation, and providing for the authority for introducing more detailed regulations to be delegated.

The most common form of delegated legislation is probably the **statutory instrument**. When an enabling Act of Parliament delegates to a minister of the government the authority for introducing more detailed regulations, these regulations are usually introduced by statutory instrument.

Other types of delegated regulation are as follows.

(1) Orders in council. These allow the Privy Council to introduce delegated legislation where a statutory instrument is inappropriate.

(2) Bye laws. Local authorities may to introduce local by laws, under powers delegated by enabling legislation (the Local Government Act 1972).

(3) Rules made by Court Rule Committees about procedures to be followed in courts.

(4) Regulations of a professional body for its members may be given the force of law. In particular, the Solicitors Act gives the Law Society the power to introduce regulations for its members.

(b) The main advantages of delegated legislation are as follows:

(1) They avoid the need for lengthy and detailed primary legislation.

(2) They are more flexible, because they can be amended quickly if necessary, for example when new regulations introduced by statutory instrument are found to be inadequate.

(3) Delegated legislation is quicker to introduce than primary legislation, so has the benefit of speed. (However, new primary legislation may be needed before secondary legislation can be introduced.)

(4) Access to expert advice. It is usually possible for bodies responsible for delegated legislation to obtain advice on detailed regulations from experts in the field. With primary legislation, it may be more difficult to obtain sufficient advice (particularly if the legislation is opposed by the opposition political parties).

(c) The courts cannot overturn primary legislation. Although it should be a rare event, the courts could find that delegated legislation is invalid because the body introducing the legislation acted outside its powers under the primary legislation (acted 'ultra vires').

Under the Human Rights Act 1998, the courts may declare aspects of primary legislation to be incompatible with the European Convention on Human Rights (ECHR), and they can recommend that Parliament should amend the offending law. The courts also have the power to re-interpret statutes if earlier interpretations (precedents) are found to be incompatible with the ECHR.

The main influence that the courts have over primary and secondary legislation lies in their ability to **interpret the law** in cases where there is disagreement or uncertainty about how the law should be applied. Through interpretation of legislation, the courts set new precedents and so establish new common law. This has an effect on how the legislation is applied.

2 Case law

Common law is developed through case law. A decision by a court in an initial case can set a precedent for similar subsequent cases.

Precedents set by a higher court must be followed in a lower court, and will probably also be applied by other courts at the same level in the judicial hierarchy. However, precedents set by a court may be overturned by a higher court. It is also possible for the House of Lords (the highest court) to overturn its own previous precedents.

A binding precedent is established by the ***ratio decidendi*** of the case. This is an abstract legal rule that the judge extracts from the case, explaining the reasoning, in abstract terms, why the eventual judgement was reached. In subsequent cases of a similar nature, courts are expected to apply the binding precedent set by the *ratio decidendi* in the earlier case.

In expressing to stating the *ratio decidendi*, a judge may also provide additional comments, also of a general nature, which are not intended as a binding precedent. These comments are ***obiter dicta***. They are a 'persuasive authority' for courts to use in similar subsequent cases, but they do not set a binding precedent.

Judgements in cases do not make a clear distinction between *ratio decidendi* and obiter dicta, so there may be some uncertainty about a precedent.

In practice, many different binding precedents have been established in cases of a fairly similar nature. A court may decide to ignore a precedent because there are some distinguishing features in the case that make it sufficiently different, so that the precedent in an earlier case does not apply. This is called **distinguishing**.

It is therefore quite possible for the opposing sides in legal dispute to present their case by referring to different (and conflicting) precedents that they argue should be applied in this particular case.

A significant feature of the doctrine of binding precedent is that it is continually used by the courts to establish new common law, largely through the interpretation of legislation.

3 Precedent and the court hierarchy

The doctrine of binding precedent means that decisions of a higher court are binding on lower courts in the hierarchical court structure. The actual decision in the case in a higher court does not set the precedent. The precedent is set by the legal rule or principle on which the decision was based – the so-called *ratio decidendi* in the case.

In addition, precedent set by a court is binding on decisions in later cases in the same court or in a court at the same level in the court hierarchy.

The judge or judges in a case must check previous court decisions to establish whether there have been similar cases in a higher court or a court of the same status. If a similar case is found, the decision in the case is normally based on the precedent set by the earlier case.

The main features of the hierarchical structure are as follows.

- The Supreme Court of the United Kingdom is at the top of the hierarchy of English courts, having taken over the role of final court of appeal from the House of Lords. Its decisions are binding on all other courts.
- The Supreme Court is able to ignore precedents set by itself in earlier cases, and on occasion has done so.
- Decisions by the Supreme Court (and formerly the House of Lords) are subject to decisions of the European Court of Justice (for cases relating to EU law) and the European Court of Human Rights (in cases relating to human rights and application of the Human Rights Act 1998). The Supreme Court is therefore not a supreme court whose decisions cannot be challenged in any circumstances.
- In the hierarchy of civil courts, the Court of Appeal is immediately beneath the Supreme Court. As a general rule, decisions by the Court of Appeal should follow precedents set in similar cases in the Supreme Court or by earlier cases in the Court of Appeal itself.
- There are circumstances in which the Court of Appeal will not be bound by precedent set by itself or the Supreme Court, for example when an earlier precedent set by the Court of Appeal was subsequently overturned by the Supreme Court on appeal, or if the precedent is now inconsistent with EC law.
- Beneath the Court of Appeal in the hierarchy of civil courts come the Divisional Courts of the High Court. These courts are bound by any precedent set by the Supreme Court and Court of Appeal (although there are circumstances in which the Divisional Court will not be bound by a precedent, similar to the reasons why the Court of Appeal might not be bound).

4 Consideration

(a) In English law a legally-binding contract does not exist unless each party gives and receives consideration. A binding contract does not exist if one party gives consideration but does not receive any consideration in return. (There is an exception to this rule: a promise without consideration in return is binding if it is given in the form of a deed.)

Consideration may be given by an act, such as providing goods or providing a service, or may be in the form of a payment for goods or services. Consideration may also be a promise 'not to do something', if this provides a benefit to the other party or involves the promise-giver in some loss. Consideration therefore involves one party either giving a benefit to the other party, or accepting a loss of benefit.

Consideration sufficient for a binding contract may be either executory or executed. Executory consideration is a promise to do something at a future time. Executed consideration is something that has already been done, after the contract was made. For example, in a dispute over payment between an electrician and a householder for electrical work done by the electrician, the electrician might claim payment from the other party for work that has already been carried out, as agreed in the contract with the householder.

(b) Past consideration is something done by one person before any agreement was made. For example in the case *Re McArdle* a man living in his mother's house paid for improvements to the house and subsequently obtained a promise from his brothers and sisters that they would contribute to the costs (because all the brothers and sisters would share in the ownership of the house after the mother died). This was an example of past consideration, because the spending on home improvements happened before the brothers and sisters made their promise to share the cost.

In contract law, past consideration is not recognised as 'good' consideration. It is ignored in deciding whether consideration has been given by both parties, and whether a contract exists. In the McArdle case the court held that the man did not have a contract with his brothers and sisters, because his spending on the house was past consideration. The brothers and sisters could not be held to their promise because they had not received 'good' consideration in return.

(c) When they make a contract, it is for the parties to agree what consideration should be given by each of them. The court will not concern itself with the value of the consideration and whether each party to the contract had a 'fair deal'. In the case Thomas v Thomas, the court held as binding and enforceable an agreement between the executors of a man's will and his widow that she should continue to live in the family house after the husband's death and pay a rent that was far below a market rate. The court ruled that it did not matter that the amount of the rent payment was not adequate consideration. The rent was sufficient consideration; therefore the agreement was binding.

The courts will also normally rule that when one party agrees to do something that he is obliged to do anyway, as part of an existing duty, this will not provide sufficient consideration and any such agreement is not binding.

5 Promissory estoppel

The doctrine of promissory estoppel might be applied in cases involving a dispute over a contract, where a promise has been given by one party to the contract to the other, without any consideration being received in return. Except where 'gratuitous' promises are made by deed, such promises for 'nothing in return' are generally unenforceable in UK contract law.

For example, the general law is that a smaller sum of money cannot be regarded as full settlement for a larger amount (Pinnel's case). This means that if A owes B £200, and B agrees to accept £125 from A in full settlement of the debt, this agreement is not binding on B. B is entitled to change his mind and demand the rest of the money owed.

The doctrine of promissory estoppel is sometimes used to make exceptions to this general rule. When one party to a contract voluntarily makes a promise to the other party, he may be 'estopped' from retracting his promise.

The doctrine was revived in UK law in the High Trees case (1947), which involved a promise by a landlord to accept a lower rent on a property than originally agreed by contract.

In order for the courts to apply the doctrine of promissory estoppel, a necessary condition is that the promise should have been given with the intention that it would be acted on, and the other party should have acted on it.

The doctrine only applies to a promise to change the rights or terms within an existing contract. It cannot apply to a promise to enter into a contract, where the promise is then retracted. It also applies only in cases where the promise is given voluntarily and without pressure being applied by the party receiving the promise (D & C Builders v Rees).

The doctrine when applied usually only suspends the rights of the person who gave the promise. This person can retract the promise provided that he gives suitable notice to the other party (Tool Metal Manufacturing v Tungsten Electric).

6 Pablo

(a) In this situation the doctrine of **privity of contract** applies. The contract is between Pablo and Rob. Rob's mother is not a party to the contract, and she has no rights under the contract.

In order for the matter to become a legal dispute, it will be necessary for Rob to take legal action. His mother cannot do this on his behalf unless she is acting in a particular legal capacity, for example if Rob gave her a power of attorney to act on his behalf whilst he is out of the country.

(b) If the dispute goes to court and Pablo is held to be liable for breach of contract, it is unlikely that the court would decide on damages as the appropriate remedy. Damages should be compensatory, and allow the injured party to be restored to the financial position he would have been in if the breach if contract had not occurred.

It is more likely that the court will rescind the contract, so that the contract is voidable as if it had never been made. Pablo would be required to return the money to Rob and Rob would be required to return the painting to Pablo.

7 Paintings

Mel and Sam

(1) The newspaper advertisement placed by Sam is an invitation to treat, not an offer.

(2) When Mel telephoned and offered to buy the painting for £1,600, this was an offer.

(3) When Sam offered to sell it for £1,800, this was a counter-offer. This terminates Mel's offer.

(4) When Mel asked for three days to think about the offer, Sam agreed to allow him this time. However, the option period is not contractually binding, because Mel did not pay for an option contract (giving the right to buy at the offer price at any time within the next three days).

(5) Sam was free to revoke the offer at any time before acceptance by Mel. This is what happened. When Sam sold the painting to someone else, the offer to Sam was terminated (revoked).

(6) Sam cannot take action against Sam for breach of contract, because there was no contract to accept when Mel wanted to accept it.

Mel and Tom

Mel's offer to sell a painting to Tom was conditional. There is no contract between Mel and Tom.

Mel and Val

(1) The letter from Mel to Val was an offer.

(2) Val sent a letter indicating acceptance, so the postal rule applies.

(3) Since Mel communicated with Val by letter, it is reasonable to suppose that acceptance by letter was contemplated.

(4) It would therefore appear that the offer was accepted as soon as Val posted the letter, and a contract for the sale of the painting exists.

(5) Whereas an offer can be revoked before acceptance, acceptance cannot be revoked after it has been given.

(6) However, it is doubtful whether in practice Mel would seek to enforce the contract. Val is a regular customer, and Mel will not want to lose Val's goodwill, so there is a good commercial reason for agreeing to allow the acceptance to be revoked. Val would argue that by telephoning Mel, Mel is made aware of the situation even before the letter of acceptance has been received.

8 Part payment

(a) **Russell**. Russell has not discussed the payment with Ali, and has acted on his own initiative in making a part-payment and declaring that this is in full settlement of his debt. The rule in Pinnel's case applies here. A lesser payment is insufficient to settle a larger debt, unless additional consideration is given.

(b) **Sam**. The general rule is that a part payment is insufficient to settle a larger debt, unless additional consideration in given. It would appear that the doctrine of promissory estoppel applies here. This rule was applied in the *High Trees* case. A creditor is 'estopped' from retracting the promise he has given. In this situation, Ali will not be able to claim an immediate payment of the remaining £600 from Sam. However it is usually possible for the promissory to retract the promise provided that he gives reasonable notice to the debtor. In this case, since Sam has now earned a large income it is likely that Ali will be able to claim the remaining £600 from Sam provided he gives reasonable notice that his promise to take part payment is being withdrawn.

(c) **Tina**. In this case, Tina is offering additional consideration to settle the debt. This additional consideration is in the form of secretarial work. Ali has agreed to accept payment of £500 of the debt in this form. Although he does not think that the work will be worth £500, this does not matter. The consideration, in kind, is sufficient even if it is not adequate. Ali has no legal right to claim extra payment from Tina after she does the work for him.

(d) **Uri**. Ali has agreed to accept part-payment of a debt from a third party, in settlement of the full amount owed by Uri. By accepting part payment from a third party, Ali cannot now demand the remaining payment from Uri, even though no additional consideration has been given in return. Part-payments from a third party are an exception to the general rule in Pinnel's case.

9 Exclusion

(a) An exemption clause or exclusion clause is a term in a contract that seeks to exempt or exclude one party from a liability (or seeks to limit the potential liability).

Exclusion clauses may be included in any form of contract. The most common disputes occur in relation to standard contract between a company and householders or consumers, such as terms and conditions for using a car park that seek to exclude the car park owner from any liability for damage to cars whilst they are in the car park.

(b) When there is a legal dispute about an exclusion clause, the court may first of all need to decide whether the contract between the parties does actually include the disputed clause. There are three ways in which an exclusion clause might be inserted in a contract:

(1) By signature. A person who signs a contract containing an exclusion clause acknowledges that the contract contains the clause. A person who has signed a contract cannot claim that the exclusion clause is void or invalid because he did not read the contract before signing it, or because he read the clause but did not understand it: (L'Estrange v Graucob).

(2) By giving the other party suitable notice of the exclusion clause. When there is no written contract between the parties, the terms and conditions of the contract might be notified to the other party on a notice board or in a document setting out terms and conditions of use. In a case of dispute, the court may have to decide on the facts of the

case whether notice has been sufficient, and so whether the exclusion clause is a part of the contract. In the case Chapelton v Barry UDC, the court held that notification of an exclusion from liability for injury to users of deck chairs was insufficient when it was printed on the back of the deck chair ticket. (The ticket was a receipt, obtained after the contract was made, so there was no advance notification of the exclusion clause.)

(3) By custom. Where the parties have been accustomed to agreements between each other where an exclusion clause has applied, the existence of the exclusion clause in a subsequent similar agreement might be implied, even though it has not been explicitly stated.

(c) When it is established that an exclusion clause does exist in a contract, the next area of dispute might be whether the clause is legally valid and enforceable.

Some exemption clauses are totally prohibited by the Unfair Contract Terms Act 1974 For example an exemption clause is prohibited if it exempts one party from liability for negligence resulting in death or injury to someone else (for example, the other party).

Other exemption clauses are regulated by the Unfair Contract Terms Act 1974 (UCTA) and the Unfair Terms in Consumer Contracts Regulations 1999. For example the UCTA states that an exemption in a contract giving one party exemption from liability for damage due to negligence is only enforceable if it is reasonable in the circumstances. What is reasonable in the circumstances might therefore be a matter for the courts to decide, on the basis of the facts of a particular case.

10 Terms, conditions and warranties

A **term in a contract** is a statement that forms part of the contract. Each party to the contract undertakes to comply with its terms. Failure to comply with a term in a contract is a breach of contract, although the remedy for breach of contract depends on what type of term it is.

A term in a contract should be distinguished from pre-contractual statements, known as representations. A statement does not form a part of the contract, even though a statement by one party might have induced the other party to agree to make the contract. Making a false statement can lead to a claim for misrepresentation by the injured party, but not for breach of contract.

Terms in a contract are either conditions or warranties.

A **condition** is a fundamental term in a contract. It is something that 'goes to the root of the contract'. A breach of condition is a fundamental breach that gives the injured party the right either:

- to terminate the contract and not perform his obligations under the contract, or
- to go ahead and fulfil his obligations under the contract, and sue the other party for damages for breach of contract.

A **warranty** is a contract term that is not fundamental to the contract. Failure by one party to fulfil the terms of a warranty does not invalidate the contract and does not give the injured party the right to terminate the contract. The injured party, in the case of a breach of warranty, must therefore go ahead and fulfil his obligations under the contract, and his only remedy is to sue the other party for damages for breach of contract.

Note: An **innominate term** in a contract is one where it cannot be decided in advance whether its breach would be a breach of condition or a breach of warranty.

11 Implied and innominate

(a) **Implied terms** are terms in a contract that are not expressly stated, but they are included in the contract by implication. Implied terms can be grouped into three types.

(1) **Terms implied by custom or usage**. Terms may be implied into a contract when it is the 'local' custom for all such contracts to include the term. For example in Hutton v Warren, the court decided that a term should be implied in the tenancy agreement of a tenant farmer, relating to costs of seed and labour in the final year of his tenancy agreement, because it was the custom for all such agreements in the region to include the term. However, express terms in a contract overrule any implied terms, where these differ.

(2) **Terms implied by statute**. A statute may specify in certain situations that if a contract does not expressly include a term relating to a particular matter, a contract term should be implied. For example the Companies Act includes some provisions that if a company's articles of association (which are a contract between the members and the company and between the members themselves) do not include an article relating to a particular matter, a standard article should be implied.

(3) **Terms implied by the court**. On occasion a court may imply a term in a contract, but only if this is necessary to give 'business efficacy' to the contract. An example is the Moorcock case, where the court decided that in a contract between a ship owner and the owner of a wharf, there was an implied term in which the wharf owner gave a warranty to the ship owner that the wharf was a safe place of anchorage for the ship.

(b) The terms in a contract are usually either conditions or warranties. If there is a breach of condition by one party, the other party will be deprived of 'substantially the whole benefit' of the contract and so will be allowed to repudiate the contract. In contrast, when the terms of a warranty are broken by one party, the other party may suffer a loss but will not be deprived of 'substantially the whole benefit' of the contract. The injured party can therefore seek a remedy for the breach, usually in the form of damages to cover the amount of the loss, but cannot repudiate the entire contract.

Innominate terms are terms in a contract that might be either a condition or a warranty. Deciding whether it is a condition or a warranty, in the event of a breach of its terms by one party, will depend on the consequences of the breach for the injured party. (Note: A reference to the Hansa Nord case as an example would be useful in answering an examination question on this topic. In this case, the court had to consider whether breach of a particular term was a breach of condition or a breach of warranty, and it decided that this would depend on the consequences o f the breach.)

12 Grand Pearl

(a) The advertisement. It is important to establish whether the advertisement is an invitation to treat or an offer for sale. If it is an offer for sale, acceptance by someone of the offer creates a contract. If the advertisement is simply an invitation to treat, it is not a legally binding offer. Anyone responding to the advertisement then makes an offer and the person who does the advertising can then choose whether or not to accept.

As a general rule, advertisements are regarded as an invitation to treat, not an offer. However, there are occasions when an advertisement might be treated as an offer for sale to the world at large. The case that established a precedent for this was *Carlill v Carbolic Smoke Ball Co*. In this case, an advertisement was considered by the court to be an offer to the world at large that could be accepted by anyone.

It is not clear in this case whether Shiruti's advertisement would be regarded as an invitation to treat or an offer for sale to the world at large. A court might decide that it is an offer for sale, because the terms of the offer were quire specific. If so, Shiruti is contractually bound by the first person who accepts the offer.

However, a court might decide instead that it is an invitation to treat, giving Shiruti that right to decide whether to accept any offers made by persons responding to the advertisement.

(b) Angus would presumably rely on the postal rule (as in *Adams v Linsell*). This is the rule that an offer is accepted as soon as the offeree posts a letter of acceptance, provided that the letter is properly addressed and stamped. (Angus would not know that Shiruti actually received and read the letter before opening for business on the Monday morning.)

If the advertisement is an invitation to treat, Shiruti is free, however, to reject the offer from Angus. If the advertisement was an offer for sale to the world at large, the question becomes one of whether the acceptance of Angus is valid.

In this case, Angus is probably unable to rely on the postal rule, even if the advertisement is considered to be an offer for sale. This is because the postal rule is only valid if acceptance by post was in the contemplation of both parties when the offer was made. In this case, it is unlikely that acceptance by letter was contemplated by Shiruti.

For the differing reasons explained, it is unlikely that a binding contract exists between Angus and Shiruti.

(c) **Brenda**. Again, the legal position depends on whether the advertisement is an invitation to treat or an offer for sale to the world at large. If the advertisement is an invitation to treat, Shiruti is free to reject Brenda's offer, without needing a reason.

If the advertisement is an offer for sale, the question becomes whether Brenda's acceptance was valid. To be valid, an acceptance must be without conditions. The offeree cannot seek to introduce new conditions into the contract (*Neale v Merritt*) and if an offeree makes new conditions this becomes a counter-offer (*Hyde v Wrench*). When there is a counter-offer, this replaces the original offer.

In this case, Brenda offered to pay by cheque. Although the courts regard a cheque as equivalne to money, this is not relevant here. Shiruti specifically asked for payment in cash. The offer by Brenda of payment by cheque is not an acceptance of the full terms of the offer, and may be a counter-offer. Shiruti is entitled to refuse to sell the watch to Brenda.

(d) **Colin**. There is no contract to sell the watch yet. Colin has simply asked Shiruti to keep the offer open until Tuesday, which Shiruti agreed to do. An agreement to keep an offer open is not legally binding unless the offeree gives some consideration in return. By taking a deposit of £40, Shiruti entered into a legal contract with Colin. This is because the cash deposit is a form of **option contract**. By refusing to sell the watch to Colin, Shiruti is liable for breach of the option contract with Colin. Colin will be able to sue for the difference between the price he had to pay to get the watch (£1,250) and the price at which he had the right to buy it from Shiruti (£800).

(e) **Donna**. Donna offered to buy the watch and Shiruti accepted. There is a legally binding contract, and in principle (although it might be difficvult in practice) Shiruti could sue Donna for breach of contract. The amount of damages that could be claimed would be the difference between the price offered for the watch by Donna (£1,000) and the price at which Shiruti is eventually able to sell it.

13 Pool

(a) CDP is in breach of the construction contract because it did not build the pool to the specified depth.

However, the court will not require CDP to carry out alterations to make the pool deeper. This is because the court will not grant the equitable remedy of specific performance in the case of contracts for personal service, and the contract for the construction of the swimming pool involves the provision of personal service by CDP.

The only remedy available to Carter Goff is damages for breach of contract by CDP. The cost of carrying out re-construction work is high in relation to the nature of the fault and the cost of the original construction work. It seems likely that a court will follow the ruling in the similar case of Ruxley Electronics and Construction Ltd v Forsyth, in which the construction company was entitled to the contracted payment for the construction work, but that it should pay some damages for the loss of value or amenity to the house owner. In all probability, the amount of the damages will be fairly small, since there is probably only a small loss of amenity from having a pool one quarter of a metre less deep than specified but still suitable for its intended purpose.

(b) CDP is again in breach of contract for failing to supply tiles in the correct material. For the same reason as in (a), the court will not grant the remedy of specific performance, and Carter Goff must sue for damages.

Carter Goff will not be able to sue for the loss of profits arising as a result of his fall and absence from work. Assuming that the accident can be attributed to the plastic material with which the floor tiles were made (which may be questionable) the second part of the rule in *Hadley v Baxendale* would apply. The loss of profits arising as a result of the absence from work is indirect and too remote. It would not have been in the contemplation of the parties that this would be a consequence of any breach of contract, at the time the contract was made. Carter Goff will not be able to sue successfully for damages to recover these losses.

(c) The announcement by John Fox that he will not install the diving board is a case of express anticipatory breach of contract. Carter Goff has the right to take immediate action for breach of contract. In this case, he should sue John Fox for the difference of £400 between the price agreed for the diving board with John Fox and the price that will have to be paid to the alternative suppliers.

(Carter Fox will not be able to get the court to issue an order for specific performance of the contract by John Fox, because it is a contract involving personal service.)

14 Damages

(a) **Unliquidated damages, liquidated damages and penalties**
Damages are a common law remedy for breach of contract. Many contracts do not specify the amount of damages that should be paid in the event of a breach of contract, by the party responsible for the breach to the injured party. In such cases, when the parties cannot agree between themselves whether a breach of contract has occurred, or if so what the amount of damages should be, the court will decide the amount of damages. These are **unliquidated damages**.

Sometimes a contract will specify the amount that will be payable in the event of a breach of contract. If this amount is a genuine attempt to estimate what the loss would be to the injured party in the event of a breach of contract, it is **liquidated damages**. In such cases, the court will rule that the liquidated damages are the appropriate amount of damages to pay.

However, if the amount of the payment includes a punitive element, so that the party in breach of contract is being punished by having to pay more than the injured party has lost, this is a **penalty**. A court will not enforce a penalty clause, and will instead decide on an amount of unliquidated damages.

(b) A court will decide on the facts of a case whether a clause in a contract specifying an amount payable in the event of a breach is a liquidated damages clause or a penalty clause.

The amount of unliquidated damages
The amount of unliquidated damages for breach of contract is decided by the court. Two key issues affect the assessment of damages: the remoteness of damage and the measure (amount) of damages.

Remoteness of damage
Essentially, damages should not be paid when a loss suffered by the injured party is remote from the breach, and insufficiently close to the breach to make the offending party liable for the loss. The case *Hadley v Baxendale* established two rules about the remoteness of damage.

The first rule is that there are some losses (**normal loss**) that should be expected as a normal consequence of the breach of contract. The party in breach of contract is deemed to be aware of the normal loss arising from the breach, regardless of whether or not he actually was aware of it. The party in breach of contract is therefore liable in damages for normal loss (and is liable to pay **normal damage**).

The second rule in *Hadley v Baxendale* is that there may be an unusual loss (**abnormal loss**) that would not normally occur as a result of a breach of contract, but which has occurred. If – and only if – both parties were aware of this abnormal loss at the time they made the contract, the party in breach of contract is liable for the abnormal loss (and will be required to pay **abnormal damage** in addition to normal damage). Otherwise, abnormal loss is too remote from the contract and the party in breach cannot be held liable for the abnormal loss.

Measure of damages
The purpose of damages should be to restore the injured party to the position he would have been in if the breach of contract and the consequential loss had not occurred. It is a compensatory award, not a punitive award.

When there is a breach of contract for the sale of goods, the court will normally apply the market rule. This means that if the goods are not delivered by the seller in accordance with the contract agreement, the buyer has the right to go into the market to obtain similar goods on the best terms possible. Damages would be assessed on the basis of the difference between the expenses actually incurred by the buyer and the purchase cost in the contract.

When a seller delivers goods in accordance with the terms of a contract and the buyer refuses to accept them, the seller has the right to go into the market and sell the goods for the best price obtainable. Damages would be based on the difference between the actual sales income and the sales price in the contract.

The court will also expect the injured party to take every reasonable measure to mitigate his loss from the breach of contract: (*Payzu v Saunders*).

Damages are normally compensation for a financial loss. However, in some cases, a court might award damages for a non-financial loss, such as loss of entertainment and enjoyment (*Jarvis v Swan Tours*).

15 Tortious liability

In cases involving alleged tort for negligence, the onus is on the injured party to demonstrate that the defendant should be held liable for a wrongful act. The claimant must be able to demonstrate:

- that the defendant owed the claimant a duty of care
- causality: that a breach of this duty of care was the direct cause of loss to the claimant, and
- that the defendant suffered loss arising from damage to assets or injury to person.

There is a three-stage test to establish whether a duty of care exists.

- The defendant must show that it was reasonable for the defendant to foresee that a breach of duty would have the consequences for the claimant that it did, and so would cause the claimant loss. In the case *Home Office v Dorset Yacht Co* for example, the claimant successfully demonstrated that is was reasonably foreseeable by Borstal guards that by leaving boys unsupervised on an island, they might attempt an escape, and that if they did they would try to get off the island by boat and this might cause damage to the claimant's yacht.
- There must be sufficient proximity between the claimant and the defendant. In the *Caparo* case, for example, it was established that there was not sufficient proximity between a company's auditors and potential investors in the company's shares, even though the potential investor in the case was already a shareholder in the company. The claim was therefore dismissed.
- In all the circumstances, it must be just and fair to impose a duty on the defendant. This appears to have been the view taken by the court in the case *White v Jones*, where a solicitor was held liable for loss to would-be beneficiaries in a will, as a result of the solicitor's negligence in failing to amend the will before the death of his client.

A court might decide that the defendant has assumed responsibility for the economic interests of the claimant, in which case a duty of care exists. However, a person might be able to avoid the assumption of responsibility to other parties by issuing a clear disclaimer of responsibility. This appears to have been a conclusion arising out of the *Bannerman* case in Scotland.

The normal test of causality is the 'but for' test which seeks to establish whether the claimant would have suffered loss but for the negligence of the defendant. If the loss would have occurred anyway, causality is not established.

If the defendant is able to establish that if the defendant owed a duty of care to the claimant, was negligently in breach of this duty and as a consequence the claimant suffered loss, the claimant must also establish that he actually suffered loss. The claimant must therefore establish the nature of the loss, and the court must be satisfied that the loss was such that it should award damages in the case. Remoteness of damage is an important consideration, because the court will not award damages for losses that are too remote from the breach of duty.

Following the case *Murphy v Brentwood DC*, it is doubtful whether the courts will award damages to the claimant for pure economic loss (which in this case was loss arising from having to sell a property for an unfavourable price).

16 Daisycutters

(a) An employed person has a contract of service with an employer, and has certain rights under UK law (such as rights under the Employment Rights Act 1996 and rights in the event of unfair discrimination at work).

A self-employed person has a contract for services with a customer. The contract is for the provision of a service in return for a payment. The rights of a self-employed person in a contract are the rights of a party to a contract under contract law.

Another important difference between an employed person and a self-employed person is that if a customer receives bad treatment from an employee, he can take legal action against the employer. However, if a customer receives bad treatment from a self-employed person, his only course of legal action is against that person individually.

(b) The courts use a number of tests to decide whether an individual is employed or self-employed.

A simple test is a **control test**. If an individual can be told by another person what to do in his work, how the work should be done and when it should be done, the other person has substantial control. The individual is therefore an employee and the other person is the employer (*Walker v Crystal Palace Football Club*).

A second test is an **integration test**. An individual is held to be an employee if his work is sufficiently integrated into the business and its operations of the other person.

The courts are likely to consider a number of different factors when deciding whether a person is employed or self-employed. This is called a **multiple test** or **economic reality test**. In the *Ready Mixed Concrete* case, the court specified three conditions for the existence of a contract of employment.

(1) The employee agrees to provide his own work (and not the work of anyone else) in return for a wage.

(2) The employee agrees specifically or by implication that he will be subject to a degree of control by the employer.

(3) The other provisions in the contract should be consistent with the terms and conditions of a contract of employment.

These other provisions or factors that a court might consider include whether the individual provides his own equipment (since an employed person is more likely to use equipment provided by the employer), and whether the individual can ask someone else to do the work (since an employee cannot do this, and must do the work himself for which he is paid). Another important factor is whether the individual faces any financial risk in his work: an employee does not whereas a self-employed person does.

(c) In this case there are several factors pointing to the conclusion that Gordon is an employee of Daisycutters, despite the written agreement between them. Under the terms of the agreement, Gordon receives a fixed wage for a stated number of hours of work each week. He appears to be subject to a degree of control by Daisycutters. He is not allowed to do work on his own account for any other customer, indicating a lack of financial risk in his work. He probably also uses equipment supplied by the company.

17 Dismissal

(a) An employee may be fairly dismissed for the following reasons:

1. lack of capability for the job or lack of qualification
2. misconduct (serious misconduct)
3. redundancy
4. where continued employment of the individual would breach a statutory regulation
5. some other substantial reason sufficient to justify dismissal.

(b) Dismissal for the following reasons is automatically unfair. (Once the employee can demonstrate that he has been dismissed, the onus is on the employer to show that dismissal was not for the reason alleged by the claimant.)

1. Dismissal for trade union reasons; for example for acting as a trade union representative, being in a trade union or taking part in a strike.
2. Dismissal for reasons related to pregnancy or childbirth
3. Dismissal for a reason related to work carried out by the employee on health and safety matters, or because the employee left his place of work in the reasonable belief that he was facing serious danger
4. Dismissal for making a 'protected disclosure' – for example a disclosure to the authorities about criminal activity, damage to the environment or breach of health and safety regulations
5. Dismissal for asserting statutory rights, such as rights under the Working Time Provisions 1998 or the National Minimum Wage Act 1998.

(c) Remedies for unfair dismissal are:

1 reinstatement
2 re-engagement
3 compensation.

Compensation may be in addition to reinstatement or re-engagement, or it may be the sole remedy.

18 Air Fair

Chris has been with the company for only eight months, and is therefore unable to make a claim for a redundancy payment (where the minimum requirement is two years of continuous employment with the employer) or for unfair dismissal (where the minimum employment requirement is one year).

For the pilots other than Chris, it is necessary to establish whether they have been dismissed. Since they appear to have been given written notice of dismissal by the employer, there would seem to be no question about the fact that they have been dismissed.

Having established that the pilots have been dismissed, the onus will be on the employer to demonstrate that any allegation of unfair dismissal is not correct, and that the dismissal was fair.

Ronnie would be able to claim for unfair dismissal but not for redundancy, because he has been with the company for over one year but less than two years. However, it would appear that the employer will be able to claim that the dismissal is due to redundancy, and so fair – provided that the employer has followed 'proper' practice in making him redundant. (Given the possible claims of Douglas, Neil and Donna, for unfair dismissal this point could be challenged.)

Redundancy

As a general rule, dismissal is not unfair if it is for reasons of redundancy. It is not clear whether Air Fair is disputing the fact that the employees have been made redundant. It is assumed here that Air Fair might claim that the pilots have been dismissed for a reason other than redundancy.

Douglas, Neil and Donna are all entitled to a redundancy payment if they have been made redundant, because they have each been in continuous employment with the company for more than two years.

It would seem difficult for the company to argue that the pilots have not been made redundant. The company is reducing its work force of pilots from 20 to 15 because of a contraction in the business. This falls within the definition of redundancy in the Employment Rights Act (ERA) 1996.

If these three pilots have been made redundant, they are entitled to a minimum redundancy payment from the employer, under the provisions of the ERA 1996. The amount of this payment varies according to length of service and the age of the employee. For example, if Douglas was aged between 22 and 40 throughout his period of employment, he would be entitled to one week's pay, up to a maximum amount per week (currently £310, from February 2007) for each full year of continuous service (or one-and-a-half weeks' pay per year of service, up to the £310 per week maximum, for each year of service when he was aged 41 or over).

Unfair dismissal
Another issue, however, is whether the dismissals of each pilot were unfair. Each pilot has a possible claim for unfair dismissal for a reason specified (as automatically unfair) in the ERA 1996.

(1) **Douglas**. Dismissal is unfair when an employee is victimised for making a 'protected disclosure'. Protected disclosures include reporting the employer to the authorities for breaches of the health and safety regulations. Douglas might have a justifiable case for unfair dismissal in this respect, and the onus is on Air Fair to prove that dismissal was not for this reason.

(2) **Neil**. Dismissal is unfair when it is for reasons connected with trade union activity, such as acting as a trade union representative or taking part in industrial action. Neil has a possible case in this respect, and the employer is in the same position as with Douglas.

(3) **Donna**. Dismissal is unfair when it is for reasons connected with pregnancy or childbirth. Donna would seem to have a justifiable case that she has been 'victimised' for this reason. Again, the employer is in the same position as with Douglas (and Neil).

To show that the choice of Douglas, Neil and Donna for redundancy was not unfair, the company would need to show to the employment tribunal that it has acted reasonably in carrying out the redundancy procedures. A reasonable employer would be expected to follow the ACAS Code of Practice. The employer should be able to demonstrate that the choice of individuals for redundancy was for objective reasons, and that no employees have been victimised by deliberate selection.

19 Redundancy

Hattie would be eligible for redundancy pay if she has worked for the company for at least two years, and to compensation for unfair dismissal if she has worked with the company for at least one year. It is assumed in this situation that Hattie would be entitled to either form of settlement.

Hattie should consider an appeal to an employment tribunal, making a claim for either redundancy or unfair dismissal, if she has a valid case.

Hattie must be able to demonstrate that she has been dismissed. In this case, it is clear that the company has dismissed her because it has given her notice.

The employer must now be able to demonstrate that the dismissal is fair, and one potential reason for fair dismissal is redundancy. Redundancy occurs when an employer ceases to carry on the business for which the employee was employed, or the requirements of the business for work of the type performed by the employee have ceased or been reduced. Here, the company will no longer operate its retail store, and this might be valid grounds for redundancy. If so, Hattie can make a claim for redundancy payment. If the employer refuses to agree to the claim, she can take her claim to an employment tribunal.

It is questionable, however, whether the employer has acted reasonably in dismissing Hattie in the way that it did, without proper consultation or considering the possibility of alternative employment, and without going through a proper procedure. This should give Hattie the right to claim for unfair dismissal because of the unreasonable behaviour of the employer.

20 Agency

(a) Agency by agreement

This is the most usual way of creating a legal principal/agent relationship. The agent is appointed by the principal to carry out certain tasks and/or fulfil a specific role. There is a contractual relationship between them, but there are no legal requirements relating to the nature or content of the contract.

However, where the powers of an agent are to include the power to sign legal documents ('execute deeds') in the principal's name, the agent must be given formal power of attorney. To do this, the agent must be appointed by a deed.

(b) Agency by ratification

An agency by ratification comes into existence when one person incorrectly claims to be the agent of another and contracts with a third party on that basis, but the other person then accepts the contract. In doing so, he ratifies the agency relationship, and accepts his position as principal. (Unless the agency relationship is ratified, the third party does not have an enforceable contract with the principal.)

Ratification must take place within a reasonable time.

For ratification to be effective, the principal must have been in existence at the time of the transaction by the 'agent' and must have legal capacity to enter into the transaction (Kelner v Baxter).

At the time the agreement is made, the other party must be aware of the existence of a named principal, and must believe that he is dealing with an agent who is acting on behalf of that named principal. A principal who is not named cannot subsequently 'adopt' the contract as principal (Keighley, Maxsted & Co v Durant).

The principal must ratify the entire contract made on his behalf by the 'agent', and cannot accept some parts of the contract but not others.

(c) Agency by estoppel

Agency by estoppel occurs where a person has led others to believe that another person is his agent, even though an agency agreement does not exist. If a third party, *believing an agency relationship to exist from what the principal has indicated*, agrees a transaction with the 'agent', the principal is prevented from ('estopped from') denying that an agency relationship does exist. The principal is therefore bound contractually by the actions of his 'agent' in respect of any transaction or agreement between that agent and the third party. (A relevant case: Freeman & Lockyer v Buckhurst Park Properties Ltd).

(d) Agency by necessity

Agency by necessity may come into existence in an emergency, when an agency agreement does not exist. An emergency may occur that requires a person to take actions to protect the property or interests of someone else. For example, a person may be in possession of goods of someone else, and is then required by necessity to take action to protect or preserve those goods.

In these circumstances, an agency arrangement comes into existence by necessity. The person taking action to protect the interest of another becomes the agent of that other person. That other person becomes the principal, who is contractually liable for actions taken by the agent. (Relevant case: Great Northern Railway Co v Swaffield).

However, for an agency by necessity to come into existence, there must be a genuine emergency. If there is no emergency, agency by necessity does not exist (Sachs v Miklos). In addition the person taking action must have been unable to contact the 'principal' to get instructions about what to do (Springer v Great Western Railway Co). This is unlikely in most cases today, given the speed and extent of modern communications.

21 Implied authority

Implied authority is authority that derives from a person's position, and whether the person appears to have the authority to act as an agent for a principal. For example, a company officer might have implied authority to enter into a contractual agreement with a third party, because his or her position is normally associated with having the required authority to do so. A third party acting in good faith can therefore reasonably rely on the implied authority of an agent, and contracts made by the agent are binding on the principal. However, if the third party is aware that the person does not have the necessary authority to enter into a contractual arrangement, he cannot rely on any such implied authority.

A well-known case of implied authority is *Watteau v Fenwick*, where a former hotel manager for a company had implied authority to buy cigars on behalf of the company even though the company's managers had expressly forbidden him from making any such purchases. The court ruled that in spite of the company forbidding the former manager to make the purchase, it was bound to the contract because he had implied authority and the third party who supplied the cigars acted in good faith and had no knowledge of the prohibition.

The extent of implied authority depends on the position of the person acting as agent. For example a managing director has the implied authority to enter any type of contract with third parties, because a managing director is normally able to exercise all the powers of the company. A company secretary has implied authority to make contracts with third parties on behalf of the company in connection with 'the administrative side of the company's affairs.' Even if the company secretary does not actually have these powers, the company will be bound to the contractual terms of any such contract made by the company secretary, provided that the contract was made with a third party acting in good faith who was unaware that actual authority did not exist.

22 Duties of partners

(a) A partnership agreement between partners is contractual. It is usually a written agreement, which should state the duties and obligations of each partner. However, partners also have rights and duties arising from their relationship and the fiduciary position (position of trust) that they have towards each other.

The fiduciary duties owed by each partner to the other partners are:

- A **duty of disclosure**: each partner must provide accurate accounts and full information concerning the business to all the other partners
- A **duty to account**: each partner must 'account' to the other partners for the profit or other benefit he receives from any transaction concerning the partnership, if the other partners have not given their consent to the profit or benefit.
- A **duty not to compete**: each partner has a duty not to compete with the partnership business, without the consent of the other partners.

(b) Sam and Tim appear to be in breach of their duty to disclose to Ron relevant information about the partnership business. Failure to tell Ron about the new contract has resulted in Ron agreeing to sell his share of the business for less than its proper value. It would therefore seem that Ron has the right to set aside his sale of his share of the business, and to re-negotiate a new deal (for example, a higher price) with the other two partners.

Sam has not disclosed to the other partners his interest in the property transaction, and has not obtained the consent of the other partners to making a personal profit on the transaction. He is therefore liable to account to the partnership for this undisclosed profit. (He will be required to pay the profit to the partnership.)

Tim is in breach of the duty not to compete with the partnership without the consent of the other partners. He will be held liable to account to the partnership for all the profits he has made from his other business. There may be a clause in the partnership agreement that allows the other partners to expel him from the partnership. If not, it seems likely that the partnership will be wound up anyway. (A new partnership excluding Tim could be formed, but since Ron may not want to remain as a partner in the business, Sam may be left on his own as a sole trader.)

23 Authority of partners

Case 1
The managing partner does not have the actual authority to arrange for the software company to do the work. The software company would argue, however, that the managing partner appeared to have the authority, and that the work was connected with the normal business of the firm. The firm is therefore likely to be bound to the debts and obligations arising from the managing partner's action.

The partners might decide to cancel the development work, and give notice to the software company in the appropriate way. However, the firm would be liable for the cost of the work done to date and for any other costs arising out of cancelling the work (such as any cancellation fee).

Case 2
The situation is now different, because the managing partner's authority was restricted by a decision of the partners, and the software company had been given notice. The firm is therefore not bound by the managing partner's action.

The partners might decide, however, that the work is desirable, even though not properly authorised, and they might decide to go ahead with it. Such a decision to ratify the decision would have the actual authority of the partners, and the firm would then be bound by that decision.

Case 3
To the exhibition organisers and the international carrier, Tim Sorenson would appear to be acting with the authority to bind the firm. Having an exhibition stand at a furniture exhibition would seem to be connected to the firm's normal business.

It would therefore seem that the firm is bound by the transactions made by Tim.

Case 4
Entering a ten-year lease agreement is a major business transaction even for a large firm, and the other party should be expected to have asked for evidence of the senior partner's authority to commit the firm to taking the property.

It might be a matter of some debate whether the senior partner had the actual or the implied/ostensible authority to make any agreement concerning the property. The firm might therefore refuse to be bound by his action. If this happens, the property owners might sue the partners for breach of contract.

If the property company sues and is successful, the partnership (the partners jointly) will be liable. If the senior partner has acted outside his actual authority, the other partners can then seek to recover the costs from the senior partner personally.

However, the partners might decide to approve the acquisition of the lease, and so give the transaction actual authority.

Case 5
Z has acted outside his actual authority by agreeing that the partnership will invest in the wine bar in Oxford. However, it is probable that the supplier of the

equipment was not aware that Z was acting outside his authority. As a partner in Sonombrera, Z has the implied/apparent authority to make the purchase.

The Sonombrera partnership will therefore be liable to the equipment supplier. However, size has acted outside his actual authority, the other partners are entitled to reclaim from Z personally the money of the partnership that has been spent.

24 Partnership dissolution

Priority for payment	Assets before payment	Amount of payment	Assets after payment
	£	£	£
External creditors	29,000	(6,000)	23,000
Bruno: creditor for unpaid rent	23,000	(2,000)	21,000
Carlos: partner's loan	21,000	(5,000)	16,000
Total partners capital			40,000
Repayment of capital to partners		(16,000/40,000)	**25p in £1**

In this case, the firm has sufficient assets to pay off all creditors in full; therefore the partners are not required to contribute anything further towards the dissolution.

25 LLP

A limited liability partnership is a form of corporate body, recognised in law as a separate legal entity. It was 'created' by the Limited Liability Partnerships Act 2000.

An LLP is similar in many ways to a company. As a legal person, it can own its own assets, acquire liabilities, enter into contracts as a party to the contract, sue and be sued.

An LLP has members, and like a limited liability company the liability of members is limited to the amount of capital they have put in to the business.

To form an LLP, two or more members must subscribe their names to a document of incorporation, which must be filed with the Registrar of Companies. The name of the LLP must end with the words 'limited liability partnership', which can be abbreviated to LLP.

The same rules apply to an LLP in insolvency and winding up as the y do to a limited company, under the provisions of the Insolvency Act 1986.

In other ways, an LLP is similar to an ordinary partnership. An LLP requires a partnership agreement but unlike a company's memorandum and association is not filed with the Registrar of Companies and does not have to be published.

Each member of an LLP is an agent of the partnership, and can bind it to legal agreements. At least two members must be designated members with responsibility for the administrative and filing duties required by law.

An LLP is not subject to tax on its profits. Instead, each member is individually liable to tax on his share of the profits of the business.

Unlike an ordinary partnership, an LLP has perpetual succession. When a member leaves or a new member joins the partnership, there is no change in the partnership. In contrast, when a new partner joins an ordinary partnership or an old partner leaves, a new partnership is created.

26 Sole trader and limited company

- A private limited company offers its shareholders the benefit of limited liability. A sole trader can be made personally liable for all the unpaid debts of his business. (However, in practice creditors such as banks may insist on a personal guarantee from the owner of a private company for the debts of the company. In such circumstances, the benefits of limited liability are lost to the extent that creditors are given personal guarantees.)
- A company structure offers continuity and succession. The sole trader can transfer some of the ownership of the business without affecting the identity of the business or 'legal personality' of the company.
- A company structure can make it easier for the owners to obtain additional equity capital by issuing new shares to other investors, without affecting the management of the business.
- A company structure provides better opportunities to grow the business in the future than if it retains a sole trader (or partnership) structure.
- There may be tax advantages for the owner in converting a sole trader business into a company, but this depends on current tax rules.

There are also disadvantages in converting a business from a sole trader structure to a company.

27 Partnerships and limited liability companies

The advantages of a limited company structure over a general partnership structure are as follows:

- **Perpetual succession**. A company continues to exist even when its owners (shareholders) change. With a traditional partnership, a new partnership has to be created whenever an existing partner leaves or a new partner joins the business.
- **Transferability of ownership**. With a limited company, it is easier for the owners to transfer some or all their share in the ownership of the business, simply by selling their shares. In a traditional partnership, partners are often prevented by the partnership agreement from selling their share in the business without the approval of the other partners.
- **Separate legal personality**. A company has a separate legal personality and can make contracts in its own name. Traditional partnerships do not have separate legal personality.
- **Ownership of assets**. A company, as a separate legal personality, can own its own assets. With partnerships, other arrangements are needed to link individual

partners to ownership in business assets. When partners change, it may therefore be necessary to alter legal documents (title deeds). Companies do not have this problem.

- **Limited liability**. Shareholders in a limited company have limited liability for the unpaid debts of the company. In comparison, partners in a traditional partnership are jointly and severally liable for all the unpaid debts of the partnership business. However, a lender may require the major shareholders in a company to give personal guarantees for the debts of their company.
- **Sources of new finance**. Companies are often better able than partnerships to raise new finance to grow the business. This is because they can offer shares to other investors. Companies may also be able borrow by issuing debentures, which ordinary partnerships cannot do.

The main disadvantage of the limited company format in comparison with a traditional partnership is that companies are subject to much heavier regulation than partnerships. For example, there are legal requirements relating to the formation of companies, registration of companies, statutory registers, annual returns, holding annual general meetings, and so on.

28 Corporate personality

(a) The doctrine of corporate personality is that a company is a legal person, separate from its owners. A company can have rights and obligations in law, just like a natural person. It can sue and be sued, own assets and be liable for debts and other obligations. The courts therefore treat companies as legal persons, without usually considering who their owners are.

As a separate person, a company continues to exist even when its owners change (for example, when a shareholder sells his shares to another person).

Outsiders can look at a company and recognise its existence without knowing who owns it. This is known as the 'veil of incorporation'.

(b) The courts will sometimes 'lift the veil of incorporation', so that a legal action in the court is applied to one or more individuals rather than to the company itself.

Circumstances in which the courts will lift the veil of incorporation include the following:

(i) Failure to comply with the regulations for the company's form. A company might fail to comply with the requirements for its formation and registration. In particular, a public company is required to have a minimum number of members (shareholders): if the number of shareholders falls below this minimum of two, the remaining shareholder may become personally liable for the company's debts.

(ii) Misuse or fraudulent use of the company form. When a company is established with the purpose of using the company form for inappropriate or fraudulent reasons, the shareholders themselves may be held liable for any liabilities that the company incurs. (In Gilford

Motor Co Limited v Horne, a former employee of a company tried to use a company to avoid compliance with a reasonable exclusion clause in the contract of employment with a former employer.)

(iii) Wrongful trading or fraudulent trading. The directors of a company may be personally liable for wrongful trading or fraudulent trading by the company, under the provisions of the Insolvency Act 1986.

(iv) In the past, the court has lifted the veil incorporation in time of war, and recognised the owners of the company rather than the company itself because the owners were nationals of an enemy state.

29 Registration of a company

On formation, companies are required to register certain documents with the Registrar of Companies.

(1) Memorandum of association. The memorandum of association is a document stating that the subscribers to wish to form a new company and agree to become members in the company when formed. In the case of a company limited by shares, each subscriber should undertake to subscribe for at least one share.

(2) An application for registration. An application for registration must state the company's proposed name, whether the registered office will be in England and Wales (or Wales), Scotland or Northern Ireland, whether the liability of the members is to be limited and if so whether it is to be limited by shares or by guarantee, and whether the company is to be a public or a private company.

(3) For a company limited by shares, the application must be accompanied by a statement of capital and initial shareholdings, which sets out the number and nominal value of each class of shares, the amount to be paid up on each share and the number of shares that will be allotted to each subscriber.

(4) The application must also contain the names of the company's proposed officers (directors and company secretary (if any), the intended address of the company's registered office and a copy of the proposed articles of association. However companies do not have to register articles of association: if they do not, default standard articles of association will apply.

(5) A statement of compliance must also be delivered to the Registrar, stating that the requirements of the Companies Act 2006 as to registration have been complied with.

A **public company** must submit the same documents as a private company. In addition, it must also obtain a trading certificate from the Registrar of Companies. This is provided when the company is able to submit a declaration stating that it meets the minimum share capital requirement for a public company (which is that the issued share capital should have a nominal value of at least £50,000 and at least 25% of the nominal capital should have been paid up).

30 Articles

The articles of association of a company is a document containing its constitutional rules. It contains rules and procedures for the regulation of the company's affairs.

Items dealt with in the articles of association will include:

- The rights attached to shares
- Rules relating to the transfer of shares
- Rules about general meetings
- The size of the board of directors
- The powers of the board of directors
- The right of the board of directors to delegate powers
- The appointment of directors.

It may also contain articles relating to its purpose (or objects), or limits on its ability to raise new capital or borrow. Some article smay be entrenched, meaning that they cannot be removed without the agreement of all the company's members (ordinary shareholders).

All companies must have articles of association. They should register these with the Registrar of Companies.

However, if a company fails to register articles, the law assumes that the company's articles of association are standard articles provided by legal regulations. For most companies formed under the Companies Act 1985, the standard articles were known as 'Table A' articles. For these companies, items in their memorandum of association are now treated as part of the articles of association. Different standard articles apply to companies formed under the Companies Act 2006 and there are different default model articles for private and public companies.

31 Shareholder's liability

Since Kara has no money or other assets, her financial position is potentially very serious.

(a) Lam Limited has gone into insolvent liquidation, owing money to its creditors. Presumably, this means that the assets of the company will be insufficient to pay off the company's liabilities in full. Although Lam Limited is a limited company, Kara will be personally liable up to the amount that has not yet been paid on the shares. This is £10,000 (40,000 shares × £0.25). She might not be required to pay this much towards the liquidation of the company: this will depend on exactly what the amount of unpaid creditors is and so how much extra money must be paid on each share. However, the **maximum** liability of Kara is £10,000.

Jam Limited has not gone into insolvent liquidation. The problem here is that companies are not allowed to issue shares at a discount to face value. To the extent that the shares in Jam are issued to Kara at a discount, they should be regarded as partly-paid shares. Kara is liable to pay the remaining 40 pence per share (£8,000) plus interest at an appropriate rate (currently 5 per cent per annum). It is unlikely that she will be required to make this payment unless the company becomes insolvent.

(b) If Kara is called upon to make further payments on the shares in Lam and Jam, the maximum liability could be £18,000 plus some interest. She would be able to sell her shares in Stamm for £15,000 at today's market price (less share dealing costs). This might not be enough to cover all her liabilities.

It might be advisable for her to try to find someone who is willing to buy (in a private sale) some of her shares in Jam Limited.

32 Names

(a) Companies are required to indicate within their name whether they are a public company or a private company, and that they are operating on the basis of limited liability.

Companies are required to indicate in their name whether they are a private limited company by including the word 'Limited' or the shortened form 'Ltd' in the name. A public company must include the words 'public limited company' or the shortened form 'plc' in its name.

A register of companies is kept by the Registrar of Companies. The Registrar will refuse to register a new company whose name is the same as the name of another company already in existence.

The Secretary of State for the Department of Business Enterprise and Regulatory Reform also has the power to declare a company name unacceptable in the following circumstances:

- the name constitutes a criminal offence (for example, a company calling itself 'Bank' in its name when it is not a bank)
- the name is considered offensive
- the name gives an impression that it is connected in some way to a government authority or department
- the name includes one or more words on a list of unacceptable words (relating to a matter that would be a matter of public concern if allowed).

The Secretary of State can ask a company to change its name if it is the same as, **or much too similar to**, the name of another company.

(b) Legislation on company names allows one company to use a name that is similar to the name of another company or another unincorporated business. There are limited controls over allowing businesses to use names that are similar to those of other businesses. The UK system relies on similarities in name being identified by the authorities.

'Passing off' refers to the use of a business name by one business that may give customers or potential customers the impression that it is another business. 'Passing off' is a wrongful act (a 'tort') and one business can apply to the court to prevent another business from using a similar name that suggests a business link.

33 Objects

Henry is in a weak position.

Farid and Gordon, by involving the company in security work, are making the company act 'ultra vires' (outside its powers). The objects of the company, formed under the provisions of the Companies Act 1985, became a part of the company's articles when the Companies Act 2006 was implemented. Acting ultra vires is therefore a breach of the company's articles (constitutional rules). However, in UK law, the fact that a company is acting ultra vires has no effect on its dealings with third parties. Contracts made with a company cannot be called into question on the grounds that the company is acting outside its stated purpose. Third parties are not required to check whether a company is acting ultra vires.

The 'doctrine' of ultra vires is therefore an internal matter for the shareholders of the company. A shareholder can propose a resolution that the directors must be required to run the company in accordance with its stated objects. However, since Farid and Gordon together own 80% of the shares, enough to pass a special resolution, they can block any such effort by Henry and can even pass a resolution to alter the company's objects clause in the articles of association.

If Henry is dissatisfied, his best way forward might be to negotiate the sale of his shares in the company.

34 Boom Limited

Carol will be required to account to the company for the secret profits that she has made. (She will have to hand over her secret profits to the company.)

Under the provisions of the Companies Act 2006, a director has a statutory general duty to avoid conflicts of interest. Carol is clearly in breach of this duty. The consequences of this breach are the same as if the corresponding common law rule or equitable principle applied.

As directors of the company Ann and Betty can bring an action against Carol for breach of her statutory duty as director of the company. Carol has made a secret profit without approval. Carol will be required to account to the company for the secret profits that she has made. (She will have to hand over her secret profits to the company.)

35 Promoter

(1) **Transaction 1**. The board of directors can decide that the company will adopt this contract, and accept the liability to pay for the goods supplied.

(2) **Transaction 2**. Although Tom used the name of the company when making the contract, it is a pre-incorporation contract. The company did not exist when the contract was made and so cannot be bound by it. (The case Kelner v

Baxter illustrates the principle.) B Supplies Limited has the option of taking legal action against Tom to recover losses suffered.

(3) **Transaction 3**. By entering into this contract in which he has a personal interest, Tom is in breach of his fiduciary duty as promoter of a company. The company has the right to 'rescind' the contract (cancel it). More likely, Tom will be required to account to the company for the profit that he made from the contract, and pay his profit to the company.

(4) **Transaction 4**. Although Tom used the name of the company when making the contract, it is a pre-incorporation contract. The company has no interest in the contract, and cannot take action to force the other party to comply with its terms.

(5) **Transaction 5**. This is another pre-incorporation contract, but it was made by Tom 'subject to adoption by Slope plc'. The board of Slope plc does not want to honour the contract and the company will not adopt it. The other party cannot take action against either Tom or Slope plc to enforce the contract.

36 Shares and charges

(a) (i) These are shares in A Limited, a private company. They are equity shares, giving the shareholder certain rights as a member of the company, including rights to the same dividend per share that is paid on other ordinary shares and rights to attend and vote at general meetings. Each share has a nominal value of £1 each. This nominal value has been paid in full. This means that the shareholder has no further liability to contribute more capital to the company. In the event that the company goes into liquidation, the company will not be able to call on the shareholder to pay more capital to the company. (The 100% paid-up nature of the shares is an expression of the limited liability of shareholders for the debts of the company.)

(ii) These are similar to the ordinary shares in A Limited, with the important difference that the nominal value of the shares is only 75% paid. The company has the right at any time to demand a further £0.25 per share from the shareholder, to make the shares fully paid. Similarly, if B Limited were to go into liquidation now, the owner of these shares would be liable to pay a further £12,500 to the company in unpaid capital. However, the liability of the owner of these shares is limited to the unpaid £0.25 per share.

(iii) Preference shares are classes of shares in a company that are different from ordinary shares. Preference shares give their holders the right to receive dividends before any dividend is paid to ordinary shareholders. They also give the shareholders preferential rights (in preference to ordinary shareholders, not creditors) in the event that the company goes into liquidation and is wound up.

Each class of preference shares has different rights. With cumulative preference shares, any unpaid preference dividend in any year accumulates and remains payable at a future date. Arrears of cumulative preference dividend must be paid before any dividends can be paid to the ordinary shareholders. During the time that the payment of dividends is in arrears, the cumulative preference shareholders will probably have rights to attend and vote at general meetings of the company.

Preference shares may be redeemable at a future date, or may be irredeemable. If they are redeemable, the company will be required to buy them back at the redemption date (and cancel them). Some classes of preference shares are convertible at a future date into ordinary shares of the company.

(b) Charges are security that may be given by a company to a creditor, such as a bank (for a loan) or debenture holders. The charge provides security for the creditor. If the company goes into default and fails to make the scheduled repayments of the debt (or interest), the holder of the charge can claim that an event of default has occurred. In this situation, the charge-holder can use the charged assets as a means of recovering the money owed, possibly by taking possession of the charged assets and selling them off.

A fixed charge is a charge on one or more specific assets, typically a valuable non-current asset such as a building. When an asset is subject to a fixed charge, the company cannot dispose of the asset (without the consent of the charge-holder) until the debt has been paid. The same asset may be subject to more than one charge.

A floating asset is a charge over one or more classes of assets, or over the entire undertaking of the company. The existence of the charge does not affect the company's ability to dispose of assets that are subject to the charge, unless an event of default occurs. This means that the company can continue its normal business without restrictions being imposed by the charge.

However, if an event of default occurs, the floating charge crystallises. All the assets subject to the charge are placed at the disposal of the charge-holder, who can use the assets to recover the money owed. In practice, this may result in the charge-holder appointing someone to run the company and trying to obtain sufficient income from the business to pay off the debt.

37 Issuing shares

(a) Nominal share capital

The nominal share capital of a company is the face value of its shares. A company limited by shares is required to issue shares with a nominal value or face value. All shares in the same class must have the same nominal value. For example, the ordinary shares in a company may all have a nominal value of £1, regardless of the amount of money raised from their issue.

If the nominal value of the issued share capital is fully paid up, the shareholders have no further liability for the unpaid debts of the company. The only obligation that shareholders may have to contribute further capital to the company is the amount of the nominal share capital that has been issued but is not yet paid.

(b)

(i) Shares issued at a premium

A company may issue shares for a price that is higher than their nominal value. When this happens, the difference between the issue price and the nominal value is share premium.

Share premium is treated as a capital reserve of the company, and there are only limited ways in which it can be 'used' so that the share premium account is reduced or eliminated entirely.

Permitted uses of the share premium account include 'funding' a bonus issue of shares. When bonus shares are issued by a company, the share premium account can be used to 'fund' the bonus issue: in effect this transfers the capital reserve (share premium) to share capital.

The only alternative use for share premium is to use it to write off expenses or commissions incurred in making the share issue to which the share premium relates.

A share premium account cannot be used to pay a dividend to shareholders.

(ii) Issuing shares at a discount

It is an established principle of company law that shares cannot be issued at a discount to their nominal value. Issuing shares at a discount would involve accepting an amount of money below nominal value as the payment of the full price for the shares.

This principle that shares cannot be issued at a discount is therefore connected with the concept of capital maintenance, and the protection of a company's creditors.

When shares are issued at a discount, for example if a company issues shares on which some of the nominal value has already been paid up, the shareholder is liable to pay an amount to the company equal to the implied discount, plus interest at the appropriate rate.

Shares are only treated as paid up to the extent that the company has received money (or 'money's worth'). Although shares may be issued partly paid, the shareholder remains liable to pay the unpaid amount on the shares, when the company makes a call for the money.

Although shares cannot be issued at a discount to nominal value, debentures can be issued at a discount.

38 Class rights

(a) Class rights are rights that attach to a class of shares. Each class of shares has different rights. A company might have different classes of preference shares. Ordinary shares and preference shares are also different classes of shares.

Class rights may relate to:

- Dividend payments. For example, each class of preference shares might be entitled to a different coupon rate of dividend. One class of preference shares might be cumulative, and another class might be non-cumulative.
- The redemption of the shares.
- The right to repayment of capital (and the priority for repayment) in the event of liquidation of the company.
- The right to vote at company meetings. (for example, there might be 'A Ordinary' and 'B ordinary' shares, each with different voting rights.)

(b) Class rights may be varied. The procedure for making a variation in the rights of a particular class of shares should be specified in the company's articles of association.

It is usual for a variation in class rights to require an extraordinary resolution by the shareholders in the class affected. (An extraordinary resolution requires a 75% majority.) The proposal might be voted on at a meeting of the class of shareholders, or approved by written consent of the shareholders affected.

39 Dividend payments

(a) How dividend payments must be funded

- Dividends must be paid out of accumulated realised profits less accumulated realised losses.
- All losses are to be treated as realised (unless they arise in a general revaluation of all the non-current assets of the company).
- Accumulated realised profits include profits of a capital nature as well as profits of a revenue nature.
- Dividends cannot be paid out of 'capital'.
- It is usual practice for the directors of a company recommend a dividend. The shareholders can vote to approve the dividend (at the annual general meeting) or can vote to reduce the dividend or not pay a dividend at all. They cannot vote a higher dividend than the amount recommended by the directors.
- These rules on dividends apply to all distributions by a company, cash or otherwise, but with some exceptions. The exceptions are bonus issues of shares, the redemption of shares, an authorised reduction in share capital and the distribution of assets in a winding up of the company.

(b) Dividend payments by public limited companies

- See points listed in (a) above.
- In addition, a distribution by a public company must not reduce the value of its net assets below the total of its called up share capital and non-distributable reserves. This rule means that a 'balance sheet' approach is taken to the calculation of maximum distributable dividend.

(c) Consequences of breaching the rules

- Directors who knowingly breaches the rules on dividend payments may be personally liable to replace the payments that were illegally made.
- A shareholder who knowingly receives an illegal dividend payment will be liable to repay the money received.

40 Capital maintenance

The concept of capital maintenance is that companies should not be allowed to reduce their assets by making payments out of capital, where this might put creditors at risk.

'Capital' may be defined as share capital plus reserves, excluding retained realised profits. (The concept of capital maintenance does not apply to distributable profits.)

Dividend law supports the concept of capital maintenance.

If a company wishes to redeem some shares or wishes to purchase and cancel some non-redeemable shares, the company must transfer an amount from distributable reserves to non-distributable reserves (a capital redemption reserve fund). This transfer to a non-distributable reserve means that the non-distributable capital of the company is maintained, even though its share capital has been reduced.

41 Purchase of own shares

The suggestion is that the company should buy back and cancel the shares of Charles. This can be done.

Purchasing and cancelling shares would reduce the capital of the company, and it may be necessary for the company to maintain its capital by transferring an amount (the nominal value of the shares purchased) from distributable profits to a non-distributable capital reserve, equal to the nominal value of the shares purchased and cancelled.

In this situation, the company needs to have the money to buy back the shares. Although its profits have been low, it is assumed that the company has the necessary cash (or could borrow it.)

Since the company is a private company, the purchase of the shares would have to be an off-market purchase. This would have to be approved by the shareholders by means of a special resolution. A special resolution requires a 75% majority, and shareholders intending to sell their shares to the company may not vote.

In this situation, Alan and Barry together, if they agree, can vote for the company to buy back the shares of Charles.

In addition, the Companies Act allows a private company to purchase its own shares out of capital, provided that it has the authority to do so in its articles of association. A permissible capital payment can only be made by the private company if its directors make a statutory declaration. This must include a statement that the directors believe the company to be solvent and that it will be able to meet all its liabilities when they fall due within the next 12 months following the purchase of shares out of capital.

This statutory declaration also requires an auditors' report stating that the auditors have looked into the company's affairs and in their opinion there is nothing to indicate that the statement by the directors about solvency and the ability to pay debts is unreasonable.

After the directors have made their declaration, the shareholders of the company should approve the purchase of shares out of capital (by special resolution at a general meeting).

42 Directors

(a) Executive and non-executive directors

In law, there is no difference between an executive director and a non-executive director in a unitary board system. They are both directors of their company, with the same powers and duties as directors. They also have the same potential liabilities.

The differences between the two types of director are practical differences, and related to corporate governance.

- Executive directors have executive management responsibilities in the company. Non-executives do not.
- Executive directors are normally full-time employees of the company, receiving a remuneration package that includes a salary. Non-executives are paid a fee. They are not employees.
- Non-executive directors are often appointed so that they can add the benefits of their experience and viewpoints to the decision-making process of the board of directors.
- In a system of corporate governance, independent non-executive directors may also be given roles that involve monitoring their executive director colleagues: for example, independent non-executive directors should make up 100% of the board's audit committee and remuneration committee in UK listed companies.

(b)

(i) Chairman of the board

The chairman of the board of directors is responsible for organising and managing the board of directors. The chairman chairs board meetings and general meetings of the companies, and it is his or her responsibility to ensure that the board of directors (and the board committees) functions effectively.

The chairman also usually acts as the company's representative in dealings with institutional investors and major shareholders.

The UK corporate governance code states that the same individual should not hold the position of both chairman and managing director/chief executive officer (in a listed company), and that a chief executive officer (CEO) should not move on to become chairman after ceasing to be the CEO.

(ii) Managing director

There is no legal definition of the duties a managing director. The role of a managing director is to act as an executive director, and exercise executive powers delegated to him by the board of directors.

A company may have several managing directors. It is usual, however, for executive powers to be delegated to a chief managing director (or chief executive officer) by the board, and this person acts as the head of the executive management of the company (including other executive directors). The CEO/managing director is then accountable to the board of directors for his exercise of power (= accountable for the operational performance of the company).

If the chairman is a non-executive director, the managing director is the senior executive director on the board.

43 Directors' authority

The board of directors is given most or all of the powers to run their company. These powers are given by the company's articles of association to the board of directors as a whole, not to individual directors. However, the articles should provide for the board to delegate some powers to individual directors, and the powers that have been delegated can be further delegated to someone else.

Individual directors cannot use powers to bind the company (for example, to commit the company to a contract agreement) unless they have been authorised to do so.

The company's articles also usually provides for the board of directors to delegate some of its powers. The powers necessary for the day-to-day running of the company are normally delegated to a managing director. (The managing director then delegates powers to other executive directors and to other members of the

management team. The board of directors does not delegate all decision-making authority, but retains decision-making over matters that the board specifies.)
When individual directors are given delegated powers, they have actual authority to bind the company within the area of their responsibility.

Actual authority is either express or implied.

- Express authority is authority that has been specifically given to an individual.
- Implied authority is authority that is normally given to a person in a particular position. In the absence of evidence to the contrary, a third party is therefore entitled to assume that the individual has authority to bind his company in the matters affected.

Ostensible authority is authority in addition to actual authority. It may arise in a situation where an individual appears to have authority in matters where authority cannot usually be implied. (The individual does not have the actual authority, but a third party does not know this). If the company allows a third party to gain the impression that the individual **does** have authority, it is 'estopped' from denying that the individual has the authority. The company is therefore liable for obligations entered into by the individual, because the individual has ostensible (apparent) authority.

A company is bound to commitments and obligations to a third party that are entered into by someone acting on the company's behalf with authority – express, implied or apparent.

(Tutorial note: In answering an examination question on this subject, it would be useful to give examples. **Watteau v Fenwick** is a useful example of implied authority and **Freeman and Lockyer v Buckhurst Park Properties** is a good example of ostensible authority.)

44 Duties of directors

In the UK, the Companies Act 2006 specifies the statutory duties of dsirectors (sections 171 – 177). These are:

- Duty to act within powers
- Duty to promote the success of the company for the benefit of its members
- Duty to exercise independent judgement
- Duty to exercise reasonable care and skill
- Duty to avoid conflicts of interest
- Duty not to accept benefits from third parties
- Duty to declare any interest in a proposed transaction with the company.

45 Capacity

(a) The company itself

A company is a legal person and so has the capacity to enter into binding contracts with third parties.

Under the provisions of the Companies Act 2006, new companies formed under the Act are assumed to have unlimited objects, and so cannot enter into contracts that are ultra vires unless limitations on the scope of its activities are actually written into its articles of association.

For companies formed under the Companies Act 1985, after the Companies Act 2006 comes into force, the objects clause is assumed to become a part of the articles of association, which means that there may possibly be an article of association relating to the company's objects that imposes restrictions on the nature of the company's permitted operations.

(b) The board of directors

The capacity of the board of directors to bind the company to a contract should be stated in the articles of association of the company. Standard 'model' articles of association allow the board of directors to exercise all the powers of the company.

These powers are given to the board of directors as a whole. For individual directors to exercise a power to bind the company, he or she must somehow have been given the authority to do so.

(c) Individual directors

There are three ways in which an individual director may be given the power and authority to enter the company into a binding contract.

- **Express authority**. A director may be given express authority by the board of directors to enter the company into a binding contract. The articles of association may permit the board of directors to delegate any of its powers to one or more directors.
- **Implied actual authority**. The authority of an individual director may be implied as a result of the position that he or she holds. In the UK, standard articles of association allow the board of directors to delegate to a managing director any powers that they consider desirable to delegate to that person. Third parties can assume (imply) from the fact that a person has been appointed as managing director that he or she has the powers normally associated with such a position.
- **Ostensible authority**. The authority of an individual director may come from powers that he appears to have, even though he does not actually have them. In other words, to a third party it may seem that the individual has the necessary powers, from indications given by other members of the board of directors, but in reality the individual has not been given the authority and power. A third party can argue that a contract made in such

circumstances is binding on the company because ostensible authority existed. The company should therefore be 'estopped' (prevented) from claiming that it is not bound to the contract because the individual acted outside his authority.

46 Small shareholder

(a) Standard articles of association state that the directors of a company may exercise all the powers of the company. These powers belong to the board of directors as a whole, not to individual directors.

Individual directors can have the authority to enter into binding contracts on behalf of their company. The authority may come from any of the following sources:

(1) actual authority, given to him by the board of directors

(2) implied authority, which is authority given to the director because it is generally implied that someone in his particular position will have the authority (even if it has not actually been given)

(3) ostensible or apparent authority. Even when a director does not have the actual or implied authority, he might be able to bind the company because of his ostensible authority. This arises when the other members of the board act in such a way that they holdout the individual director to have the authority.

If a third party enters into a transaction with a director acting on behalf of the company, the company is bound to the contract if the director has the actual, implied or ostensible authority.

In this case it would appear that even if Gil does not have the actual or even the implied authority to act for the company, he has the ostensible authority, and can bind the company to contracts that he arranges with another party on the company's behalf.

(b) The law places a duty of skill and care on directors (Companies Act 2006, and previously common law). However the level of duty and skill required is not particularly high. The case of City Equitable Fire Assurance established the following guidelines:

(1) A director is only required to show a level of skill and care that would reasonably expected from a person with their knowledge and experience.

(2) Directors are not required to give continuous attention to the affairs of their company.

(3) Unless they have grounds for suspicion, directors can leave the management of the day-to-day affairs of the company to the company's management.

Directors would be liable however, if the company is trading wrongfully and the directors should have known (s214 Insolvency Act 1986).

In this case, there may be grounds for arguing that the directors are liable for wrongful trading by the company, but this would only apply if the company is close to becoming insolvent.

Otherwise there is no obvious reason to accuse Gil of a failure in his duty of skill and care. However, the accusation might be made against the other three directors who do not give any attention to the affairs of the company. In the case of Dorchester Finance Co Ltd v Stebbing, two non-executive directors were found negligent and in breach of their duty of care when they did not pay sufficient attention to the affairs of the company.

This situation could apply here.

(c) Under the provisions of the Companies Act 2006, directors have a statutory duty to the company to avoid conflicts of interest. The requirement that directors must not allow a conflict of interest to arise between himself and the company applies to situations where a director makes a profit from acting in his position, and failing to obtain the approval of the company (the shareholders)

There is a suspicion that Gil is making a secret profit by accepting commissions from suppliers. If this is the case, he would be liable to the company for any commissions he has received and for any losses the company has suffered as a consequence.

The problem in this case, however, is proving that Gil has actually accepted the commissions.

(d) The shareholders can remove a director from office under the provisions of the Companies Act. An ordinary resolution must be proposed by a sufficient number of shareholders, who must give 28 days notice (special notice) of the proposal. Gil would be able to speak in his own defence at the general meeting where the proposal is put to the shareholders.

A problem in this case, however, is that Ravi is a small shareholder. On his own, he might not hold enough shares to call a general meeting and submit the resolution to remove Gil from office. It is also not at all clear that he would obtain the necessary simply majority of votes in favour of the resolution at a general meeting

47 Interest in a contract

Lee has a conflict of interest arising from the contract between ABC plc and DF Ltd. As a director of ABC plc, Lee has failed to declare his interest in the contract to the other directors. He is therefore in breach of his fiduciary duty to the company.

When a director fails to declare an interest, the contract is voidable by the company. Lee may also be required to account to ABC plc for any profit he has made from the contract.

It is an offence for a director to fail to declare an interest in a contract with the company to the other directors. A director found guilty of this criminal offence is liable to a fine.

It is worth noting that the company's articles of association may prohibit a director from voting in a board meeting on a matter in which he has an interest. (In practice, the director may be asked to leave the meeting whilst the matter is discussed by the other directors.)

48 More interest in a contract

Directors owe a duty to their company duty not to permit a conflict of interests between the director and the company. The Companies Act 2006 includes a specific provision that directors have a statutory duty to avoid conflicts of interest with their company.

Model articles of association include the rule that a contract with the company in which a director has an interest is voidable by the company, unless the director concerned has declared his interest to the other directors. (If the director declares his interest, it is then up to the company to decide how to proceed.)

The Companies Act also requires directors to declare any interest they have (direct or indirect) in contracts with the company, and provides for a fine to be levied on directors who fail to comply with this requirement.

The disclosure by a director may take the form of a disclosure relating to a specific transaction, or may be a general disclosure of an interest in another company with which the company may do business in the future.

Any such declaration of interest must be made a the first board meeting at which the contract is considered, or at the first board meeting after the director first acquires an interest in the contract, if this happens later.

Model articles of association prevent a director from voting on contracts in which they have a personal interest.

A failure to disclose an interest makes the contract voidable by the company, and the director may also be liable to account to the company for any profit he has made from the contract.

These rules apply to the situation in the question.

- Hans is a director in Imp plc but has failed to disclose his interest in the contract with Jam Limited to the other directors of Imp. He has also failed to disclose a more general interest in Jam Limited.
- If the directors of Imp plc had found out about this interest of Hans, they could have declared the contract with Jam Limited void. However, they are probably too late to take this course of action.
- However, because of his failure to disclose his interest, Hans is liable to account to Imp for any profit he has made from the deal.

- For his failure to disclose an interest in an existing transaction or arrangement, Hans would also have been criminally liable under the Companies Act, and may be required to pay a fine.

49 Pesos

(a) When a transaction is to be made between the director of a holding company and a subsidiary, approval must be obtained from the members of the holding company. A general meeting of the shareholders of FX plc should have been called, not a general meeting of Pesos Limited.

(b) The loan by the holding company to Michael Hudson is not permissible. Under the provisions of the Companies Act 2006, loans to directors or connected persons are permissible only if they have been approved by the members by ordinary resolution. Michael Hudson is connected to a director of the holding company. (The loan agreement is voidable at the instance of the company.)

(c) Pesos Limited should sue George, on the grounds that he has obtained a personal advantage from his position as director of the company, and he should be made to account for his profit from the transaction with the company. The facts of this case are similar to those in *Industrial Development Consultants Ltd v Cooley*.

50 Disqualification

The CDDA 1986 identifies three broad categories of conduct that might provide grounds for the disqualification of an individual from holding a position as director of a company. Any disqualification order is for a stated length of time, up to a maximum specified by the Act.

(1) **General misconduct in relation to company activity**

This category of conduct that might lead to disqualification includes:

- conviction for an offence (on indictment) in connection with the formation, promotion, management or dissolution of a company
- persistent breaches of Companies Act requirements for the filing of returns, reports and accounts and other documents with the Registrar of Companies: (three breaches within five years is sufficient for disqualification)
- fraud in connection with the winding up of a company, such as acting with intent to defraud a creditor.

(2) **Disqualification for reasons of unfitness**

This category includes:

- the court deciding that an individual who was director of a company that is now insolvent is unfit to be a director
- the court deciding following an official investigation of the company's affairs that an individual is unfit to be a director.

(3) **Other reasons for disqualification**
These are specified in the CDDA 1986 as:
- participation by the individual as a director in wrongful trading or fraudulent trading by the company, under the provisions of the Insolvency Act 1986
- the individual is an undischarged bankrupt
- the individual has failed to make a payment under a county court administration order.

51 Company secretary

(a) Under the provision of the Companies Act 2006, only public companies are required to have a company secretary. However, if a private company does not have a company secretary, the directors must ensure that someone carries out the statutory tasks that would previously have been performed by the company secretary.

The company secretary of a public company should have suitable qualifications or experience for the job. Suitable qualifications include qualification as a Chartered Secretary or as a professional accountant (for example, ACCA) or professional lawyer. In the UK, suitable experience might be having acted as a company secretary of a public company in at least three of the past five years.

(b) **Duties of a company secretary:**

- These are set by the board of directors and vary from one company to another.
- They usually include:
  - maintaining the statutory registers and keeping them up to date
  - submitting statutory returns to the registrar of companies
  - organising board meetings (and taking the minutes or having responsibility for preparing the minutes)
  - organising general meetings of the company
  - communications between the board of directors and board committees
  - signing documents where the signature of a director or company secretary is required by law
  - ensuring compliance by the company with its statutory requirements.

Powers of a company secretary:

- These vary: The actual powers of the company secretary are delegated by the board of directors.
- A company secretary may also have the implied authority to sign contracts on behalf of the company relating to the administration affairs of the company – such as the employment of new staff.

52 Auditors

(a) Dismissal

When the directors of a company wish to dismiss the auditors and replace them with new auditors, one way of doing this is to appoint new auditors at the annual general meeting (AGM) of the company.

A company may also dismiss its auditors sooner, by means of an ordinary resolution at an extraordinary general meeting. If the directors do not wish to call an EGM to propose such a resolution, an EGM can be requisitioned by shareholders representing at least 10% of the voting shares. As there is a disagreement between the shareholders and directors of the client company, this may be the method that is intended.

When a resolution to dismiss the auditors is passed, the company must notify the Registrar of Companies.

Special notice is required of an intended resolution to dismiss the auditors, either before the expiry of the auditors' term of office or by appointing a different auditor at the AGM. The members proposing the resolution must give the special notice to the company at least 28 days before the EGM, and a copy of the notice must be given to the auditors.

The auditors have the right to make representations to the company about the proposal to dismiss them, and if there is time a copy of the representations should be sent to the members before the meeting.

The auditors of a private company are deemed to be reappointed each year, from the end of the 28-day period following the circulation of the annual accounts. Five per cent of members may prevent the deemed re-appointment of the auditors by giving notice to the company. Special notice and a general meeting of the shareholders is required for the dismissal of the auditors before the end of their term of office.

(b) Resignation

An auditor of a company may resign by delivering notice of his resignation in writing to the company's registered office. The notice must be accompanied by a statement explaining the circumstances leading to the resignation that the auditors consider should be brought to the attention of the company's members or creditors. If there are no such circumstances, the statement should say that there are none.

If the statement contains circumstances leading to the resignation that the auditors consider should be brought to the attention of the company's members or creditors, the company must send a copy of the statement to everyone who is entitled to receive a copy of the company's annual report and accounts.

(The company may apply to the court for permission not to send out the auditors' statement, on the grounds that it contains allegations that are defamatory.)

The date of the auditors' resignation is the date that the notice is delivered to the company's registered office.

A resigning auditor has certain rights. He can require the directors to call a general meeting (EGM) to consider the circumstances surrounding the resignation. The auditors have the right to attend and speak at this meeting to explain the reasons for their resignation.

53 General meetings

An annual general meeting and an extraordinary general meeting are both general meetings of a company, which the ordinary shareholders (equity shareholders) are invited to attend.

The main purpose of a general meeting is to enable the shareholders to vote on one or more resolutions. A vote on a resolution is a decision by the company, taken by its shareholders in accordance with company law or the company's constitution. (Where votes are taken by a poll, shareholders may vote by proxy, without having to attend the meeting.) Both ordinary and special resolutions may be considered at either type of general meeting.

Annual general meeting

An annual general meeting is a general meeting that a public company is required by law to hold each year to vote on certain statutory resolutions (and possibly also on other non-statutory resolutions). The resolutions at an annual general meeting include resolutions to elect or re-elect directors, and to appoint or re-appoint the external auditors. The shareholders are also required to consider the annual report and accounts.

There may be other statutory resolutions at an AGM. For example, the shareholders of quoted companies are required to vote on a resolution to approve the directors' remuneration report.

There may be other routine but non-statutory resolutions at an AGM. (Tutorial note. It is quite usual, for example, for the shareholders to vote on a resolution to waive their pre-emption rights to a limited extent. This allows the directors to issue some new shares for cash in the next year without having to offer them as a rights issue to existing shareholders.)

Extraordinary general meeting

An extraordinary general meeting (EGM) is any general meeting other than an annual general meeting. EGMs are held to allow shareholders to vote on a resolution where a decision by the shareholders is required, and where it will not be appropriate to wait until the next AGM for the vote.

EGMs are therefore usually held to deal with unexpected or special events and decisions, such as a vote on putting the company into voluntary liquidation, a vote to approve a major transaction such as a large takeover bid or a vote on a proposed special dividend.

An EGM may be called by the board of directors. Alternatively, an EGM may be called by shareholders. An EGM can be called by shareholders owning together 10% or more of the ordinary share capital. When an EGM is called by shareholders, it is often to propose a resolution that is proposed by the board of directors, such as a resolution to dismiss one or more directors from office.

An auditor may also call an EGM when he resigns, if the circumstances of the resignation make this appropriate.

Private companies

Under the provisions of the Companies Act 2006, a private company is not required to hold an annual general meeting, although it may do so if it wishes. By using written resolutions, it is possible for private companies to avoid holding any general meetings in normal circumstances. However, a general meeting must be held if there is a proposal to dismiss a director or the auditors before the end of their term of office.

In other respects, general meetings of private companies are similar to those of public companies.

54 Meetings

General meetings of the company are usually called by the board of directors, giving sufficient notice. In the case of a public company, the required notice is usually at least 21 days in the case of an AGM and at least 14 days in the case of an EGM. The minimum notice is usually 14 days for any general meeting in the case of a private company.

A company is required to hold an annual general meeting each year. The AGM of a public company must be held within six months of the end of the financial year.

Other general meetings (extraordinary general meetings) may be called at any time. They are usually called to consider a particular item of importance.

In addition, the directors of a public company must call a general meeting when the company has suffered a serious loss of capital, so that its net assets are half or less of the nominal value of its called-up share capital.

General meetings may also be called in the following situations.

(1) Shareholders representing at least 10% of the share capital can requisition a general meeting. The requisition must be made to the company, and state the purpose of the meeting. It should be signed by the requisitionists and delivered to the company's registered office. Shareholders will only call a general meeting in this way when they are dissatisfied with the way the company is being managed by the directors.

(2) A resigning auditor has the right to ask a company to call a general meeting, when there are circumstances surrounding the resignation that (the auditor believes) should be brought to the attention of the shareholders.

(3) The court may order a meeting of the company to be held when it is impracticable to call and hold a meeting in any other way. For example, a court may order that a general meeting should be held and the quorum should be one person (instead of the usual minimum of two).

55 Votes at general meetings

(a) General meetings are usually convened by the **board of directors**. The board should have the power to call general meetings, under the constitution of the company. (This power should be included in the articles of association.) The board of directors is also required by law to call a general meeting in certain circumstances, including the requirement to call an annual general meeting

Shareholders may also have the power to require the company to hold a general meeting. **Shareholders** may ask the company to hold a general meeting provided that they together have **at least 10% of the share capital** carrying voting rights. If the directors fail to hold a meeting following their request, they may organise the holding of the meeting themselves.

An **external auditor resigning from his position** may require the company to hold a general meeting, so that he can explain to the shareholders his reasons for resignation.

In an extreme situation, the **court** may require a company to hold a general meeting. The court may do so when it would be impracticable under the law or the company's articles of association to hold a general meeting without a court order, and when the court considers that the holding of a general meeting is desirable.

(b) The rules on voting at general meetings may vary between countries, in accordance with national company law.

A vote on a resolution at a general meeting may be by a show of hands, or by a poll vote.

The decision about which method of voting should be used is taken by the company chairman, who is also the chairman of the general meeting.

It is usual for the chairman to ask first of all for a vote by a show of hands. Only shareholders attending the meeting in person may vote in this way. People attending as a proxy for a shareholder cannot vote in a show of hands.

A vote on a show of hands is decided by a simple majority. The number of shares held by each shareholder is irrelevant.

The chairman may decide after a vote by show of hands that there should be a poll vote on the resolution. (The chairman may decide to go straight to a poll vote without a vote by show of hands.) In a poll vote, each shareholder has one vote for each voting share; therefore the number of shares held by each shareholder is relevant. Proxy votes are also counted. (Many shareholders submit proxy votes before the meeting, and nominate the individual who will cast the votes on their behalf. The nominated person is usually the chairman.)

If a poll vote is taken after a vote by show of hands, the poll vote takes precedence.

However, the company chairman is not required to submit any resolution to a poll vote. He can, if he wishes, restrict voting to a vote by show of hands.

Quoted companies are required to publish the results of polls at their general meetings on their web site, showing the number of votes cast for and against the resolution.

56 Resolutions

(a) Resolutions

When the ordinary shareholders of a company meet in general meeting, they make decisions by passing resolutions. These are either ordinary resolutions or special resolutions. An ordinary resolution requires a simple majority of votes (from the members voting in person or by proxy) to be passed. A special resolution requires at least 75% of the votes. Depending on how the general meeting is conducted, the vote is taken either on a show of ands of the members in attendance, or by a poll vote.

Under the provisions of the Companies Act 2006, the minimum notice period for general meetings is 14 days, except for the AGM of public companies where the minimum notice period is 21 days.

If their articles of association allow it, private companies may pass a resolution in the form of a written resolution, without the need to call a general meeting. Under the provisions of the Companies Act 1985 written resolution required the agreement of all members entitled to attend and vote at a general meeting. The Companies Act 2006 removed the requirement for unanimity, and introduced ordinary written resolutions (simple majority required of members eligible to vote) and special written resolutions (75% majority required).

The date of the written resolution is the date when the final signature is obtained. Written resolutions are practical only for private companies with a small number of members.

(b) Altering the articles of association

Subject to any conditions or restrictions there might be in the company's constitution, a company may alter any of its articles of association by special resolution in a general meeting. This requires a majority of at least 75% of the members voting (in person or by proxy).

Any amendment to the articles must be registered with the Registrar of Companies, together with a copy of the amended articles.

57 Winding up

(a) A company is a separate legal personality. It continues to exist unchanged when its ownership changes, and it continues in existence unless and until it is wound up.

Winding up is the process of bringing the existence of a company to an end.

When a company is wound up, it is liquidated. This means that its assets are sold off and the proceeds are used to pay the creditors of the company. If there is any money left over after paying the creditors in full, this is distributed to the shareholders as a return of capital.

Winding up procedures can be started by either shareholders of the company or by creditors, depending on the solvency of the company. If the company is solvent, it is able to pay its creditors in full when it winds up. If the company is insolvent, it is unable to pay its creditors in full.

(b) **(i) Voluntary winding up**

A voluntary winding up is winding up that is not compulsory.

A voluntary winding up is started by a resolution of its shareholders.

- An ordinary resolution is required for a voluntary winding up when the company is solvent and is reaching the end of a fixed period of time for which it was set up, or when it has achieved all its objects.
- An extraordinary resolution is required for a voluntary winding up when the company cannot continue in business due to its liabilities.
- A special resolution is required for a voluntary winding up in all other circumstances.

There are two types of voluntary winding up: a members' voluntary winding up and a creditors' voluntary winding up.

Members' voluntary winding up

The shareholders may decide to wind up the company provided that it is solvent. In UK law, the directors are required to make a formal declaration that in their opinion the company is solvent and that it will be able to pay all its debts within 12 months of the start of the liquidation process. A liquidator is then appointed to liquidate the assets of the company, pay the company's creditors in full and then distribute any remaining money to the shareholders.

After the liquidation is complete, the liquidator then presents a final report to the shareholders, and submits to the Registrar of Companies a copy of the report and notice that the final meeting has been held. The Registrar registers these details, and the company is dissolved three months later.

Creditors' voluntary winding up

The shareholders may decide to wind up the company when it is insolvent. In these circumstances, the unpaid creditors are given an active role in the winding up process. When the shareholders have voted to wind up the company, the company must call a meeting of creditors, at which the directors will present a statement of the company's affairs. The creditors have the power to appoint a liquidator, and may also set up a liquidation committee to represent their interests and work with the liquidator.

After the liquidation is complete, the liquidator then presents a final report to the shareholders and to the creditors. He then submits to the Registrar of Companies a copy of the report and notice that the final meetings have been held. The Registrar registers these details, and the company is dissolved three months later.

(ii) Compulsory winding up

A compulsory winding up is a winding up of a company following a court order. The main reason for a court order for a compulsory winding up is that the court decides, following an application from a petitioner (a creditor, members of the company or the company itself) that it is unable to pay its debts.

When a compulsory winding up order is made, the court appoints the Official Receiver to act as liquidator until a meeting of creditors and members is held to appoint a liquidator of their own choice. The creditors may also set up a liquidation committee to supervise the liquidation process.

When a compulsory winding up order has been made, no other court action can be started or continued against the company without the approval of the court.

After the liquidation process is complete and the creditors have been paid as much as possible of what they are owed, the liquidator must call a meeting of creditors. At this meeting, he must and give an account to them of the liquidation process and ask for the termination of his role as liquidator.

The liquidator must then notify the Registrar of Companies that the meeting has been held. The Registrar registers the details, and the company is dissolved three months later.

58 Kevin and Kim

Fraudulent trading occurs when a company, in the course of winding up, carries on business with intent to defraud creditors. However there is a high burden of proof to demonstrate fraudulent trading, and it needs to be shown that the directors acted dishonestly. In this situation, it is doubtful whether Kevin or Kim acted dishonestly. They appear to have considered that the company's fortunes could be improved.

This does not indicate dishonest behaviour, although they might have acted unwisely in allowing the company to continue in business for so long.

Wrongful trading occurs when a company is being wound up, and some time before the winding up procedures began, a director knew, or ought to have known, that there was no reasonable chance of the company being able to avoid insolvent liquidation. Wrongful trading does not involve dishonesty and the burden of proof is lower than for fraudulent trading.

When the directors know, or ought to know, that insolvent liquidation is unavoidable, they should take every reasonable step to minimise the losses for the company's creditors. If they fail to do so, the court will lift the veil of incorporation and make them personally liable for the losses that should have been avoided. The court will therefore order them to contribute personally a specified sum of money towards the payment of creditors in the winding up and dissolution.

In the case Re Produce Marketing Consortium, the amount of compensation payable by the directors personally was calculated from the time that the directors **should have known** that insolvent liquidation was unavoidable, not from the (later) time that they actually recognised this fact.

On the basis of the facts in this case, it seems probable that Kevin and Kim will be held to be liable for wrongful trading under the provisions of the Insolvency Act 1986. The court will hold them liable for losses from the time that they should have known that insolvent liquidation was unavoidable, which is probably after the losses of £90,000 in October 2007. The losses incurred by the company after that date, which could have been avoided if winding up procedures had started in November, were £60,000 in total.

The court might therefore order that Kevin and Kim should contribute personally a total of £60,000 toward the winding up and payment of the company's creditors. Together with the company's assets, this would provide £70,000 to pay creditors for £175,000. If all the creditors are unsecured, they would therefore receive payment of 40 pence in the £1.

Under the provisions of the Company Directors Disqualification Act 1986, the court might also disqualify Kevin and Kim from acting a s the director of any company, for a period of up to 15 years.

59 Combined Code

(a) The Combined Code is a voluntary code of practice, and with the exception of UK listed companies, there is no requirement to comply with its provisions. Large quoted companies whose shares are traded on AIM are encouraged to apply the provisions of the Code, but compliance is voluntary.

UK listed companies must comply with the Listing Rules. The Listing Rules require that listed companies must comply with the provisions of the Combined Code, or explain any non-compliance with any provision in the annual report. It is recognised that non-compliance with a provision might be appropriate in particular circumstances, but the reasons for such non-compliance should be explained. The rule for listed companies is therefore 'comply or explain'.

(b) The main issues covered by the Combined Code are as follows.

(1) The board of directors. The Code seeks to ensure that a company has an effective board of directors that does not delegate too much decision-making to individuals or executive management. It therefore includes regulations about the need for the board to reserve certain matters for its decision, and that it should meet sufficiently often to discharge its role effectively.

(2) The chairman and chief executive. The Code seeks to establish a clear division of roles between the company chairman and the CEO, with a provision that the two roles should not be performed by the same individual.

(3) Board balance and independence. The Code establishes provisions that seek to achieve a suitable balance of executive and non-executive directors on the board, so that no individual or group of individuals can dominate decision-making by the board. Except in smaller listed companies, there should be a majority of independent NEDs on the board (excluding the chairman).

(4) Appointments to the board. There should be a system of appointing new directors to the board that is formal and rigorous, involving a nominations committee of the board.

(5) Information and professional development. There are provisions relating to the requirement that directors should be properly informed and given induction on appointment and suitable professional development thereafter. The aim is to ensure that the directors are suitably informed and have appropriate knowledge and skills to perform their role effectively.

(6) Performance evaluation. There is a requirement for an annual performance evaluation of the board as a whole, its committees and individual directors.

(7) Re-election. There are provisions to ensure the regular re-election of individual directors.

(8) Remuneration. There are provisions that seek to ensure that directors are remunerated in appropriate way, with enough remuneration to attract and retain talented individuals, but avoiding excessive payments. In addition, remuneration packages should include a suitable element of short-term bonuses and longer-term incentives, to motivate the director to work for the achievement of performance targets that meet the objectives of the company. The remuneration of executive directors should be the responsibility of a remuneration committee of independent non-executive directors.

(9) Accountability and audit. Financial reporting by companies is largely the responsibility of the FRC, but the Code includes provisions that seek to ensure that the company's financial accounts provide a balanced and understandable assessment. In addition there are provisions to ensure the independence and effectiveness of the company's external auditors. An audit committee of independent NEDs should play a significant role in this area of corporate governance.

(10) Relations with shareholders. There are provisions to ensure that the company maintains effective relations with its shareholders, through dialogue and constructive use of the AGM.

60 Stick plc

Stick plc should comply with the provisions of the Combined Code or explain any non-compliance. In normal circumstances the company should therefore be expected to comply with the Code's provisions. This means that a majority of the company's board, excluding the chairman, should be independent non-executive directors (NEDs). Excluding the chairman there are eight directors. This means that at least five of these should be independent NEDs, leaving three to be executive directors or possibly non-independent NEDs. The chairman should have been independent when he (or she) was first appointed.

The company should have an audit committee and a remuneration committee. These should consist entirely of independent NEDs and there should be at least three members of each committee. The chairman of the audit committee should have some audit-related experience. There should also be a nominations committee of at least three members, with a majority of independent NEDs.

61 Legislation on corporate governance

There are several reasons why the government might legislate on corporate governance issues, rather than rely on compliance with a voluntary code.

(1) In the UK, only listed companies are required to comply with the Combined Code (or explain their non-compliance). If the government wishes to apply requirements more generally to other companies, legislation is a suitable way of doing this. An example is the inclusion in the Companies Act 2006 of statutory general duties of directors to their company, which apply to all companies. Some legislation applies to quoted companies only (for example the regulations on the directors remuneration report) or to all companies except small companies (the requirement for an annual business review).

(2) Legislation might be required to implement an EU Directive. For example the requirement for an annual business review resulted from the EU Accounts Modernisation Directive.

(3) A voluntary code might not provide sufficiently detailed regulations, and legislation (or other regulatory measures) is necessary to introduce detailed rules and requirements. An example is the directors' remuneration report for quoted companies, where the Companies Act sets out detailed requirements for disclosures relating to directors' remuneration, as well as a requirement for a part of the report to be audited and for shareholders to be invited to approve the report at the AGM.

(4) It is possible that legislation might be required to fill a gap left by a voluntary code. However, it is more likely that if a weakness or gap is found in the Combined Code that the Code will be amended without the need for legislation (which is less flexible and would take longer to introduce).

62 Inside information

- The information must relate to particular securities or securities of a particular issuer (company)
- The information must be specific or precise.
- The information must not yet have been made public.
- It must be information that, if made public, would be likely to have a significant effect on the market price of the security.

63 Dealing

(1) **Event 1**. Chancer is guilty of the criminal offence of insider dealing.

(2) **Event 2**. Chancer is now guilty of the offence of disclosure. Bent becomes an insider on receipt of the inside information, and so is guilty of the criminal offence of insider dealing by purchasing the shares in Gross.

(3) **Event 3**. Bent is now guilty of the offence of disclosure. Moll becomes an insider on receipt of the inside information, and so is guilty of the criminal offence of insider dealing by purchasing the shares in Gross.

(4) **Event 4**. Moll is now guilty of the offence of disclosure. Kat becomes an insider on receipt of the inside information, and so is guilty of the criminal offence of insider dealing by purchasing the shares in Gross.

(5) **Event 5**. Chancer is guilty of the crime of encouraging another person to deal when in possession of inside information. His father has not committed an offence because he has not been given the inside information, and has not bought shares in Gross on the basis of knowing inside information.

64 Money laundering

(a) Money laundering is the process of getting the proceeds from crime ('dirty money') to appear to have come from a legitimate source. Dirty money that has been laundered becomes 'clean money'.

Dirty money may be defined as money coming from specific crimes (drug trafficking terrorism etcetera) or may be defined more generally as money from any serious crime or even money from any crime.

The offences related to money laundering itself consist of:

- Placement – getting the money into the 'system', such as getting proceeds from crime, often cash, paid into the banking system
- Layering – transferring money from one place to another in order to cover up its origins
- Integration – this is the process of making dirty money actually appear to have come from a legitimate source.

(b) The Proceeds of Crime Act 2002 make the following activities an offence.

- **Laundering** or assisting with money laundering. It is an offence to conceal, disguise, convert, or transfer criminal property, or remove criminal property from the UK. Concealing or disguising dirty money includes concealing or disguising its nature, source, location, movement or ownership.

These offences are punishable on conviction by a maximum prison sentence of 14 years and or a fine.

- **Failure to report**. It is an offence to fail to report knowledge or suspicion of money laundering by someone else. Knowledge or suspicion of money laundering must be reported to an appropriate authority.

  These offences are punishable on conviction by a maximum prison sentence of 5 years and or a fine.

- **Tipping off**. It is an offence to let another person know that he is under suspicion or investigation for money laundering. This offence is punishable on conviction by a maximum prison sentence of 5 years and or a fine.

  Regulations about reporting money laundering have been issued (and are enforced) by the Financial Services Authority. These include requirements that:

- Certain organisations such as banks must appoint a Money Laundering Reporting Officer. Employees in the organisation should report any suspicions of money laundering to this individual, who must then pass the information to the authorities.
- These organisations must have established internal procedures for reporting suspicions of money laundering.
- Records of evidence must be obtained and kept (for example, evidence of the identity of customers).
- The organisation must educate/train its staff in anti-money laundering procedures.

65 Using information

Don is an insider. As an insider, he obtained inside information. The information about the profitability of the company is inside information because:

- it relates to a specific company, Coaster plc
- it is specific, because it relates to the company's profits for the year
- it has not yet been made public, and
- when made public it would be likely to have a significant effect on the share price.

Dealing in Coaster shares through Grab Limited is insider dealing, which is both a criminal offence and a civil offence in UK law. Don is guilty of insider dealing. (It is not clear what role or knowledge his wife had.)

It could also be argued in UK law that if the insider dealing was a criminal offence, trying to disguise the proceeds of the criminal activity is money laundering. Don is trying to disguise the source of the money by pretending to be a consultant for Grab Limited. If money laundering can be proved, this too is a criminal activity.

The firm of solicitors is required to report any suspicions they may have of money laundering by Don (and his wife), otherwise they will be guilty of failing to report money laundering. The solicitors are possibly guilty of money laundering itself, because they help to make the money available to Don and his wife.

66 Drug dealing

The laundry business is being used to conceal the fact that most of the money going through the business is proceeds from serious crime. The laundry business might have been purchased with 'dirty money', but the income of the business clearly consists largely or mainly of dirty money.
Kim is therefore guilty of money laundering.

It seems that Los is assisting Kim to hide the true source of the illegal drugs money. Assisting with money laundering and concealing criminal property are money laundering offences under the Proceeds of Crime Act. Kim is therefore guilty under the provisions of the Act.

From the information available, it also seems that Mel is guilty of assisting Kim with money laundering and helping to conceal criminal property. He does this by preparing false accounts for the laundry business. (Even if Mel had been unaware that the money of the laundry business comes from illegal sources, which is extremely unlikely, h would probably be liable for the lesser criminal charge of failing to report knowledge or suspicion of money laundering.)

67 Fraudulent and wrongful

- **Fraudulent trading** occurs when the business of a company is carried on with the **intent to defraud creditors**, or for any other fraudulent purpose. Fraudulent trading may occur whether or not the company is in the course of being wound up.
- Fraudulent trading is a criminal offence, punishable by imprisonment, a fine or both.
- Fraudulent trading is also a civil offence. If fraudulent trading occurs and the company is wound up, the directors may also be made liable, in a civil action, for some or all of the company's debts. The liquidator of a company that is being wound up may apply to the court for named directors to be held personally liable for some or all of the company's debts.

Wrongful trading occurs when:

- the directors of a company decide to keep the company in business when they know, or should know, that there is no reasonable prospect of the company avoiding insolvency, or
- the directors know that the company will have to go into insolvent liquidation, but do not do enough to minimise the potential loss for the company's creditors.

The court will assume that a director should have known that the company would have to go into insolvent liquidation:

- if this would have been the opinion of a reasonably diligent person
- with the general knowledge, skill and experience that the director might reasonably be expected to have.

Unlike fraudulent trading, wrongful trading is not a criminal offence. It is a civil offence.

If the liquidator of the company is able to show that directors were responsible for wrongful trading, the court may decide that the directors should be personally liable to make a contribution to the company's assets. Any such payment to the company by a director will be used towards paying the company's creditors in the winding up process.

The answers to (b) and (c) are included in the answer above.

In practice, it may be difficult to obtain a decision by a court that fraudulent trading has occurred. This is because fraudulent trading is a crime as well as a civil offence. A director must be judged guilty of fraudulent trading only if the evidence indicates his guilt beyond all reasonable doubt. Liability for wrongful trading only has to be demonstrated on the balance of probabilities. Legal action against a director is therefore more likely to be on an accusation of wrongful trading rather than fraudulent trading.

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