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Company Law

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Key Facts Key Cases

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Ann Ridley and Chris Shepherd

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Preface

The **Key Facts Key Cases** Series is a practical and complete revision aid that can be used by students of law courses at all levels from A Level to degree and beyond, and in professional and vocational courses too.

The Key Facts Key Cases series is designed to give a clear view of each subject. This will be useful to students when tackling new topics and is invaluable as a revision aid.

Most chapters open with an outline in diagram form of the points covered in that chapter. The points are then developed in a structured list form to make learning easier. Supporting cases are given throughout by name and for some complex areas facts are given to reinforce the point being made.

The Key Facts Key Cases series aims to accommodate the syllabus content of most qualifications in a subject area, using many visual learning aids.

Each title in the Key Facts Key Cases Series now incorporates a Key Cases section at the end of each chapter, which is designed to give a clear understanding of important cases. This is useful when studying a new topic and invaluable as a revision aid. Each case is broken down into fact and law. In addition, many cases are extended by the use of important extracts from the judgment or by comment or by highlighting problems. Cases marked in bold in the key facts section signify that they have then been included with further detail in the key cases checklist at the end of the chapter.

In some instances students are reminded that there is a link to other cases or material. If the link case is in another part of the book, the reference will be clearly shown. Links will be to additional cases or materials that do not feature in the book.

To give a clear layout, symbols have been used at the start of each component of the case. The symbols are:

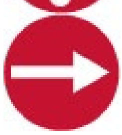
 Key Facts

 Key Law

 Key Judgment

 Key Comment

 Key Problem

 Key Link

The Key Link symbol alerts readers to links within the book and also to cases and other material, especially statutory provisions, which are not included.

The law is as we believe it to be on 28 July 2014.

Table of Cases

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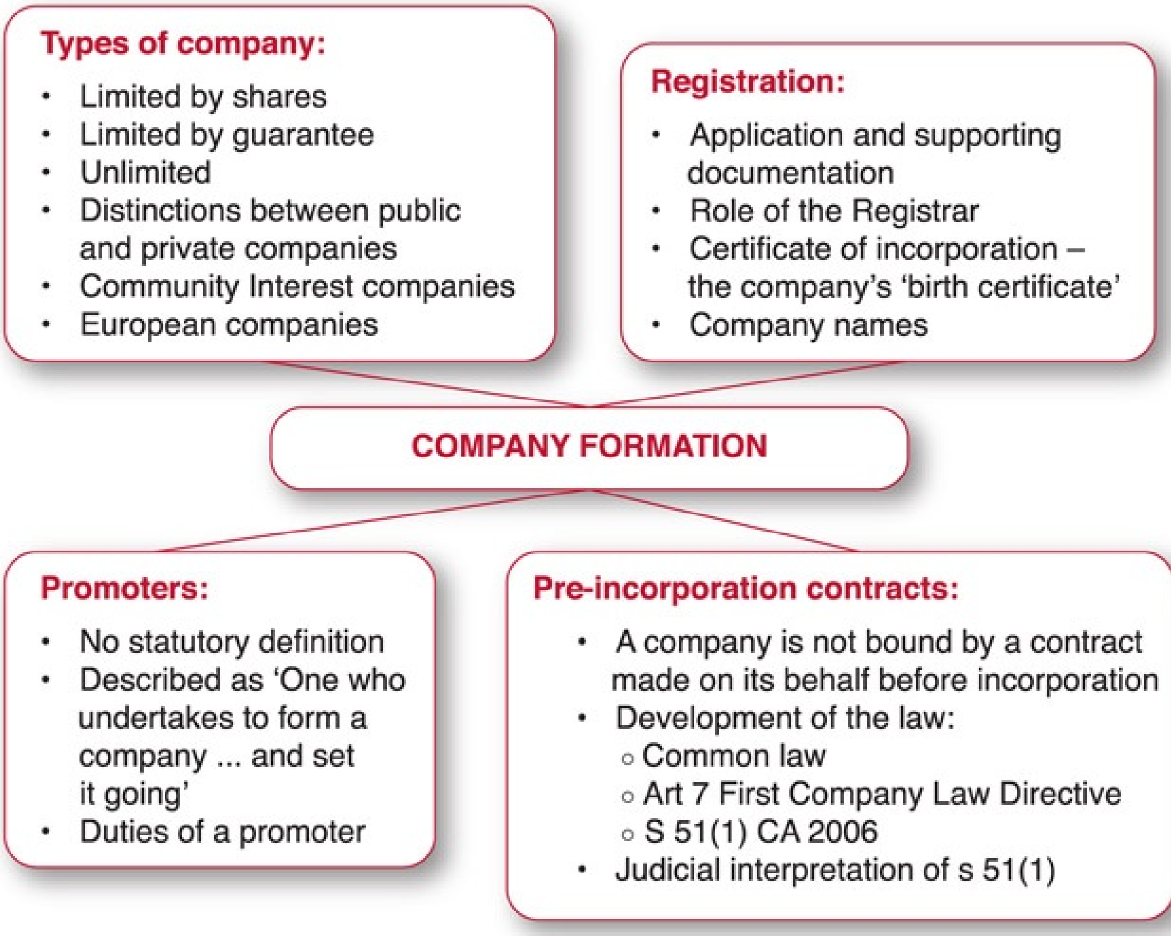
Company formation



1.1 Types of company

1 A company may be created by registration of documents with the Registrar of Companies under the Companies Act (currently CA 2006), registration with another public official or body under another act (e.g. under the Charities Act 1993), by statute or by Royal Charter (the BBC is an example of the last of these). We are concerned only with the first method, that is, with 'registered companies'.

2 Companies may be registered as follows:

- Limited by shares. This is a company with a share capital divided into shares which are issued to members. The liability of members on a winding up is limited to any amount unpaid on the shares.

- Limited by guarantee. Section 3(3) CA 2006 provides that in such a company the liability of members is limited to the amount they agree to contribute in the event of the company being wound up. Prior to the CA 1980, a company could be limited by guarantee with a share capital. However, although a few such companies still exist, this is no longer permitted by s 5(1) CA 2006.
- Unlimited. A private company may be registered with unlimited liability, in which case the members will be liable to contribute to the whole of the company's debts on liquidation. The main advantage of forming an unlimited company is that such companies are not subject to the disclosure requirements that apply to limited companies with respect to their accounts.

3 A major distinction is between public and private companies.

- A public company is defined in s 4(2) CA 2006 as a company limited by shares (or by guarantee having a share capital) whose certificate of incorporation states that it is a public company in relation to which the requirements of the Act (or former Companies Acts) have been complied with.
- Under s 761(1) CA 2006 a public company must not do business or exercise any borrowing powers unless the registrar is satisfied that the company has allotted shares with a nominal value of at least £50,000, of which 25 per cent must be paid up (the 'authorised minimum').
- Under s 4(1) a private company is defined as any company that is not a public company. This is by far the most numerous type of company.
- Both types of company may now be formed with one member: s 7(1) CA 2006.

4 A public company is subject to more stringent rules than a private company, especially in relation to disclosure, and throughout this book reference will be made to differences between public and private companies. Some of the more obvious differences are set out in the table below.

Public companies	Private companies
Defined by s 4(2) CA 2006	Defined by s 4(1) CA 2006
Limited by shares or by guarantee having a share capital	May be limited by shares or by guarantee, or unlimited
Minimum share capital requirements: ss 761, 763 CA 2006	No minimum share capital requirement
Designated by 'plc' or Welsh equivalent	If limited, must include 'Limited' or 'Ltd' after name
Shares may be offered to the public	Shares may not be offered to the public

5 Community interest companies (CICs) were initially created by the Companies (Audit Investigations and Community Enterprise) Act 2004 for people who wanted to create social enterprises. The community interest company is recognised in s 6 CA 2006. The objects of such a company must show the intention to benefit the community and the directors must produce an annual report to show what the company has done for the benefit of the community. Community interest companies do not have charitable status, but do enjoy lighter regulation than other companies.

6 European Companies: Regulation (EC) No 2157/2001 made it possible, from October 2004, to create a European public limited company, or *Societas Europaea*, where there is co-operation between at least two different companies in different member states.

7 The Limited Liability Partnership Act 2000 allows for incorporation by registration of a limited liability partnership (LLP). An LLP is a corporate body with a separate legal personality, while the relationship between the partners is the same as in a partnership. An LLP may only be formed for 'carrying on a lawful business with a view to profit'. Whereas an LLP must be for profit, a company can be registered for non-business purposes.

1.2 Registration

1.2.1 Documentation under the Companies Act 2006

1 All companies must be registered by Companies House, a government agency (for more information see www.companieshouse.gov.uk). To incorporate a company it is necessary to deliver an application together with the necessary documents to the Registrar of Companies for England and Wales or, for a company to be registered in Scotland, the Registrar of Companies for Scotland: s 9 CA 2006.

2 Electronic incorporation has been possible for certain users, mainly company formation agents, since 2001 and for individual users since 2007.

3 The application must contain the following information:

- the company's proposed name;
- the part of the United Kingdom where it is to be registered – whether in England and Wales, Scotland or Northern Ireland;
- whether the members are to have limited liability and, if so, whether by shares or by guarantee;
- whether the company is to be a public or private company.

4 The application must be accompanied by supporting documents:

(a) The memorandum of association, which must include a statement that the subscribers wish to form a company and, in the case of a company with a share capital, that they agree to take at least one share each. One subscriber can form a company and there is no upper limit.

(b) The company's constitution, that is the articles of association, which may be in the form of the appropriate model articles unless excluded or modified to suit the needs of the particular company.

(c) A statement of capital and the initial shareholdings. This gives details of the shares that the company will issue when it is incorporated and to whom they will be issued. The statement must be updated each time new shares are issued.

(d) A statement of the company's proposed officers, setting out details of the proposed director(s) and secretary (if applicable), together with a consent by each person to act in the proposed role. A private company may have only one director, a public company must have at least two: s 154 CA 2006. Those named will take up office on the date of incorporation.

(e) A statement of compliance, which states that the registration requirements set out in the Companies Act 2006 have been complied with. Companies House may accept this as sufficient evidence that the Act has in fact been complied with.

5 The prescribed fee must be paid. This is currently £40 for a private company limited by shares and £15 for web incorporation.

6 With respect to the articles note the following:

- Companies registered under the Companies Act 1985 may have articles in the form of Table A, CA 1985, which were the same for public and private companies. See Chapter 3 for more detail.
- The Companies Act 2006 model articles apply to new companies incorporated on or after 1 October 2009. There are separate model articles for public companies limited by shares, companies limited by guarantee and private companies limited by shares.
- Under CA 2006 the articles of association comprise the main constitutional document (see further Chapter 3).

7 One person can form any kind of company, including a public company: s 7(1) CA 2006. Under CA 1985 a public company had to have at least two members. A private company must have at least one director, a public

company two: s 154 CA 2006.

1.2.2 The role of the registrar

1 If all the documentation is in order, the Registrar must issue a certificate of incorporation, which is conclusive evidence:

- that the requirements of the Act in respect of registration and of matters precedent and incidental to it have been complied with, and that the association is a company authorised to be registered, and is duly registered under the Act; and
- that if the certificate contains a statement that the company is a public company, it is in fact such a company.

2 Public notice must be given that the memorandum and articles of association have been received by Companies House.

3 A company comes into being on the date of incorporation stated on the certificate of incorporation: ***Jubilee Cotton Mills Ltd v Lewis* (1924)** and see now s 16 CA 2006.

4 Section 7(2) CA 2006 provides that a company may not be formed for an unlawful purpose. The Registrar may refuse registration if he considers this to be the case.

5 Under previous companies legislation, every company was required to include an objects clause in its memorandum of association which, in theory, set out the purpose for which the company was being set up. This allowed the Registrar, in certain cases, to determine whether or not the purpose was unlawful: ***Bowman v Secular Society Ltd* (1917)**; ***R v Registrar of Joint Stock Companies, ex parte More; R v Registrar of Companies, ex parte AG* (1980) reported (1991)**. Note, however, that under the CA 2006 a company is not required to have an objects clause, but may choose to do so (see Chapter 4).

6 If the Registrar is satisfied that the requirements of the Act have been

complied with, he must register the company: s 14 CA 2006.

7 A refusal by the Registrar to register a company is subject to judicial review.

8 A public company cannot start trading until a trading certificate has been issued under s 761 CA 2006, whereas a private company can trade immediately on incorporation.

1.2.3 Off-the-shelf companies

It is also possible to buy a 'ready-made' company 'off the shelf'. Such companies are incorporated by registration agents and are available for purchase relatively cheaply and very quickly. When the ready-made company is sold, its shares are transferred to nominees of the purchaser. The original directors and secretary resign and new directors and secretary are appointed by the purchaser.

1.2.4 Company names

1 The CA 2006, and associated statutory instruments, contain a number of provisions relating to company names, including:

- the name of a private company limited by shares must end with 'Ltd' or 'limited', or, in the case of company registered in Wales, the Welsh equivalent;
- a public company's name must end with 'public limited company', 'plc' or the Welsh equivalent;
- a company may not be registered with a name which is illegal or which the Registrar considers to be offensive or misleading: ***Re Association of Certified Public Accountants of Britain* (1998)**;
- permission is needed to use certain words, for example anything that suggests that the company is connected with government or a local authority;
- under s 66 CA 2006 a company may not register a name that is the

same or too like one already registered on the Registrar's index of names. There are exceptions to this and ss 67 and 68 contain provisions dealing with situations where such names are registered in error.

2 If a company seeks to register a name that is deceptively similar to that of another business to the extent that damage may be caused to the reputation or goodwill of the other business, an action in the tort of passing off may provide a remedy: ***Ewing v Buttercup Margarine Company Ltd*** **(1917)**. See also ***Exxon Corporation v Exxon Insurance Consultants International Ltd*** **(1982)**, where the defendant company was already incorporated. In such cases an injunction may be obtained requiring the directors not to continue to allow the name to be registered.

1.3 Promoters

1.3.1 Introduction

1 During the nineteenth century it was common for people setting up a new company to raise money by offering shares to the public. This provided an opportunity for abuse, and the principles described below were developed in response to this.

2 As a result of legal regulation and the Stock Exchange Listing Rules, the law relating to duties of promoters is now of little practical importance as far as public companies are concerned. It may still have some relevance to private companies.

1.3.2 Who is a promoter?

1 The term *promoter* is one of fact, not of law. A promoter has been

described as: ‘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’ (Cockburn CJ, *Twycross v Grant* (1877) 2 CPD 469). See also ***Whaley Bridge Printing Co v Green* (1879)**.

2 People who act in a purely administrative capacity (e.g. solicitors and accountants) do not become promoters simply by carrying out a professional service: *Great Wheal Polgooth Co Ltd* (1883).

3 Promoters working together to set up a company are not necessarily partners: *Keith Spicer v Mansell* (1970).

4 In each case the courts will look to the surrounding facts to establish whether a person is a promoter.

1.3.3 Remuneration

1 A proposer has no right to remuneration. A contract purportedly made with the company before it was formed will not be binding on the company (see section 1.4 below).

2 This applies even if the company has received the benefit of work done: ***Re English & Colonial Produce Co Ltd* (1906)**.

3 Promoters will not have a right to remuneration even if this is stated in the articles, since the scope of the statutory contract extends only to members in their capacity as members, so only a member can rely on the articles as a contract: see further Chapter 3, section 3.3.

1.3.4 Duties of a promoter

1 As the early cases show, there is often the opportunity for a promoter to abuse his position and take a profit from deals made in the course of promotion. For example, they may purchase property which they later sell to the company.

2 In equity a promoter owes a fiduciary duty to the company when it is incorporated. The fiduciary relationship begins as soon as the promoter starts to take steps to set up the company: ***Erlanger v New Sombrero***

***Phosphate Co* (1878)**.

3 The essence of this duty is 'good faith, fair dealing and full disclosure'. The most important aspect of the duty is that the promoter may not make a secret profit and must declare an interest or profit in any transaction that involves the company.

4 Some problems arise as to how and to whom disclosure should be made. Disclosure to, and approval by, a board of directors who are independent of the promoters is sufficient, as is disclosure in a prospectus inviting prospective shareholders to invest in the company. Disclosure to the members as a whole has long been recognised as effective (***Erlanger v New Sombrero Phosphate Co* (1878)**; *Lagunas Nitrate Co v Lagunas Syndicate* (1899)).

5 Partial disclosure is insufficient – promoters must declare the whole profit: ***Gluckstein v Barnes* (1900)**.

6 Remedies available to the company for breach of fiduciary duty include:

(a) Rescission of a contract entered into as a result of non-disclosure or misrepresentation. Rescission will not be granted if one of the 'bars' to rescission applies. These are: (1) affirmation of the contract, (2) lapse of time, (3) acquisition of third party rights, (4) impossibility of restoring the parties to their pre-contractual position, and (5) liquidation of the company.

(b) Recovery of a secret profit. Here it is necessary to distinguish between situations where the property was acquired by the promoter as part of the promotion of the company and those where it was acquired before the promotion, that is before a fiduciary relationship between the promoter and the company arose. In the latter case, if rescission is not available, the company will not be able to recover any secret profit: ***Re Cape Breton Co* (1885)**; affirmed ***sub nom Bentinck v Fenn* (HL 1887)**.

(c) Damages for breach of fiduciary duty (***Re Leeds & Hanley Theatres* (1902)**) – however, the scope of this remedy is somewhat uncertain.

7 At common law a promoter may be liable in tort for loss caused by fraud or negligence, for example a promoter who buys premises for the company above the market value.

1.4 Pre-incorporation contracts

1 The company, once incorporated, is recognised by the law as a separate legal person. As such it can act only through agents (see Chapter 4). Agency problems arise when a person purports to make a contract for a company prior to incorporation because the principal (the company) does not yet exist.

2 A contract made on behalf of a company before its incorporation does not bind the company, nor can it be enforced or ratified by the company after incorporation: ***Re Northumberland Avenue Hotel Co* (1886)**. However, there may be a remedy against the person purportedly acting for the company.

3 Early cases distinguished between contracts made 'for and on behalf of' the company (***Kelner v Baxter* (1866)**, where it was held that the person who purported to act as agent was personally liable in place of the non-existent principal), and those where the promoter signed his own name to authenticate the name of the company (***Newborne v Sensolid* (1954)**, where it was held that because the company did not exist there was no contract). The fine distinctions suggested by these and other cases made the position at common law quite complex, but essentially whether the promoter was personally liable depended upon the intention of the parties. This has, however, been superseded by statute.

4 Article 7 of the First Company Law Directive provides: 'If, before a company being formed has acquired legal personality, action has been carried out in its name and the company does not assume the obligations arising from such action, the persons who acted shall, without limit, be jointly and severally liable therefore unless otherwise agreed.'

5 This was implemented by the European Communities Act 1972 and is now

re-enacted as s 51(1) CA 2006, which provides: 'A contract that purports to be made by or on behalf of a company at a time when the company has not been formed has effect, subject to any agreement to the contrary, as one made with the person purporting to act for the company or as agent for it, and he is personally liable on the contract accordingly.'

6 The section was interpreted in ***Phonogram v Lane* (1982)**.

7 Section 51(1) CA 2006 makes it clear that a purported agent will be liable under a pre-incorporation contract (unless the parties have agreed otherwise).

8 Until recently it was unclear whether an agent would be able to enforce such a contract as the section only mentions liability. This issue was addressed in ***Braymist Ltd v Wise Finance Ltd* (2001)** and it was held that where s 51(1) applies, a fully effective contract is deemed to have been concluded between the purported agent and the contracting party, conferring both liability and a right of action on the purported agent.

9 Section 51(2) CA 2006 provides that the same provisions apply to a deed.

10 A pre-incorporation contract cannot be ratified by the company after incorporation. The company did not exist when the contract was purportedly made on its behalf and the purported agent cannot retrospectively be given authority to act on behalf of a non-existent entity. The only way that the company can assume liability on the contract is by way of novation – that is by entering into a new contract with the contractor.

11 The section has limitations:

(a) It will not apply when a company has been bought off the shelf and is in the process of changing its name. In this situation the company does not comply with the requirement in s 51(1) that it 'has not been formed': ***Oshkosh B'Gosh Inc v Dan Marbel Inc Ltd* (1989)**.

(b) The agent must purport to make the contract on behalf of a new company, so the section will not apply in a situation where the parties are unaware that the company has been dissolved: ***Cotronic (UK) Ltd v Dezonie* (1991)**.

(c) The statute does not change the common law requirement for novation described above, so does not make it easier for companies to ratify or enforce the contract after incorporation.

Key Cases Checklist

Registration

The Role of the Registrar

Jubilee Cotton Mills Ltd v Lewis (1924)
A company comes into existence on the date of its certificate of incorporation
Bowman v Secular Society Ltd (1917)
R v Registrar of Joint Stock Companies, ex parte More (1931)
The registrar will not register a company set up for an unlawful purpose
R v Registrar of Companies, ex parte AG (1980) reported (1991)
A company with unlawful objects already in existence may be struck off the register of companies

Company Names

Re Association of Certified Public Accountants of Britain (1998)
A company name must not be illegal, offensive or misleading
Ewing v Buttercup Margarine Company Ltd (1917)
The tort of passing off may provide a remedy if a name is deceptively

similar to that of another company

Exxon Corporation v Exxon Insurance Consultants International Ltd (1982)

An injunction may be sought requiring the controllers of a company already registered to stop using a name that is too similar to that of another company

Promoters

Whaley Bridge Printing Co v Green (1879)

Definition of promoter: 'A term of business not of law'

Re English & Colonial Produce Co Ltd (1906)

Promoters are not entitled to payment

Erlanger v New Sombrero Phosphate Co (1878)

Promoters owe a fiduciary duty to the company when it is incorporated

Gluckstein v Barnes (1900)

Promoters must not make a secret profit

Re Cape Breton Co (1885); affirmed *sub nom Bentinck v Fenn* (HL 1887)

A promoter not in fiduciary position at the time of the transaction, will not be liable for breach of duty

Re Leeds & Hanley Theatres (1902)

A promoter must disclose any profit on a pre-incorporation transaction

Pre-Incorporation Contracts

Re Northumberland Avenue Hotel Co (1886)

A contract made on behalf of a company before it is made does not bind the company

Kelner v Baxter (1866)

The person who purported to make a contract on behalf of the company was personally liable

Newborne v Sensolid (1954)

The contract was a nullity, so the purported agent was not liable. Note the fine distinction between this case and *Kelner v Baxter*

Phonogram v Lane (1982)

Subject to any agreement to the contrary, promoters are personally liable with respect to pre-incorporation contracts made on behalf of an unformed company

Braymist Ltd v Wise Finance Ltd (2001)

A promoter can enforce a pre-incorporation contract

Oshkosh B'Gosh Inc v Dan Marbel Inc Ltd (1989)

Section 51(1) only applies when a company is 'in the process of being formed'

Cotronic (UK) Ltd v Dezonie (1991)

At the time of the contract there was no intention to form a new company so s 51(1) CA 2006 did not apply

1.2.2 *Jubilee Cotton Mills Ltd v Lewis* [1924] AC 958

HL

Key Facts

The company allotted shares to Lewis on 6 May 1924, the same day that the registrar signed the certificate of incorporation. It was not signed, however, until two days later. Lewis sold the shares and made a profit in breach of his duty as a promoter. He was sued by the liquidator. He claimed he did not have to account for the profit as the company did not exist on the date the shares were allotted.

Key Law

A company comes into existence from the first moment on the date mentioned in its certificate of incorporation. Lewis had to account for the profit he made.

Key Link

See below 1.3.4: Duties of a promoter.

1.2.2 *Bowman v Secular Society Ltd* [1917] AC 406 HL

Key Facts

The Secular Society was bequeathed some property but it was argued that it could not accept it as its objects denied Christianity and were therefore illegal as against public policy.

Key Law

The objects were not unlawful, but if they were the conclusiveness of the registrar's certificate under s 1 CA 1900 [s 15(4) CA 2006] would not bind the Crown and the Attorney-General could apply to have the registration quashed.

1.2.2 *R v Registrar of Joint Stock Companies, ex parte More* [1931] 2 KB 197 CA

Key Facts

The registrar refused to register a company whose objects were to sell, in England, tickets for an Irish lottery. The promoters sought an order of *mandamus* ordering the registrar to register the company.

Key Law

The objects were unlawful and the registrar was entitled to refuse to register such a company.

1.2.2 *R v Registrar of Companies, ex parte Attorney-General* [1991] BCLC 476 QBD

Key Facts

A prostitute was advised by her accountant to run her business as a company. She formed and registered Lindi St Claire (Personal Services) Ltd. The main object was 'To carry on the business of prostitution'. The Attorney-General sought an order of *certiorari* to quash the incorporation and registration of the company.

Key Law

The conclusiveness of the registrar's certificate of incorporation did not bind the Crown and therefore the Attorney-General was authorised to bring the proceedings. The company's objects were illegal and the company was struck off the register as it had not been formed for a 'lawful purpose' within s 1(1) CA 1948 [s 7(2) CA 2006].

1.2.4 *Re Association of Certified Public Accountants of Britain* [1998] 1 WLR 164 CH

Key Facts

The Association was registered as a company but the name was objected to by the Secretary of State for Trade and Industry who argued that it was misleading under s 32 CA 1985 [s 76 CA 2006].

Key Law

The court ordered the company to abandon the name. The word 'Certified' suggested to the public that its members had undergone a rigorous diet of education, training and examinations. It gave a misleading indication as to the nature of its activities and could cause harm to the public as they were likely to be prepared to pay more in fees for the services of a member of a company with this name.

1.2.4 *Ewing v Buttercup Margarine Company Ltd* [1917] 2 Ch 1 CH

Key Facts

The claimant carried on a wholesale and retail business of selling margarine in shops under the name 'Buttercup Dairy Co'. It wished to prevent the newly formed defendant company from carrying on a wholesale business of selling margarine under the name 'Buttercup Margarine Co Ltd'.

Key Law

The claimant succeeded in a passing off action in tort. The two names were so similar that the public were likely to be confused by the two companies' products. It made no difference that the claimant's business was based in Scotland and the north of England, and the defendant was based in Westminster. The public might think the defendant's business was a branch of the claimant or connected with it.

Key Link

A new regime was introduced in ss 69–74 CA 2006 to allow a challenge to a company name to which someone else has a better claim.

1.2.4 *Exxon Corporation v Exxon Insurance*

Consultants International Ltd [1982] Ch 119 CA

Key Facts

The Exxon Corporation carried on a multinational business in 100 countries. The defendant wanted to use the word ‘Exxon’ in its insurance business, which it carried on in the UK.

Key Law

The claimant was granted an injunction in a passing off action as the two names were held likely to cause confusion in the minds of the public.

1.3.2 *Whaley Bridge Calico Printing Co v Green* (1879) 5 QBD 109 QBD

Key Judgment

Bowen J defined a promoter as a business term, rather than a legal one: ‘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.’

Key Link

See also the definition in *Twycross v Grant* (1877) in the Facts section at 1.3.2.

1.3.3 *Re English & Colonial Produce Co Ltd* [1906] 2 Ch 435 CA

Key Facts

A firm of solicitors prepared the formation documents and paid the registration fees for the company. The company went into liquidation and the firm lodged a claim for its fees.

Key Law

Despite the fact that the company had the benefit of the work there was no rule in equity that the company had to reimburse them for their fees.

1.3.4 *Erlanger v New Sombrero Phosphate Co* (1878) 3 App Cas 1218 HL

Key Facts

Company promoters purchased the lease of an island in the West Indies for £55,000. The island allegedly contained large quantities of phosphate. The lease was held in the name of a nominee. A prospectus was prepared and there were many subscribers for the company's shares. The company then purchased the lease from the promoters for £110,000 but the prospectus did not disclose the interests or profit to be made by the promoters. The phosphate turned out to be of low grade. The shareholders replaced the original board of directors, who sought rescission of the contract.

Key Law

The court ordered rescission of the contract. The promoters had broken their fiduciary duty to disclose their interest in the lease and their profit on resale to the company. Disclosure should have been made either to an independent board or the shareholders.

Key Judgment

Lord Cairns LC
'They stand in my opinion, undoubtably in a fiduciary position . . . I do not say that the owner of property may not promote and form a joint stock company, and then sell his property to it, but I do say that if he does he is bound to take care that he sells it to the company through the medium of a board of directors who can and do exercise an independent and intelligent judgment on the transaction, and who are not left under the belief that the property belongs, not to the promoter, but to some other person.'

Key Link

For more information on rescission and bars to rescission see Facts section

1.3.4, point 6.

1.3.4 *Gluckstein v Barnes* [1900] AC 240 HL

Key Facts

The promoters purchased property for £140,000 and sold it to the company for £180,000. Their profit of £40,000 was disclosed in a prospectus inviting the public to buy shares but it did not disclose a further profit of £20,000, made when they purchased charges on the property at a discount which were later repaid in full.

Key Law

The promoters were liable to repay the profit to the company as there had been inadequate disclosure.

Key Comment

Rescission was not possible as the company had gone into liquidation and four years had elapsed since the sale of the property to the company. The liquidator's action was against Gluckstein only but the liability of promoters is both joint and several.

1.3.4 *Re Cape Breton Co* (1885) 29 Ch D 795 CA

Key Facts

A syndicate, including F, purchased some coal-bearing areas for £5,000. A company was promoted two years later and F became a director. The coal areas were sold to the company for £44,000 without F disclosing his interest as a part owner of the land. The company affirmed the contract but later went into liquidation. The liquidator commenced proceedings against F for breach of duty.

Key Law

The company could have rescinded the contract with F but this was barred as the company affirmed the contract. F acquired the property at a time when he was not in a fiduciary position as a promoter. He was not, therefore, liable for the difference in value between the price he paid and the price paid by the company.

Key Comment

The result of this case is that if the right to rescind has been lost and the property was acquired before the promotion of the company began, then the court will not require the promoter to account for any profit he has made on the sale. This decision was affirmed by the House of Lords in *Bentinck v Fenn* (1887) 12 App Cas 652.

Key Link

A claim for damages could be made instead: *Re Leeds and Hanley Theatres of Varieties Ltd* [1902] 2 Ch 809.

1.3.4 *Re Leeds and Hanley Theatres of Varieties Ltd* [1902] 2 Ch 809 CA

Key Facts

The promoters purchased two music halls for £24,000 which they later sold to the company for £75,000. A prospectus inviting the public to purchase shares in the company did not disclose this profit or that they were the vendors. The company went into liquidation and the liquidator brought this action to recover their profit.

Key Law

They were ordered to pay damages to the company equal to the amount of the profits for breach of duty. An allowance was made for the expenses of the promotion and the costs that they had incurred in redecorating the music halls.

Key Comment

The remedy of rescission was barred as third party rights had been acquired through the sale of the music halls.

1.4 *Re Northumberland Avenue Hotel Co* (1866) 33 Ch D 16 CA

Key Facts

An unformed hotel company agreed to lease a piece of land and to build on it. The articles purported to adopt the contract. After incorporation, the company took possession of the land and spent £40,000 on building works. Before completing the work the company went into liquidation. The other party to the contract claimed damages in the liquidation of the company.

Key Law

The claim failed as the company did not exist at the time of the contract. Simply performing the contract after formation did not amount to a fresh contract.

Key Comment

Merely ratifying and performing the contract does not establish a new agreement but in *Howard v Patent Ivory Manufacturing Co* (1866) 33 Ch D 156, where the terms of the pre-incorporation contract were changed after formation, a new contract was found.

1.4 *Kelner v Baxter* (1866) LR 2 CP 174 CP

Key Facts

The promoters of an unformed hotel company purchased some wines and spirits from Kelner. The promoters signed the contract 'on behalf of the company', which was formed but went into liquidation before payment was made. Kelner sued the promoters for the price of the goods.

Key Law

The promoters were personally liable. The company was not liable as it was not in existence at the time the contract was made. Ratification by the company after formation was also ineffective as this also requires an existing principal at the time of the contract.

1.4 *Newborne v Sensolid (Great Britain) Ltd* [1954] 1 QB 45 CA

Key Facts

S agreed to buy 200 cases of tinned ham from a company which was not formed at the time of the contract. The contract was signed 'Leopold Newbourne (London) Ltd' and underneath was the signature of Leopold Newbourne, the promoter and director. S refused to take delivery of the ham. The company was in fact never formed and the court had to decide whether Leopold Newbourne could enforce the contract personally.

Key Law

He could not enforce the contract as it was a nullity. He did not enter the contract either as principal or agent; instead the contract was purported to be made by a company not yet in existence. His signature merely confirmed the company's signature but it did not make him a party to the contract.

Key Judgment

Lord Goddard CJ
'The only person who had any contract here was the company [which did not exist], and Mr. Newbourne's signature merely confirmed the company's signature.'

1.4 *Phonogram v Lane* [1982] 1 QB 938 CA

Key Facts

L was a music promoter. He intended to form a company, Fragile Management Ltd, to manage a band called 'Cheap, Mean and Nasty'. He signed a contract, 'for and on behalf of Fragile Management Ltd', with P under which P agreed to advance £12,000 to help promote the band. The company was never formed and P sued L to recover £6,000 outstanding on the advance.

Key Law

L was personally liable to repay the money under s 36C(1) CA 1985 [s 51(1) CA 2006]. Former common law distinctions regarding how promoters signed pre-incorporation contracts have been removed. Only an express agreement between the parties can exclude the operation of the section. A person can 'purport' to act on behalf of an unformed company even though no physical steps have yet been taken to incorporate the company.

1.4 *Braymist Ltd v Wise Finance Co Ltd* [2002] EWCA Civ 127; [2002] 2 All ER 333 CA

Key Facts

A firm of solicitors acted as the agents of Braymist, an unformed company, and signed a contract on the company's behalf to sell land to Wise, who were property developers. Wise refused to complete the sale and the issue was whether the solicitors were entitled to *enforce* the contract under what is now s 51(1) CA 2006.

Key Law

A person who purports to act on behalf of a company not yet formed can enforce the contract under the section as well as being personally liable on it.

1.4 *Oshkosh B'Gosh Inc v Dan Marbel Inc Ltd* (1988) 4 BCC 795 CA

Key Facts

C purchased a company 'off the shelf' called E Ltd. A special resolution was passed to change the name of the company to DM Inc Ltd. Before receiving the new certificate of incorporation bearing the new name, the company, through C, entered into a contract with O to purchase goods. When the goods were not paid for O sued C under s 36C(1) CA 1985 [s 51(1) CA 2006], alleging he had made a contract on behalf of a company which had 'not been formed'.

Key Law

C was not personally liable as the section did not apply. A change of name does not amount to a re-incorporation of the company so at the time this contract was made there was a company in existence, albeit wrongly named.

1.4 *Cotronic (UK) Ltd v Dezonie* [1991] BCC 200 CA

Key Facts

D owned and controlled WB Ltd. Acting on behalf of the company he entered into a contract with a third party but unknown to both of them the company had been struck off the register five years earlier so that it was not in existence at the time of the contract. On discovering this D formed another company with the same name and sought to enforce the contract against the third party under s 36C(1) CA 1986 [s 51(1) CA 2006].

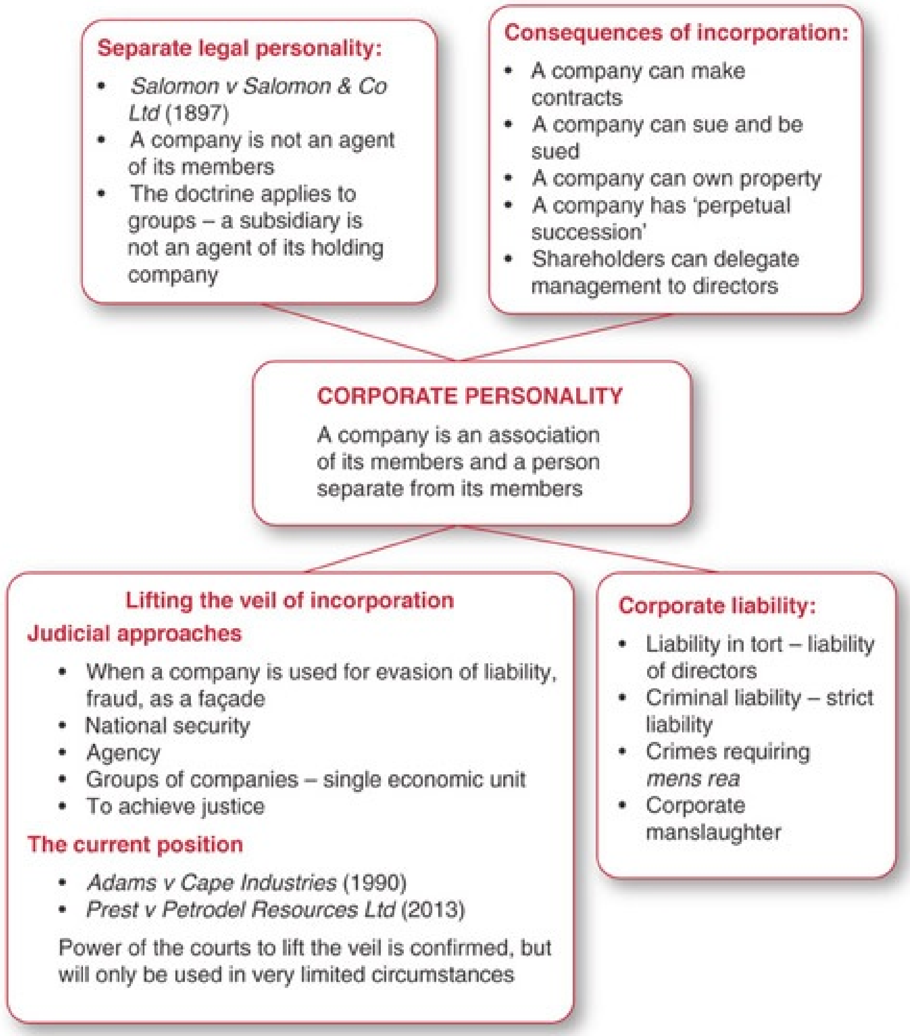
Key Law

His action failed. At the time of the contract no one had given a thought to the need to form a new company. It could not, therefore, be said that he was 'purporting to act for the company' within the meaning of the section. In this situation the person purporting to act on behalf of the company can claim a *quantum meruit* payment for any work done under the 'contract'.

Key Link

The ability to enforce a pre-incorporation contract under the section was confirmed in *Braymist Ltd v Wise Finance Co Ltd* [2002] 2 All ER 333.

2
Corporate personality



2.1 Introduction

1 A company is both a separate legal person and an association of its members. This is an underpinning feature of company law. This chapter will describe the principles and the limitations of separate legal personality.

2 On incorporation, the company acquires separate legal personality; that is, the company is recognised as a person separate from its members, a principle established in ***Salomon v Salomon & Co Ltd* (1897)**.

3 It was further established in this case that the company is not the agent of its members.

4 A registered company created under foreign law is also recognised as a separate legal person in the United Kingdom. In *Arab Monetary Fund v Hashim (No 3)* (1991) the House of Lords held that the Arab Monetary Fund, a body created and given legal personality in the United Arab Emirates, had capacity to commence proceedings in its own name.

2.2 Consequences of incorporation

1 The company is an association of its members and a person separate from its members. It is the company, not its members, that conducts the business of the company.
2 The company can make contracts.
3 The company can sue and be sued.
4 The company can own property.
5 The company continues in existence despite changes of membership or the death of its members: *Re Noel Tedman Holdings Pty Ltd* (1967). In other words, a company enjoys 'perpetual succession'.
6 The members can delegate management to directors.

2.3 The *Salomon* principle

1 The principle of separate legal personality is a powerful device, allowing incorporators to manage commercial risk, but in certain situations it can be used unfairly or fraudulently.
2 The concept of separate personality also extends to groups of companies, with each subsidiary in a group having a separate identity. In *Lonrho Ltd v Shell Petroleum Co Ltd* (1980), Lonrho sought disclosure of documents which were held by a wholly-owned subsidiary of Shell. Disclosure was refused. Shaw LJ said, 'It would involve not merely raising the corporate veil, but committing an affront to the persona of the company itself.'
3 Furthermore, as a company is not an agent of its members, it follows that,

unless there is specific evidence of an agency arrangement, a subsidiary is not an agent of its parent company (see further at section 2.4.3).

4 The following cases are examples of affirmation of the *Salomon* principle by the courts:

- ***Macaura v Northern Assurance* (1925)**: a shareholder had no insurable interest in property owned by the company. Note that in this case the principle was applied to the disadvantage of the shareholder.
- ***Lee v Lee's Air Farming* (1961)**: a company can employ one of its members who will have all statutory and other rights against the company.
- *Secretary of State for Trade and Industry v Bottrill* (1999): a sole shareholder can be employed by the company and will have rights under the Employment Rights Act 1996.
- *Secretary of State for Business, Enterprise and Regulatory Reform v Neufeld* (2009): the Court of Appeal reviewed the law and held that a director of a company can be an employee as long as he is employed under a genuine contract of employment and not a contract for services.
- *R v Philippou* (1989): the sole directors and shareholders were convicted of theft from the company when they withdrew funds from the company's account in London and bought themselves a property in Spain. The Court of Appeal refused to accept the argument that they had acted with the consent of the company.
- *Foss v Harbottle* (1843): since a company is a legal person separate from its members, a member cannot bring an action to redress a wrong done to the company and the company itself is considered to be the proper claimant. But note the statutory provisions in Part 11 CA 2006 considered in Chapter 11.

2.4 Lifting the veil of incorporation

2.4.1 Introduction

1 The notion that a company is recognised as a person separate from its members is often described as the 'veil of incorporation', which is a metaphor used to describe the separation of the company from its members and directors.

2 In certain circumstances, the *Salomon* principle can be used in ways that appear to be unjust to third parties, creditors or even the shareholders themselves. The development of the law shows how the courts have sometimes taken the view that the veil of incorporation should be lifted to avoid abuse of separate personality.

3 Furthermore, there are a number of statutory exceptions to the principle.

4 Limited liability is not a direct consequence of the corporate entity principle (it is possible to form an unlimited company), but the vast majority of companies are limited and the concept goes hand-in-hand with the principle of separate personality. If the veil is lifted this right to limited liability may be lost.

5 The courts have been very reluctant to lift the veil in order to impose personal liability for the company's debts on a shareholder or director.

6 The approach has not always been consistent and it has been difficult to identify clear principles to determine when the courts may be prepared to lift the veil and when they would decline to do so.

7 The Supreme Court recently sought to provide some 'coherent, practical and principled basis' for lifting the veil in ***Prest v Petrodel Resources Ltd* (2013)**. The court stressed that, in the absence of an express statutory provision, the veil will be pierced only in those rare cases when a company is being used to evade a legal obligation (see further below at 2.4.4). The cases that follow show how the courts have applied and developed the principles relating to lifting the veil.

2.4.2 Judicial approaches

2.4.2 Judicial approaches

1 The Companies Act 2006 itself contains provisions that have the effect of lifting the veil in certain circumstances (see section 2.4.5) and the courts have also interpreted provisions in other statutes so as to require that the veil should be lifted. However, in *Dimbleby & Sons Ltd v National Union of Journalists* (1984) it was held that any parliamentary intention that the veil should be lifted must be expressed in 'clear and unambiguous language'.

2 The veil has been lifted in cases where it has been shown that the corporate form was being used as a façade in order to avoid liability or to gain an illegitimate benefit for the shareholders. Examples include:

(a) evasion of liability to pay tax: *Littlewoods Mail Order Stores Ltd v Inland Revenue Commissioners* (1969);

(b) evasion of a restraint of trade clause in a contract of employment: ***Gilford Motor Co Ltd v Horne* (1933)**; *Dadourian Group International Inc v Simms* (2006);

(c) attempt to avoid an order of specific performance: ***Jones v Lipman* (1962)**.

3 In the cases above, those in control of the company used the corporate form to commit a wrong. The veil will not be lifted when the company is controlled by others who have had no part in the wrongdoing (*Ben Hashem v Shayif* (2008)) or where there has been no impropriety or attempt to hide the facts (***Ord v Belhaven Pubs Ltd* (1998)**).

4 The courts have lifted the veil in cases involving national security, particularly in times of war. In *Daimler Co Ltd v Continental Tyre and Rubber Co (Great Britain) Ltd* (1916) the House of Lords looked behind the veil of an English company and discovered that its directors and all but one of its shareholders were German nationals. This meant that the contract could not be enforced against it as it amounted to trading with the enemy.

2.4.3 Groups of companies

1 A number of cases have involved groups of companies and several different approaches have been employed by the courts. In *Re Southard & Co Ltd* (1979) Templeman LJ set out the general position: 'A parent company may spawn a number of subsidiary companies, all controlled directly or indirectly by the shareholders of the parent company. If one of the subsidiary companies, to change the metaphor, turns out to be the runt of the litter and declines into insolvency to the dismay of its creditors, the parent company and the other subsidiary companies may prosper to the joy of the shareholders without any liability for the debts of the insolvent subsidiary.'

2 **Group enterprise**: the high water mark of the courts' willingness to lift veils was ***DHN Food Distributors Ltd v Tower Hamlets LBC* (1975)**, in which it was held that a group of companies was a single economic unit, thus enabling the group to claim compensation on the compulsory purchase of land even though the land from which the business operated was owned by a subsidiary and the business was operated by the parent company.

3 This case was disapproved by the House of Lords in *Woolfson v Strathclyde Regional Council* (1978) and the argument was not accepted in subsequent cases, including *Re Southard & Co Ltd* (1979) and *Adams v Cape Industries* (1990).

4 **Agency**: it was held in *Salomon v Salomon* (1895) that a company is not an agent of its shareholders. However, the agency argument has been used in a number of cases involving groups of companies. Every company in a group is recognised as a separate legal person and it has been argued that a subsidiary is in certain circumstances an agent of the holding company. If on the facts of the case there is actual evidence of an agency existing, this is consistent with the principle of separate legal personality, but the issue is usually whether an agency can be inferred.

(a) In ***FG Films Ltd* (1953)** the court inferred agency in a case where a United Kingdom company was set up in order to acquire film distribution rights in the United Kingdom for an American holding company.

(b) In *Smith, Stone & Knight Ltd v Birmingham Corporation* (1939) the court laid down guidelines to establish whether an agency could be implied between a holding company and its subsidiaries. However, this case has been criticised and has not been followed.

(c) In *JH Rayner (Mincing Lane) Ltd v Department of Trade and Industry* (1989) it was held that an agency cannot be inferred from the mere fact that the company is controlled by its shareholders.

5 **Justice**: in some cases the courts have been willing to accept that the veil can be lifted where this is necessary in order to achieve justice, for example *Creasey v Breachwood Motors Ltd* (1992). However, this view has not been accepted in recent cases, and *Creasey* was overruled by the Court of Appeal in ***Ord v Belhaven Pubs Ltd* (1998)**.

2.4.4 Towards certainty

1 In ***Adams v Cape Industries* (1990)** the Court of Appeal reviewed the arguments for lifting the veil discussed above, in particular the agency argument, the single economic unit argument and the 'façade' argument, and held that none of these applied on the facts.

2 The case signalled a shift towards the view that in the absence of fraud, incorporators can rely on the principle of separate corporate personality. This view has been affirmed in ***Ord v Belhaven Pubs Ltd* (1998)**, where it was held that the court may not lift the veil in situations where there is no attempt to hide the true facts, no ulterior motive and no impropriety. Following *Adams* it seems that the only circumstances where the courts might lift the veil were:

- when the court is construing a statute, contract or other document which requires the veil to be lifted;

- when the court is satisfied that the company is a 'mere façade', so that there is an abuse of the corporate form: ***Trustor AB v Smallbone (No 2)*** **(2001)**;
- when it can be established that the company is an authorised agent of its controllers or its members, corporate or human.

3 Subsequent cases have given victims of tort caused by a foreign subsidiary a direct claim against the parent company in the UK on the basis that the parent may in some circumstances owe them a duty of care in tort. The does not involve piercing the corporate veil: ***Chandler v Cape*** **(2012)**.

4 Each case is considered on its facts and there have been suggestions in some recent cases that the Court of Appeal may be more willing than in *Adams* to treat a group of companies as a single concern: see *Beckett Investment Management Group Ltd v Hall* (2007), where a contract in restraint of trade was construed as applying not only to the client's holding company, but also to its subsidiaries.

5 The court will not pierce the veil of incorporation to attach contractual liability to a person merely because he controls the company which entered into the contract with a third party. The effect of this would be to treat the controller as a co-contracting party when the parties to the contract did not intend this: ***VTB Capital plc v Nutritek International Corpn and others*** **(2013)**.

6 In the important case of ***Prest v Petrodel Resources Ltd*** **(2013)** a seven-strong Supreme Court settled the point that, while the power to lift the corporate veil exists, it may only be used in very limited circumstances. It was recognised that in most instances it has not be necessary to lift the veil, as alternative remedies have been available.

2.4.5 Statutory exceptions

1 There are a number of statutory provisions in the Companies Act 2006 that have the effect of lifting the veil.

2 Section 767(3) CA 2006 provides that if a public company acts before obtaining a trading certificate, all the officers and directors are liable to fines and if the company fails to comply within 21 days the directors are liable to indemnify anyone who suffered loss as a result of the transaction.
3 For groups of companies, s 399 provides that, unless subject to the small companies regime or otherwise exempt, the directors of a parent company must file group accounts.
4 Other Acts also provide examples: ss 213 and 214 Insolvency Act 1986, which provide that in cases of fraudulent trading and wrongful trading a director may be liable to make a contribution to the company's assets, and s 15 Company Directors Disqualification Act 1986, which provides that a person involved in the management of a company in contravention of a disqualification order is liable for the debts of the company.

2.5 Civil and criminal liability

The fact that a company is an artificial person raises interesting questions as to the limits of a company's liability for wrongful acts.

2.5.1 Liability in tort: vicarious liability

1 In tort, a company may be held vicariously liable for the wrongful acts of its officers and employees as long as they were acting in the course of their employment. The employee who commits the act will also be liable as the primary tortfeasor.
2 Vicarious liability has been described as 'a loss distribution device based on grounds of social and economic policy' (Lord Millett in *Dubai Aluminium Co Ltd v Salaam* (2002)). The company may be held liable for a tort of someone else, for example its employee or agent.

2.5.2 When are directors liable in tort?

2.5.2 When are directors liable in tort?

1 If a director, acting for a company, causes the company to commit a tort it is the company not the director who becomes liable. However, if a director is acting in a personal capacity or assumes personal responsibility he or she will be liable for the tort. Difficult questions arise as it is not always easy to establish whether the director has acted in a personal capacity and each case depends on its own facts: see *Fairline Shipping Corporation v Adamson* (1975); *Mancetter Developments Ltd v Garmanson Ltd* (1986); ***Williams v Natural Health Foods Ltd* (1990)** and ***MCA Records Inc v Charly Records Ltd* (2003)**.

2 If a director is held to be personally liable for a tort, this will effectively remove the protection of incorporation and, in the case of a limited company, of limited liability. In *Williams* Lord Steyn said: '[In] order to establish personal liability under the principle of Hedley Byrne [*Hedley Byrne & Co Ltd v Heller & Partners (1964)*], which requires the existence of a special relationship between plaintiff and tortfeasor, it is not sufficient that there should have been a special relationship with the principal. There must have been an assumption of responsibility such as to create a special relationship with the director or employee himself.' In this case it had not been possible to show that such a relationship existed.

3 However, it may be possible to show that the director is personally liable for a tort involving fraud or dishonesty, as in ***Standard Chartered Bank v Pakistan National Shipping Corp (Nos 2 and 4)* (2002 and 2003)**, where both the director and the company were sued for the tort of deceit. See also *Contex Drouzhba Ltd v Wiseman* (2007).

2.5.3 Liability for crime

1 Companies can commit crimes of strict liability and there are a large number of regulatory offences that apply to companies. In such cases it is necessary only to show that the company committed the criminal act (*actus reus*): *Alphacell Ltd v Woodward* (1972).

2 There are certain crimes which it is impossible for a company to commit

since the *actus reus* could not be committed by an artificial person, for example driving a vehicle in an unsafe condition: *Richmond-on-Thames BC v Pinn & Wheeler Ltd* (1989).

3 There are also obvious limitations on the sanctions that can be applied to companies: notably, a company cannot be imprisoned.

4 In recent years debate has centred on whether a company, being a legal entity without a mind of its own, is able to form the necessary *mens rea* for the offence in question.

5 The notion that the directors of a company may be its 'directing mind and will' was accepted by the courts in ***Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* (1915)** and ***HL Bolton (Engineering) Co Ltd v TJ Graham & Sons Ltd* (1957)**. This is sometimes described as the identification theory.

6 The principle that in certain circumstances a company can commit a crime requiring *mens rea* was recognised by the House of Lords in ***Tesco Supermarkets Ltd v Nattrass* (1972)**, although in this case the company's defence that the store manager was 'another person' and not the controlling mind and will of the company was accepted. See also ***Tesco Stores Ltd v Brent Borough Council* (1993)**, where the court reached a different conclusion on the facts.

7 An alternative theory, the attribution theory, was suggested by Lord Hoffman in ***Meridian Global Funds Management Asia Ltd v Securities Commission* (1995)**.

2.5.4 Corporate manslaughter

1 Following the capsize of the car ferry *Herald of Free Enterprise* in 1987, the question of whether a company could be convicted of manslaughter was considered. In *R v P&O European Ferries (Dover) Ltd* (1990) it was held that it was possible for a company to commit manslaughter, as long as it could be established that a person who could be identified as the 'mind and will of the company' could be found guilty of the offence. In that case, however, the court found that there was insufficient evidence

against any of the directors to convict.

2 The first successful prosecution of a company for manslaughter was ***R v Kite* (1996)**.

3 Some of the difficulties are highlighted in *Attorney General's Reference (No 2 of 1999)* (2000) and it became clear that a change in the law was needed.

4 In March 1996, the Law Commission published a report, *Legislating the Criminal Code: Involuntary Manslaughter* (Law Com No 237), in which the Commission made a number of recommendations, including proposals for a new offence of corporate killing, separate from the offences that can be committed by individuals. After further consultation and long delays the Corporate Manslaughter and Corporate Homicide Act 2007 was passed in July 2007.

5 The Act abolishes the common law offence of corporate manslaughter by gross negligence (s 20) and signals a shift from the identification principle to the concept of management failure. Whereas previously it had been necessary to show that death had been caused by a person or persons who could be identified as the 'mind and will' of the company, the Act now focuses on the way an organisation is managed by its 'senior management'.

6 On conviction an organisation is liable to pay a fine. The Act also gives power to the court to make:

- a remedial order, requiring the organisation to take steps to remedy the breach or any deficiency relating to health and safety (s 9); and
- a publicity order, requiring the organisation to publicise the fact that it has been convicted of the offence and other details as ordered by the court; this is provided for in s 10, but this has not been brought into force.

Key Cases Checklist

Separate Legal Personality

Salomon v Salomon & Co Ltd (1897) A company is a person separate from its shareholders and directors *Macaura v Northern Assurance* (1925) A shareholder had no insurable interest in company property *Lee v Lee's Air Farming* (1961) A shareholder who is also an employee of the company will have all statutory rights against the company

Lifting the Veil of Incorporation

Judicial Approaches to Lifting the Veil

Gilford Motor Co Ltd v Horne (1933) Evasion of restraint of trade clause in contract *Jones v Lipman* (1962) An attempt to evade an order of specific performance: an example of the company being a 'sham'
DHN Food Distributors Ltd v Tower Hamlets LBC (1975) Three companies in a group treated as a 'single economic unit'
FG Films Ltd (1953) FG Films Ltd held to be an agent of American company

Recent cases:

Adams v Cape Industries (1990) The Court of Appeal reviewed the arguments for lifting the veil and declined to lift the veil in this case, marking a return to the strict application of the *Salomon* principle *Ord v Belhaven Pubs Ltd* (1998) Where there was no fraud or attempt to misuse the corporate form the veil will not be lifted *Trustor AB v Smallbone (No 2)* (2001) The veil will be lifted in cases where the company is mere façade, an abuse of the corporate form *Chandler v*

Cape (2012) *VTB Capital plc v Nutritek International Corpn and others* (2013) The veil will not be pierced so as to make a non-contracting party liable just because he owns and controls the company A parent company owed a direct duty of care to employees of a foreign subsidiary: the court emphasised that this was not an instance of lifting the veil *Prest v Petrodel Resources Ltd* (2013) While the power to lift the corporate veil exists, it may only be used in very limited cases

Corporate Liability

Directors' Liability in Tort

Williams v Natural Health Foods Ltd (1990) and *MCA Records Inc v Charly Records Ltd* (2003) A director, acting for the company, will not be liable in tort unless he had assumed personal responsibility for the act *MCA Records Inc v Charly Records Ltd* (2003) A director will not be liable as joint tortfeasor with the company if he is doing no more than his constitutional duty *Standard Chartered Bank v Pakistan National Shipping Corp (Nos 2 and 4)* (2002 and 2003) A director will be personally liable for torts such as deceit or fraudulent misrepresentation

Corporate Liability for Crime

Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd (1915) *HL Bolton (Engineering) Co Ltd v TJ Graham & Sons Ltd* (1957) The court applied the identification theory in both cases *Tesco Supermarkets Ltd v Nattrass* (1972) A company can commit a crime requiring *mens rea*, but may be able to rely on the defence that the act was committed by 'another person', not the directing mind and will of the company *Meridian Global Funds Management Asia Ltd v Securities Commission* (1995) The knowledge of employees in committing an offence may be attributed to the company *R v*

Kite (1996) A director was the directing mind and will of the company and was convicted of manslaughter. Note now the Corporate Manslaughter and Corporate Homicide Act 2007

2.1 *Salomon v A Salomon & Co Ltd* [1897] AC 22 HL

Key Facts

S carried on a business as a leather boot manufacturer as a sole trader. He decided to form a company to run the business and A. Salomon & Co Ltd was registered under the Companies Act 1862. S, his wife and five children became the only shareholders, taking one share each, and S and his two sons were the directors. Once incorporated, the company purchased the business from him. The purchase price was set at £39,000 although it was really only worth about £10,000. The company paid for the business partly by issuing S with 20,000 £1 shares and also issuing him £10,000 in debentures (a document issued by a company to evidence a loan). The debenture was secured by a floating charge over the company's assets. Following a depression in the boot trade the company went into liquidation. There was only £1,055 to satisfy the unsecured debts of £7,773 plus S's debenture. As a secured debenture holder, S claimed to be entitled to the £1,055.

Key Law

At first instance it was decided that the company was his agent and that as principal, S was liable to indemnify the company for its debts. The Court of Appeal upheld this decision but on the different ground that the company was operating as a trustee for S.

The House of Lords reversed the judgment of the Court of Appeal and held that the company was properly incorporated under the 1862 Act and was, therefore, a separate person from its shareholders and directors. The company was not S's agent; he was the company's agent. It made no difference that his wife and children played no active part in running the business. As a secured debenture holder S was entitled to be paid his debt in priority to the unsecured creditors.

Key Judgment

Lord Macnaghten 'The company is at law a different person from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act.'

Key Comment

Under the CA 1862 seven shareholders were required to form a company. Under s 7 CA 2006 any company (public or private) may now be formed with just one.

2.3 *Macaura v Northern Assurance Co* [1925] AC 619 HL

Key Facts

M owned a timber estate in Ireland. He sold the estate to a company formed for the purpose and afterwards insured the timber with the defendant company in his own name. A fire on the estate destroyed the timber and M claimed under the insurance policy. The defendant denied his claim and alleged that the timber was no longer his to insure but now belonged to the company.

Key Law

M's claim failed. Even though M was the only shareholder and the largest creditor of the company, the House of Lords held that he had no insurable interest in the timber and could not, therefore, insure it in his own name.

Key Judgment

Lord Wrenbury 'My Lords, this appeal may be disposed of by saying that the incorporator even if he holds all the shares is not the corporation, and that neither he nor any creditor of the company has any property legal or equitable in the assets of the corporation.'

Key Comment

Forming the company turned out to be a disadvantage to M. Otto Khan-Freund in (1944) 7 MLR 54 stated: 'Sometimes, as shown by the cases concerning insurable interest . . . "corporate entity" works like a boomerang and hits the man trying to use it.'

2.3 *Lee v Lee's Air Farming Ltd* [1961] AC 12 PC

Key Facts

The company was an aerial crop sprayer. L owned all but one of the 3,000 issued shares and was the company's sole governing director. In accordance with the articles he appointed himself to be the company's chief pilot. He was killed while crop spraying when the aircraft crashed. Mrs Lee claimed against the company's insurers under New Zealand legislation that required L to be a 'worker'. The insurance company disputed that he was a 'worker'.

Key Law

Mrs L succeeded. His position as a principal shareholder and governing director did not stop him from making a contract of employment between the company and himself. *Salomon* was applied so that the company was distinct from L who was, therefore, a 'worker'.

Key Judgment

Lord Morris of Borth-y-Gest 'In their lordships' view it is a logical consequence of the decision in Salomon v A Salomon & Co Ltd [1897] AC 22 that one person may operate in dual capacities. There is no reason, therefore, to deny the possibility of a contractual relationship being created as between the deceased and the company.'

2.4.2 *Gilford Motor Co Ltd v Horne* [1933] Ch 935 CA

Key Facts

H was employed by GM as its managing director. His contract of employment contained a covenant not to solicit its customers after leaving its employment. He left and set up a new company which then began to compete with GM and solicit its customers in breach of the covenant. GM sought an injunction against both H and his new company.

Key Law

The injunction was granted. H's new company was a sham, set up in order to evade his contractual undertaking not to compete with GM.

Key Judgment

Lord Hanworth MR
'I am quite satisfied that this company was formed as a device, a stratagem, in order to mask the effective carrying on of a business of [the defendant].'

2.4.2 *Jones v Lipman* [1962] 1 All ER 442 QBD

Key Facts

L contracted to sell his house to J. He changed his mind and in order to avoid completion, conveyed the house to a company that he owned and controlled. The claimant sought specific performance against either L or the company.

Key Law

Specific performance was ordered against both of them as the company was a sham. Russell J described the company as ‘the creature of [Lipman], a device and a sham, a mask which he holds before his face in an attempt to avoid recognition by the eye of equity’.

Key Link

Jones v Lipman was said to be a good example of a ‘façade’ in *Adams v Cape Industries plc* [1990] Ch 433.

2.4.3 *DHN Food Distributors Ltd v London Borough of Tower Hamlets* [1976] 1 WLR 852 CA

Key Facts

A parent company, DHN, ran its business through two wholly-owned subsidiaries. The directors and shareholders were the same in all three companies. One subsidiary owned the premises, which were compulsorily purchased by Tower Hamlets to build houses on the land. Statutory compensation was payable both for the value of the land and also for disturbance of the business. Tower Hamlets paid compensation for the land value but refused to pay for disturbance of the business. They argued that the business was owned by the parent, DHN, and, therefore, the subsidiary had no business to disturb.

Key Law

DHN was allowed to claim the compensation as the three separate companies were treated as one group enterprise. To treat the companies as separate entities would have denied DHN the compensation on a technical point.

Key Judgment

Lord Denning MR
'The three companies should, for present purposes, be treated as one, and the parent company DHN should be treated as that one. So DHN are entitled to the compensation accordingly.'

2.4.3 *Re FG Films Ltd* [1953] 1 All ER 615 CH

Key Facts

The company applied to the court for a declaration that they had made a British film for which generous tax concessions were available. The company had a paid-up share capital of £100 and the staff and finance to make the film, which cost £80,000, was provided by an American company. The company had no place of business other than its registered office and the President of the American company also owned 90 per cent of the shares.

Key Law

The declaration was refused as FG Films Ltd was merely an agent for the American company.

Key Comment

This case does not provide any guidelines for establishing an agency relationship.

2.4.4 *Adams v Cape Industries plc* [1990] Ch 443 CA

Key Facts

Adams obtained judgment in the United States against a subsidiary of the defendant after he suffered personal injuries due to asbestos exposure. The subsidiary had no assets to meet the claim and Adams wanted to enforce the judgment against the UK parent company, Cape. This involved an argument that Cape was present in the US through its subsidiaries there.

Key Law

The claim failed. The court refused to lift the veil between the parent and the subsidiary companies. In doing so the court rejected arguments that: (1) Cape and its subsidiaries were one single economic unit; (2) the subsidiaries were a façade concealing the true facts; and (3) the subsidiaries were agents of Cape. A suggestion that the veil could be lifted in the interests of justice was also rejected.

Key Judgment

Slade LJ

'We do not accept as a matter of law that the court is entitled to lift the corporate veil as against a defendant company which is the member of a corporate group merely because the corporate structure has been used so as to ensure that the legal liability (if any) in respect of particular future activities of the group (and correspondingly the risk of enforcement of that liability) will fall on another member of the group rather than the defendant company. Whether or not this is desirable, the right to use a corporate structure in this way is inherent in our corporate law.'

Key Comment

This decision marks a return to a strict application of the *Salomon* principle.

2.4.4 *Ord v Belhaven Pubs Ltd* [1998] 2 BCLC 447 HL

Key Facts

The claimants purchased a 20-year lease from the defendant to run one of its pubs. They alleged the defendant had misrepresented turnover and profits figures for the pub. Following a group restructure the defendant no longer had any substantial assets to meet the claim. The claimants now wanted to substitute the holding company of the group in place of the defendant.

Key Law

It was not appropriate to lift the veil. No fraud was alleged and the defendant company was not a façade for the holding company. The restructuring was perfectly proper and involved no concealment of the facts. All the companies within the group were trading companies and not shams or formed for an improper purpose.

2.4.4 *Trustor AB v Smallbone* [2001] 1 WLR 1177 CH

Key Facts

S was the managing director of TAB, a Swedish company. In breach of his duty as a director he transferred £20m from the company's bank account to another company, 'Introcom', which he owned and controlled. TAB sought summary judgment against S, alleging that he was jointly and severally liable with Introcom for the return of the money.

Key Law

Summary judgment was granted. It was appropriate to pierce the corporate veil and treat the receipt of the money by 'Introcom' as receipt by S himself. This was because 'Introcom' was a device or façade concealing the true facts which allowed S to receive the money.

Key Comment

His Lordship refused to base his judgment on the grounds that justice required the veil to be lifted. This would have been inconsistent with the Court of Appeal's views in *Adams v Cape Industries plc* [1990] Ch 433.

2.4.3 *Chandler v Cape* [2012] EWCA civ 525; [2012] 1 WLR 3111 CA

Key Facts

Chandler was employed by a subsidiary of Cape as a brick loader. He was exposed to asbestos dust at the subsidiary's factory and contracted asbestosis. The subsidiary was dissolved and so he sued Cape arguing that it owed a direct duty to the employees of its subsidiary company to provide a safe system of work.

Key Law

The court held that Cape was liable. It owed a tortious duty to its subsidiary's employees as it had assumed responsibility for their health and safety. Such an assumption does not arise by reason only that a company is a parent of another company and it is not necessary for the parent to have absolute control over its subsidiary.

Key Judgment

Arden LJ identified the following circumstances as being relevant to imposition of responsibility: '(1) the business of the parent and subsidiary are in a relevant respect the same; (2) the parent has, or ought to have, superior knowledge on some relevant aspect of health and safety in the particular industry; (3) the subsidiary's system of work is unsafe as the parent company knew, or ought to have been known; and (4) the parent knew or ought to have foreseen that the subsidiary or its employees would rely on its superior knowledge for the employees' protection.'

Key Comment

The court emphatically rejected any suggestion that the case involved in any way piercing the corporate veil.

2.4.4 *VTB Capital plc v Nutritek International Corpn and others* [2013] UKSC5; [2013] 2 WLR 398 SC

Key Facts

The claimant bank, VTB, provided a loan to a Russian company, RAP, to allow it to buy six Russian dairy companies from Nutritek, the defendant. RAP defaulted on the loan and VTB alleged that RAP and Nutritek were under the common control of a Mr Malofeev. VTB argued there were two misrepresentations: first, that RAP and Nutritek were not under common control, and second, that the value of the dairies was overstated. VTB now sought to pierce the veil so as to make Malofeev a party to the loan contract, thereby incurring joint and several liability for the default by RAP.

Key Judgment

- It was inappropriate to pierce the corporate veil in these circumstances. Malofeev could not be made a co-contracting party to the loan contract just because he controlled RAP and Nutritek.
- RAP was not being used as a façade to conceal the true facts and neither Malofeev nor the actual contracting parties to the loan contract intended him to be a party to it.
- Lord Neuberger PSC felt that to pierce the veil in this case would be 'contrary to authority and contrary to principle'.

2.4.4 *Prest v Petrodel Resources Ltd* [2013] UKSC 34 HL

Key Facts

Mr P owned and controlled a number of companies which owned properties and, following divorce proceedings, the question was whether Mr P was 'entitled' to the properties under the Matrimonial Causes Act 1973, so that the court could order a transfer to Mrs P.

Key Law

The court held that the corporate veil could not be lifted for the purpose of showing that Mr P owned the properties but that on the evidence the properties were held by the companies in trust for Mr P, so the order could be made.

Key Judgment

Lord Sumption JSC concluded that: '[T]here is a limited principle of English law which applies when a person is under an existing legal obligation or liability or subject to an existing legal restriction which he deliberately evades or whose enforcement he deliberately frustrates by imposing a company under his control. The court may then pierce the corporate veil for the purpose, and only for the purpose, of depriving the company or its controller of the advantage that they would otherwise have obtained by the company's separate legal personality.'

Key Comment

There was no ground to lift the veil because Mr P had vested the properties in the companies before the marriage had broken up and there was no evidence that he did so in order to avoid any legal obligation relevant to the proceedings in the case.

2.5.2 *Williams v Natural Life Health Foods Ltd* [1998] 1 WLR 830 HL

Key Facts

The claimants entered into a franchise agreement with the defendants for the running of a health food shop. They relied on negligently prepared financial projections contained in a brochure prepared by the defendants. The brochure made it clear that the company's expertise was derived from M, who was the managing director, owner and controller of the company. The claimants, however, never met M and dealt with other company employees. When the company went into liquidation, the claimants sued M personally and the court had to decide whether he was personally liable for the negligent advice in the company's brochure.

Key Law

M was not liable. In the absence of an assumption of personal responsibility, a director is not liable for a tort committed by the company. No such assumption was present on the facts of the case.

Key Comment

If M had written a personal letter to the claimants stating that he was personally answerable for the services provided then the case would probably have been decided differently.

2.5.2 *MCA Records Inc v Charly Records Ltd* [2001] EWCA Civ 1441; [2003] 1 BCLC 93 CA

Key Facts

A claim was made against a director of the defendant company that he was personally liable as a joint tortfeasor for infringements of copyright committed by the company.

Key Law

The director was not liable. Chadwick LJ said that: (1) a director is not liable as a joint tortfeasor if he does no more than carry out his constitutional role by voting at board meetings; and (2) the test is whether the director 'intends and procures and shares a common design that the infringement takes place'.

2.5.2 *Standard Chartered Bank v Pakistan National Shipping Corp (No 2)* [2002] UKHL 43; [2003] 1 AC 959

HL

Key Facts

The managing director of a company fraudulently misrepresented the date on a bill of lading so that the company could obtain payment under a letter of credit from the Bank. The court awarded damages against the director for deceit but he argued he had made the misrepresentation on behalf of the company and not personally.

Key Law

He was liable for the damages. Lord Hoffman said: 'No one can escape liability for his fraud by saying, "I wish to make it clear that I am committing this fraud on behalf of someone else and I am not to be personally liable." '

2.5.3 *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705 HL

Key Facts

A ship's cargo was destroyed by a fire caused by defective boilers which made it unseaworthy. The appellant ship owner, L Ltd, claimed to be entitled to a statutory defence but had to show the damage happened 'without his actual fault or privity'. L Ltd claimed that the loss was due to the fault of Mr Lennard, who was a director of the company. His name also appeared in the ship's register as the person responsible for the management of the ship but he took no steps to ensure the boilers were in a seaworthy condition.

Key Law

The defence could not be relied on as Mr Lennard was the 'directing mind and will' of the company and his actions were those of the company itself.

Key Judgment

Vicount Haldane LC
'My Lords, a corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation.'

Key Comment

The ‘directing mind and will theory’ has it origins in German law. It is also known as the ‘alter ego’, ‘organic’ or ‘identification’ theory.

2.5.3 *HL Bolton (Engineering) Co Ltd v TJ Graham & Sons Ltd* [1957] 1 QB 159 CA

Key Facts

TJ Graham Ltd was the landlord of Bolton. It did not want to renew the lease granted to Bolton as it ‘intended’ to occupy the premises for the purpose of carrying on its own business. The company only held one board meeting a year but the directors met frequently, though not as a board, to discuss the development plans for the premises. Bolton argued that the company had not shown the necessary intention.

Key Law

The company had shown the necessary intention which could be inferred from its directors and managers who were its directing mind and will.

Key Judgment

Lord Denning MR likened a company to a human body: ‘It has a brain and nerve centre which controls what it does. It has hands which hold the tools and act in accordance with directions from the centre.'

2.5.3 *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153

HL

Key Facts

Tesco were charged with an offence under the Trade Descriptions Act 1968 for offering 'Radiant' washing powder at a price higher than that advertised. Tesco sought to rely on a defence in the Act but they had to show it was due to the act or default of 'another person'. They claimed that their store manager was 'another person' for the purposes of the Act.

Key Law

Tesco were able to rely on the defence as the store manager could not be regarded as the directing mind and will of the company. Tesco had several hundred stores and he could not be 'identified' with the company as he was relatively low down in the company's management structure.

Key Judgment

Lord Reid 'The board never delegated any of their functions. They set up a chain of command through regional and district supervisors, but they remained in control. The shop managers had to obey their general directions and also take orders from their superiors. The acts or omissions of shop managers were not the acts of the company itself.'

Key Comment

The result is that the larger the company is and the more complex its management structure is, the more difficult it will be to identify those who are its directing mind and will.

2.5.3 *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500 PC

Key Facts

Two senior employees acting on behalf of Meridian purchased shares in another company. As a result, Meridian became a 'substantial security holder' in that company and had a statutory obligation to notify the New Zealand Stock Exchange. Meridian failed to do so, arguing that they had no knowledge of the share purchases.

Key Law

It is only necessary to rely on the directing mind and will theory if the relevant legal rule requires this. The correct approach is to ask whose act, knowledge or state of mind was for the purpose of the relevant legal rule intended to count as the act of the company. For the purpose of this legislation, it was the knowledge of the two employees which was to be attributed to Meridian.

Key Comment

This approach restricts the role of the directing mind and will theory but extends the range of people whose acts can be attributable to the company.

2.5.4 *R v Kite* [1996] Cr App R (S) 295 CA

Key Facts

Kite was the managing director and shareholder of OLL Ltd, which ran an activity centre. Four teenagers drowned while canoeing on the open sea. They had not been instructed properly.

Key Law

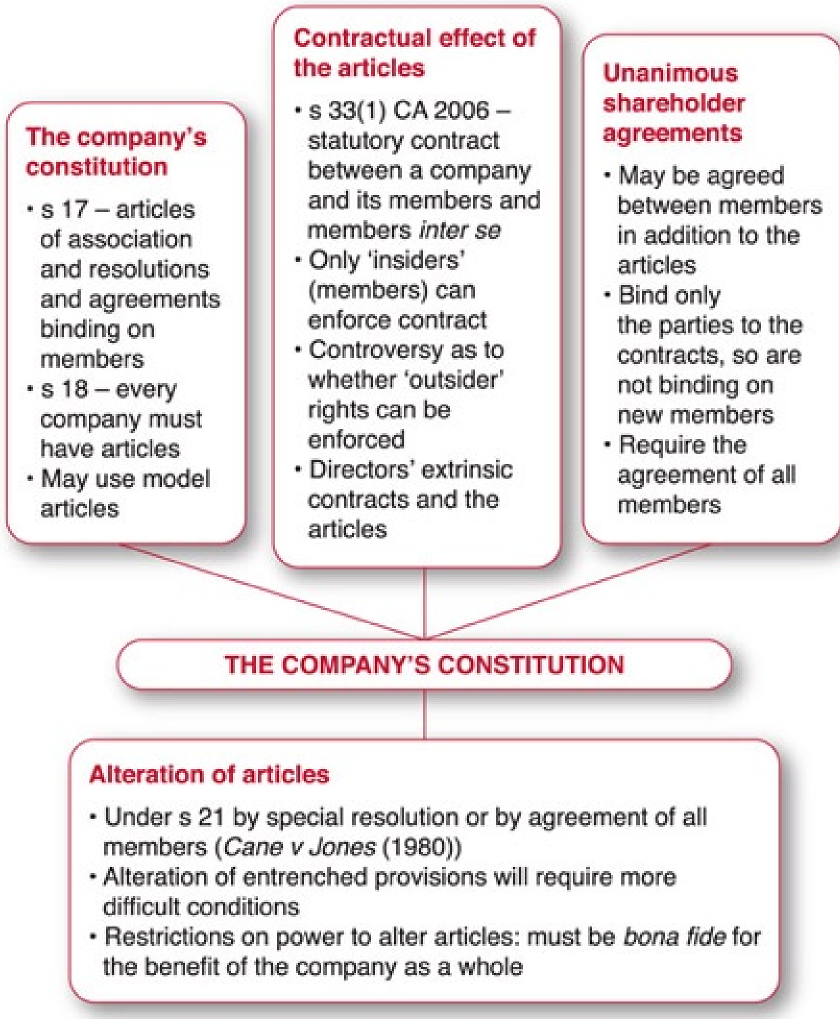
Both Kite and his company were convicted of manslaughter. The company was fined £60,000, which represented its entire assets, and Kite received a three-year prison sentence.
On appeal, Kite's sentence was reduced to two years.

Key Comment

This is the first case in which a company was convicted for corporate manslaughter. Treating Kite as the directing mind and will of the company was relatively straightforward as his was a ‘one man’ company.

3

The constitution



3.1 The company's constitution

1 Under previous Companies Acts every company was required to have two important constitutional documents: a memorandum of association and articles of association.

2 The Companies Act 2006 (CA 2006) has reduced the significance of the memorandum, which now simply contains an undertaking by each of the subscribers that they intend to form a company and agree to take at least one share each. The articles are now the company's main constitutional document. Information previously set out in the memorandum of

association is now given as part of the application for registration.

3 Under s 17 CA 2006 a company's constitutional documents include:

- the company's articles; and
- resolutions and agreements 'binding on members' which, in terms of s 29, include any special resolution and a broad range of other resolutions and agreements.

4 Section 18 provides that every company must have articles, which contain the rules on how the company is to be run. The articles must be contained in a single document and divided into paragraphs numbered consecutively.

5 The content of the articles will normally include a statement of limited liability followed by rules on:

- the appointment, removal and remuneration of directors;
- the authority and power of directors;
- decision-making by directors and shareholders (meetings, resolutions and voting rights);
- shares (types, rights and transfer) and dividend distributions;
- administrative arrangements (means of communication, inspection of books and records, directors' indemnity and insurance).

6 Previous Companies Acts included model articles, for example Table A CA 1985, which applied to both private and public companies and which could be adopted with or without amendments. Companies registered under previous Acts may continue to have as their constitution what has been termed an 'old style memorandum' and articles which may be in the form of Table A. In such cases the provisions of the 'old style memorandum' are treated as provisions of the articles. Alternatively, companies registered under previous acts may amend their articles to conform with the CA 2006 if the company agrees to do so by special

resolution.

7 Section 19(2) CA 2006 gives power to the Secretary of State for Business Innovation and Skills to prescribe separate model articles for public companies, private companies limited by shares and private companies limited by guarantee, now found in SI (statutory instrument) 2008/3229.

8 A company may adopt the relevant model articles in whole or in part, as was the case under previous legislation.

3.2 Shareholder agreements

1 A shareholder agreement may be used in addition to the articles. Such an agreement may be made between all or some of the members and others, including directors, and is enforceable as an ordinary contract.

2 An example is ***Russell v Northern Bank Development Corporation Ltd* (1992)** (see also section 3.5.1 below).

3 A shareholder agreement will only bind the parties to it, so problems may arise on the transfer of shares as the new shareholder will not be bound by the agreement.

4 Because shareholder agreements require agreement by all members to be fully effective, they are generally only suitable for use by small private companies.

5 The advantage of shareholder agreements, compared to the articles, is that they are generally easier to alter and enforce and they are private. In *Puddephatt v Leith* (1916) a mandatory injunction was granted which compelled the defendant to vote in accordance with a shareholder agreement contained in a letter written by the claimant.

3.3 Contractual effect of the constitution

1 The ownership of shares in a company gives rise to certain rights and obligations. A company is an artificial person in its own right as well as

an association of its members, and is therefore able to contract with its members.

2 Section 33(1) CA 2006 (previously s 14 CA 1985) provides: 'The provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions.'

3 Previous versions of this provision referred only to 'covenants on the part of each member to observe all the provisions of the memorandum and the articles', making no mention of the company's obligation. Although it has been generally accepted that there is a contract between the company and its members (***Hickman v Kent or Romney Marsh Sheepbreeders Association* (1915)**), the change of wording to 'covenants on the part of *the company and of* each member' removes any doubt.

4 Under previous legislation the equivalent section referred to the memorandum and articles, although discussion focused on the articles since this document contained the rules for internal management of the company. Section 33 CA 2006 refers to the constitution and although the principal constitutional document is the articles of association, this may also include certain resolutions (see s 17 CA 2006).

3.3.1 Special features of the s 33 contract

Ordinary contract	Contract formed by the articles under s 33
Terms agreed by parties	Member usually accepts terms by purchase of shares in company
Terms provide for obligations/rights which when performed come to an end	The constitution creates ongoing rights/obligations – sometimes referred to as a relational contract
Terms may only be altered by agreement of all parties	Articles can be altered by special resolution (s 21 CA 2006)
Rectification available	Rectification not available (*Scott v Scott* (1940))
Damages are the usual remedy	Damages usually not appropriate (but may be claimed for liquidated sum, e.g. dividend); a

Damages are the usual remedy for breach	claimed for liquidated sum, e.g. dividend), a declaration is the usual remedy

1 Model articles are prescribed by statutory instrument, so must be construed in accordance with the Interpretation Act 1978. Furthermore, the articles are a public document and it is important that third parties, especially prospective members, are able to rely on the accuracy of these documents as registered. See *Bratton Seymour Service Co Ltd v Oxenborough* (1992), where the Court of Appeal refused to imply a term into the articles imposing a financial obligation on members in order to give the articles 'business efficacy'.

2 However, in ***Attorney General of Belize v Belize Telecom Ltd* (2009)** the Privy Council held that while the court had no power to improve the articles, it could imply a term to give the articles the meaning intended by the parties and in *Folkes Group plc v Alexander* (2002) the court construed an article by adding five words to correct what, according to the evidence, must have been a drafting error. It was noted that the general principle remains that external factors should not be taken into account when construing articles of association.

3.3.2 The scope of the statutory contract

1 The scope of the s 33 contract has been considered in a number of cases, which cannot easily be reconciled. The following points are established:

(a) Once registered, the articles constitute a contract between the members and the company and between the members *inter se*: ***Wood v Odessa Waterworks Co* (1889)**. This is now more clearly stated in the 2006 Act than in previous legislation. This contract gives rise to:

- contractual rights between the company and its members: ***Hickman v Kent or Romney Marsh Sheepbreeders Association* (1915)**;

- contractual rights for shareholders against fellow shareholders: ***Rayfield v Hands* (1960)**.

(b) Only an *insider* (a member in this context) can enforce the contract and only those rights that are held in his or her capacity as a member fall within the scope of s 33.

(c) A claim under s 33 made by an *outsider* (that is, a person claiming in a capacity other than that of member) will not succeed: ***Eley v Positive Government Security Life Assurance* (1876)**; ***Browne v La Trinidad* (1887)**; ***Beattie v E and F Beattie* (1938)**. It should be noted here that 'outsider' has been strictly defined and a claim based on rights held as a director will fail, even if the director is also a member.

(d) A member's statutory rights cannot be limited by the articles; for example in *Baring-Gould v Sharpington Combined Pick & Shovel Syndicate* (1899) a resolution in the articles purporting to limit members' rights under what is now s 111(2) Insolvency Act 1986 could not be enforced.

3.3.3 What rights can be enforced?

1 The statutory contract confers on a member, in his capacity as a member, the right to bring a personal action to enforce certain constitutional rights. There are conflicting cases on what may be enforced under s 33: see for example *MacDougall v Gardiner* (1875), where the refusal by the chairman to accept a request for a poll in breach of the articles was held to be an internal irregularity which could be put right by the company's own mechanisms and therefore was not enforceable by personal action. Compare this with *Pender v Lushington* (1877) below.

2 The following rights contained in the articles have been enforced by

members:

- a provision in the articles requiring directors to purchase shares from a member wishing to leave the company: ***Rayfield v Hands* (1960)**;
- a right to exercise a vote at a general meeting: *Pender v Lushington* (1877);
- payment of a dividend, duly declared: ***Wood v Odessa Waterworks Co* (1889)**;
- a right to enforce a veto by directors on certain acts: ***Salmon v Quin & Axtens* (1909)**.

3 The company may enforce a provision in the articles; for example in ***Hickman v Kent or Romney Marsh Sheepbreeders Association* (1915)** the company was able to stop an action by a member and require that the dispute between it and its members be referred to arbitration as provided in the articles.

3.3.4 Enforcing 'outsider rights'

1 It is well established that no contract is created under s 33 between the company and an outsider, even a director. It is less clear whether 'outsider' rights can be enforced by a person bringing a claim as a member, on the basis that every member has the right to have the company's business conducted in accordance with the articles: see for example *Salmon v Quin & Axtens* (1909).

2 This was suggested by Professor Lord Wedderburn in an important article in [1957] CLJ 194 and has been the subject of academic debate since then.

3 It has also been suggested that if the provision in the articles relates to a constitutional matter, for example those listed above in section 3.3.3, then a member will be able to enforce the article as a contract, even if this indirectly enforces outsider rights.

4 But if the matter relates to an aspect of internal organisation or management of the company, for example the right to be paid a salary or the right to be the company's solicitor (***Eley v Positive Government Security Life Assurance Co Ltd* (1876)**), then the provision will not be enforceable.

5 The provisions relating to unfair prejudice in Part 30 CA 2006 provide an alternative way for members and directors to enforce certain rights which might be unenforceable under s 33 (see further Chapter 11) and in the case of small private companies shareholder agreements may be used to protect rights under the general law of contract.

3.4 Directors, the articles and extrinsic contracts

1 Under s 171 CA 2006, directors must act in accordance with the constitution but in their capacity as directors they have no contractual relationship with the company under s 33.

2 However, a company can make contracts with its directors and others, which expressly or impliedly incorporate terms contained in the articles, for example articles about directors' remuneration may be incorporated in a contract of service.

3 Where an article provides for the employment of a director but there is no contract, the court may imply an extrinsic contract: ***Re New British Iron Co, ex parte Beckwith* (1898)**.

4 These rights can be enforced against the company without relying on the articles, but alteration of the articles may vary the terms of the contract.

5 The articles can be altered at any time by special resolution, thus varying the terms of the contract, but terms cannot be altered retrospectively: ***Swabey v Port Darwin Gold Mining Co* (1889)**.

6 If provisions from the articles are incorporated into extrinsic contracts, alteration of the articles may result in breach of the extrinsic contract. A third party cannot prevent alteration of the articles, but in such cases the company may be liable to pay damages: *Southern Foundries (1926) Ltd v*

Shirlaw (1940).

3.5 Alteration of articles

1 Other than in the case of an entrenched article, a company may alter its articles by:

- special resolution: s 21(1) CA 2006;
- agreement by all members (without a resolution): *Cane v Jones* (1980).

2 A company may not prevent its articles being altered, but it may entrench certain provisions by requiring something more than a special resolution to change them. Such entrenched provisions can only be included:

- on formation of the company; or
- after incorporation, by agreement of all the members of the company.

3 In the case of companies registered under previous legislation, certain provisions may have been included in the memorandum in order to make them more difficult to change. Such provisions will now be treated as if they were part of the articles (s 28 CA 2006) and may be treated as entrenched.

4 Notice of entrenchment must be given to the Registrar.

5 Provision for entrenchment does not prevent alteration of the articles by agreement of all the members or by order of the court.

6 Notice of alteration must be given to the Registrar within 15 days of alteration: s 26 CA 2006.

3.5.1 Restrictions on power to alter articles

1. Apart from the possibility of entrenchment, there are a number of restrictions on a company's power to alter its articles.
2. It has long been recognised that there are statutory limitations on amendment of articles, for example:

    - s 25 CA 2006: a member is not bound by a change which requires him/her to take more shares or in any way increase the member's liability, without the written agreement of the member.
    - ss 630–635 CA 2006: any alteration which varies class rights must follow the procedures laid down in these sections (see Chapter 5, section 5.3 below).

3. A company may not include a provision in its articles that would restrict alteration of the articles: ***Punt v Symons & Co* (1903)**. It has further been held that a shareholders' agreement not to alter its articles is also unenforceable: ***Russell v Northern Bank Development Corporation* (1992)**. However, in the same case it was stated that it is possible for individual members to enter into a contract setting out how they might use their votes in certain situations, which could produce the same result.
4. Alterations to the articles are effective only if they are made *bona fide* for the benefit of the company as a whole. This principle, articulated in ***Allen v Gold Reefs of West Africa Ltd* (1900)**, has been interpreted and further developed as the courts have applied it in different situations.

    - A member cannot challenge an alteration which was carried out *bona fide* for the benefit of the company as a whole, even if such alteration has affected the member's personal rights, as long as the altered article was intended to apply indiscriminately to all members: ***Greenhalgh v Arderne Cinemas Ltd* (1951)**.
    - The court will generally accept the majority's *bona fide* view of what is for the benefit of the company as a whole, as long as the

alteration is not one which no reasonable person could consider to be for the benefit of the company: ***Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* (1927)**.

- In some cases, for example *Greenhalgh*, where the alteration would not affect the company as a corporate body, the courts have sought to distinguish between the company as a separate entity and the company as an association of members and in deciding on the validity of such amendments have applied a test based on whether the amendment was for the benefit of the 'individual hypothetical member'.
- This concept has raised difficulties of application, as in *Brown v British Abrasive Wheel Co Ltd* (1919) and other cases where a director or group of shareholders would be disadvantaged. Cases in this area often involve minority shareholders challenging the decision of the majority and in many instances the protection available under ss 994–996 CA 2006 will provide a more effective remedy (see Chapter 11).
- Alternative tests, such as the 'proper purpose' test, have been applied in other jurisdictions, notably Australia, but this has not been supported by English courts: see *Gambotto v WCP Ltd* (1995).
- In ***Citco Banking Corporation NV v Pusser's Ltd* (2007)** the Privy Council confirmed that the benefit of the company as a separate commercial entity was the primary test in establishing the validity of an amendment to articles.

5 Amendment of the articles may put the company in breach of a separate contract and liable to pay damages: ***Southern Foundries (1926) Ltd v Shirlaw* (1940)**.

Key Cases Checklist

Contractual Effect of the Articles

Section 33 CA 2006: The Statutory Contract

Hickman v Kent or Romney Marsh Sheepbreeders Association (1915) The articles create a contract between the members and the company and the members *inter se Attorney General of Belize v Belize Telecom Ltd* (2009) While the court may not alter a company's articles, in this case the articles were construed as containing an implied term to 'spell out what the instrument means'
Wood v Odessa Waterworks Co (1889) A member enforced an article requiring that dividends be paid in cash *Rayfield v Hands* (1960) The articles create a contract between the members themselves *Eley v Positive Government Security Life Assurance* (1876) A person claiming as an 'outsider', in this case the company solicitor, has no rights under the statutory contract *Browne v La Trinidad* (1887) *Beattie v E and F Beattie* (1938) In both cases a person claiming as a director, albeit also a member, was unable to rely on the statutory contract *Salmon v Quin & Axtens* (1909) Directors were able to enforce an article giving them a right of veto

Directors, The Articles and Extrinsic Contracts

Re New British Iron Co, ex parte Beckwith (1898) Directors may not rely on the articles to enforce their fee, but an extrinsic contract may be implied *Swabey v Port Darwin Gold Mining Co* (1889) The articles may be altered but may not be relied on retrospectively

Alteration of Articles

Punt v Symons & Co (1903) A provision in the articles that the articles may not be altered is invalid *Russell v Northern Bank Development*

Corporation (1992) A shareholder agreement providing that articles cannot be altered is unenforceable *Allen v Gold Reefs of West Africa Ltd* (1900) Alteration of articles is effective only if made *bona fide* for the benefit of the company *Greenhalgh v Arderne Cinemas Ltd* (1951) Changes made *bona fide* for the benefit of the company cannot be challenged if the change affects all members indiscriminately *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* (1927) The shareholders' majority view that the alteration is for the benefit of the company will only be challenged if it is unreasonable *Citco Banking Corporation NV v Pusser's Ltd* (2007) The test laid down in *Shuttleworth* is confirmed in this case *Southern Foundries (1926) Ltd v Shirlaw* (1940) Alteration of the articles may result in breach of a separate contract

3.2 *Russell v Northern Bank Development Corporation Ltd* [1992] 1 WLR 588

Key Facts

A shareholders' agreement was entered into by the Bank and its four individual shareholders. The agreement required all of the parties to consent to an increase in the Bank's share capital. The directors called an extraordinary general meeting to increase the share capital and R, a party to the shareholders' agreement, sought to enforce it and asked for an injunction preventing the others from voting on the increase at the meeting.

Key Law

A company has the right to alter its share capital clause in the memorandum by increasing it under what is now s 617(2) CA 2006 provided it is permitted by the articles, which it was. The House of Lords decided, however, that this would be a breach of the shareholders' agreement as R did not consent to it. The company itself cannot contract out of s 617 and so it was not bound by the agreement but the shareholders were bound by it. The court granted a declaration to this effect rather than an injunction as R gave evidence that he was only concerned with knowing whether or not the agreement was valid.

3.3 *Hickman v Kent or Romney Marsh Sheepbreeders Association* [1915] 1 Ch 881

Key Facts

The Association, a registered company, refused to register H's sheep in their pedigree flock book and sought to expel him from membership. The articles provided that all differences between the Association and any of its members were to be referred to arbitration. H commenced a court action to restrain the company from expelling him. The Association issued a summons to stay the proceedings relying on the articles which provided for arbitration.

Key Law

The proceedings were stayed. Under what is now s 33 CA 2006 the articles amount to a statutory agreement between the members and the company as well as between the members *inter se.* Hickman was therefore bound to submit his case to arbitration.

Key Judgment

Astbury J

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

Key Comment

Astbury J introduced a limitation that a member can only rely on an article if it affects him in his capacity as a member but the section does not say this.

3.3.1 *Attorney General of Belize v Belize Telecom Ltd* [2009] UKPC 10

Key Facts

The articles of the company provided that as long as the holder of one special redeemable preference share also held at least 37.5 per cent of the C class shares, it could appoint and remove two directors. There was no provision in the articles, however, about what was to happen if the holder of the special share ceased to hold 37.5 per cent of the C class shares. The claimant sought a declaration that this would result in not only the right to appoint two directors being lost but also that the two directors appointed would be required to vacate office. This required the articles to be construed as containing an implied term to this effect.

Key Law

The declaration was granted. A court has no power to improve the articles to make them fairer or more reasonable, but it can imply a term if it would spell out in express words what the articles, read against the relevant background, would reasonably be understood to mean.

Key Judgment

Lord Hoffmann 'But the implication of the term is not an addition to the instrument. It only spells out what the instrument means.'

Key Comment

Lord Hoffmann referred to the previous tests for the implication of a contractual term, such as the 'business efficacy' established in *The Moorcock* (1889), but did not think they were individual tests that each had to be surmounted. He described them as expressing in different ways the central idea of 'what the contract actually means.' He said there is only one question to ask, which is, 'what the instrument, read as a whole against the relevant background, would reasonably be understood to mean.'

3.3.2 *Wood v Odessa Waterworks Co* (1889) 42 Ch D 636 CH

Key Facts

The directors of the company recommended that shareholders receive their dividends in debentures instead of cash. An ordinary resolution was passed by the members adopting this recommendation. W, a shareholder, alleged that this breached the articles which referred to 'a dividend to be paid to the members'.

Key Law

An injunction was granted to stop the directors issuing the debentures. The provision in the articles *prima facie* meant that the dividend should be paid in cash.

3.3.2 *Rayfield v Hands* [1960] 1 Ch 1 CH

Key Facts

The company's articles provided that 'Every member who intends to transfer shares shall inform the directors who will take the said shares equally between them at a fair value.' The claimant notified the defendant directors that he intended to transfer his shares to them but they refused to take them. The claimant sought an order from the court that they should do so.

Key Law

The directors were ordered to buy the shares as the articles have contractual effect between the members themselves (*inter se*) and they can be enforced by a member without the need to join the company as a party to the proceedings. The directors were required by the articles to hold qualification shares and this was therefore a dispute between the members themselves.

Key Judgment

Vaisey J
'[T]he relationship here is between the plaintiff as a member and the defendants not as directors but as members.'

Key Comment

Vaisy J stressed that the company was a quasi partnership type of company and that his decision may not extend to the articles of every company. The CA 2006 does not clear up the position so the issue remains a live one.

3.3.2 *Eley v Positive Government Security Life*

Assurance Co Ltd (1876) 1 Ex D 88 CA

Key Facts

The articles of the company appointed E to be the company's solicitor and stated that he should not be removed except for misconduct. Later on he also became a member but after acting as the solicitor for some time, the company then employed other solicitors to transact their business. E sued the company for breach of contract.

Key Law

There was no breach of contract as the articles had no contractual effect as between the company and E. In his capacity as a solicitor, E was an outsider who could not rely on the contractual effect of the articles. The court also rejected an argument that the articles could be relied on as evidence of an extrinsic contract outside the articles.

3.3.2 *Browne v La Trinidad* (1887) 37 Ch D 1 CA

Key Facts

B was a shareholder of La Trinidad. The company's articles provided that he was also to be a director of the company for four years. Before this period expired he was removed from his directorship and challenged his removal. He argued that this was a breach of contract contained in the articles.

Key Law

He could not rely on the articles as the right to be a director was not given to him in his capacity as a member.

Key Judgment

Lindley LJ
'It would be remarkable that, upon the shares being allotted to him, a contract between him and the company, as a matter not connected with the holding of shares, should arise.'

3.3.3 *Beattie v E & F Beattie Ltd* [1938] 1 Ch 708 CA

Key Facts

B was a member and a director of the company. Whilst acting as a director it was alleged that he had paid himself and his son unauthorised expenses and a writ was issued against him. He sought to rely on an article which required disputes between the company and a member to be referred to arbitration.

Key Law

His dispute with the company was in his capacity as a director and not as a member. He could not, therefore, rely on the arbitration clause as he was trying to enforce the articles as an outsider.

3.3.3 *Salmon v Quin and Axtens Ltd* [1909] AC 442

Key Facts

The articles of the company gave S, one of the company's managing directors, the power to veto certain board resolutions relating to the purchase and letting of premises. When he tried to exercise his veto it was ignored and the directors resolved to acquire and let some premises. An ordinary resolution of the members later confirmed their decision. S sought an injunction restraining the directors from acting on the resolution.

Key Law

An injunction was granted as the resolutions were inconsistent with the articles.

Key Link

Lord Wedderburn, [1957] CLJ 194, relies on this decision to support his view that outsider rights can be indirectly enforced by a member so long as he sues in his capacity as a member and not as an outsider.

3.4 *Re New British Iron Co, ex parte Beckwith* [1898] 1 Ch 324 CH

Key Facts

Article 62 provided that remuneration of the directors was to be £1,000 per year, to be divided between whoever the directors decided. The company went into liquidation and Beckwith and the other directors claimed in the liquidation for the arrears of their fees.

Key Law

Their claim succeeded. Article 62 was not in itself a contract between the company and the directors. However, it could be relied on by them, to the extent that it supplied the amount the directors were to be paid under an external contract, separate from the articles. This external contract was implied from the conduct of the parties.

Key Comment

The directors could not rely on the articles as a contract as they were outsiders.

Key Link

Beattie v E & F Beattie [1938] 1 Ch 708 at 3.3.4 above.

3.4 *Swabey v Port Darwin Gold Mining Co* (1889) 1 Meg 385 CA

Key Facts

The company's articles provided for directors' fees of £200 per year. A special resolution was passed reducing this to £5 per month. S claimed three months arrears at the old rate.

Key Law

His claim succeeded. The articles themselves did not constitute the contract between the company and the directors but they provided the terms upon which the directors were serving under an external contract. The company had the right to alter its articles but not retrospectively.

3.5.1 *Punt v Symons & Co Ltd* [1903] 2 Ch 506 CH

Key Facts

The company purchased the business of Mr Symons. The contract of sale stated that the company would not alter its articles, which appointed him to be the governing director with extensive powers of management and the right to appoint and remove directors. Similar rights were given to his trustees in the event of his death. After he died, the company proposed to alter the relevant articles depriving the trustees of these powers.

Key Law

A company cannot contract itself out of its statutory right to alter its articles either by an agreement inside the articles or in an external agreement.

3.5.1 *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 CA

Key Facts

The articles gave the company a lien over partly paid shares for debts owed to the company by the relevant member. Z died owing the company £6,000 in respect of unpaid calls on his partly paid shares. After his death the company altered its articles to extend the lien over fully paid shares as well. Z was the only holder of fully paid up shares and A, one of his executors, challenged the alteration.

Key Law

The alteration was valid. The power of the company to alter its articles is subject to the general principles of law and equity that require the power to be exercised *bona fide* for the benefit of the company as a whole. It made no difference that Z was the only member of the company affected by the alteration.

Key Comment

The test is subjective. It is the *bona fide* view of the majority members that counts and not the court's view of the alteration.

Key Link

See Section 3.5 above: Amendment of the articles is now dealt with in s 21 CA 2006. Entrenched provisions in the articles which, for example, may require a greater majority than needed for a special resolution to amend the articles are permitted by s 22 CA 2006.

3.5.1 *Greenhalgh v Arderne Cinemas Ltd*[1951] Ch 286

CA

Key Facts

The company's articles were altered to allow the majority shareholders in a family company to sell their shares to an outsider by obtaining an ordinary resolution. This replaced an article which required members selling their shares to offer them first to the existing members. G, a minority shareholder, sought a declaration that the resolution altering the articles was void, as it sacrificed the interests of the minority to the interests of the majority without any benefit to the company.

Key Law

The resolution was valid. Although it deprived the minority of their rights of pre-emption under the articles, G was unable to show it was not *bona fide* for the benefit of the company. There was also no discrimination between the majority and the minority as it allowed *any* member to sell his shares to an outsider.

Key Judgment

Evershed MR
'It means that the shareholder must proceed upon what, in his honest opinion is for the benefit of the company as a whole . . . the phrase "the company as a whole" does not . . . mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body. That is to say, the case may be taken of an individual hypothetical member and it may be asked whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit.'

3.5.1 *Shuttleworth v Cox Bros & Co (Maidenhead) Ltd* [1927] 2 KB 9 CA

Key Facts

S was appointed a permanent director under the company's articles of association. Between 1924 and 1925 he failed to account for money on 22 occasions. The articles were altered to allow a director to be removed if asked to do so in writing by all of the other directors. S challenged the alteration of the articles and also claimed that his removal was a breach of contract.

Key Law

There was no evidence that the members had not acted in good faith and the alteration was therefore *bona fide* for the benefit of the company as a whole. There was no breach of contract as his contract was taken to be alterable under what is now s 22(1) CA 2006.

3.5.1 *Citco Banking Corpn NV v Pusser's Ltd* [2007] UKPC 13; [2007] Bus LR 960 PC

Key Facts

The articles of Pusser's Ltd were altered by special resolution to create some new shares in favour of the company's chairman. The effect of the alteration was to give him voting control over the company. Citco voted against the alteration and challenged it on the basis that it was not in the best interests of the company, but only in the interests of the chairman.

Key Law

The alteration was valid and the challenge failed. The court applied the test laid down in *Shuttleworth v Cox Bros* [1927], which is whether reasonable shareholders could have considered that the amendment was for the benefit of the company. The court found that they could, as potential investors wanted the chairman to have indisputable control over the company. An alteration of the articles can be for the benefit of the company despite the fact that it benefits one shareholder who is entitled to vote for the alteration. It was not necessary to show that the resolution would be passed without the chairman's votes.

Key Comment

The test as expressed in this case appears to be objective but it is predominately subjective. It requires the shareholders to genuinely believe that the alteration was for the benefit of the company but that this belief must be one which a reasonable shareholder could hold.

3.5.1 *Southern Foundries (1926) Ltd v Shirlaw* [1940] AC 701 HL

Key Facts

S was appointed managing director of Southern under a written agreement for a period of ten years. New articles were adopted which included a provision allowing the company to remove a director by written notice. The company then relied on this provision and removed S as a director, which also meant that he could no longer be the managing director. He sued for breach of the ten-year agreement.

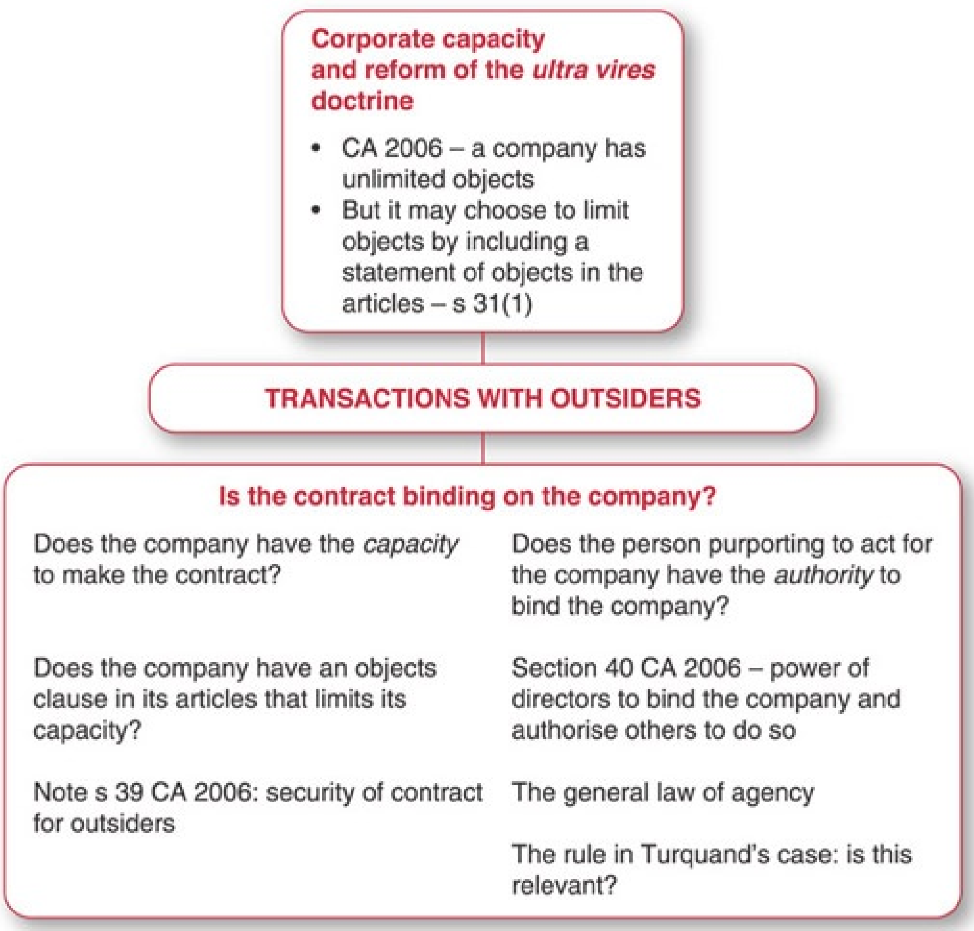
Key Law

A company cannot be precluded from altering its articles and then acting upon them, and so the removal of S as a director under the new articles could not be challenged. However, this had a knock-on effect and led to a breach of the earlier ten-year written agreement for which damages were payable. The court upheld an award of £12,000 for wrongful dismissal.

Key Link

Sections 188–189 CA 2006 now regulate directors' long-term service contracts.

4
Transactions with outsiders



4.1 Introduction

1 A company is a legal person separate from its members. One of the most important consequences of incorporation is that a company can enter into contracts and other commercial transactions and is fully liable for the debts it incurs.

2 A company, being an artificial person, can only act through its agents, acting within the scope of their authority, and the usual principles of agency, together with the provisions of s 40 CA 2006, will apply in deciding whether a company is liable on any contract. The agent is not a party to the contract, so it is the company and not its agents that will be liable for breach of contract (agency is considered more fully below at 4.3).

3 Under previous companies legislation, every company was required to include an objects clause in its memorandum of association, which set out the purpose for which the company was formed and limited the activities of the company to those set out in its objects clause. Any transaction that fell outside the objects clause was *ultra vires*, that is outside the capacity of the company, and therefore void. It is important not to confuse the *capacity* of the company, considered at 4.2, with the *authority* of the agent, discussed below at 4.3.

4 The *ultra vires* doctrine was effectively abolished by CA 1989 s 108(1) (now s 39(1) CA 2006) as far as transactions with outsiders are concerned, but is outlined briefly below as it still has some relevance with respect to the internal management of companies with restricted objects.

5 Section 39(1) CA 2006 is designed to provide security of contract to persons dealing with a company, stating: '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.' This section does not apply to charitable companies.

6 Directors have a duty to act in accordance with the company's

constitution (s 171 CA 2006), so where a company has a statement of objects, failure to act within the objects will be a breach of duty (see Chapter 10, section 10.2.1).

4.2 The *ultra vires* doctrine: historical perspective

4.2.1 The contractual capacity of companies

1 Since 1856 successive Companies Acts had required that an objects clause be included in the memorandum of association and this remained the case, with some modification as to the nature of the objects clause, until s 31(1) CA 2006, which provides that 'unless a company's articles specifically restrict the objects of the company, its objects are unrestricted', was brought into force.

2 The objects clause sets out the purpose for which the company was formed and any activity outside this statement of objects is said to be *ultra vires* the company (outside the company's capacity). At common law any such transaction was void.

3 The reasons for the rule were:

- that members are entitled to know the purpose for which their investment is to be used;
- it was supposed to protect creditors, who were deemed to know the contents of the memorandum.

4 There is a tension between the need to ensure that the company's property is used for the benefit of the members, and the need not to place undue constraints on the directors' freedom to take the company forward. The objects clause and the *ultra vires* doctrine achieved the former at common law, but not the latter.

4.2.2 Development of the law

1. In ***Ashbury Railway Carriage & Iron Co Ltd v Riche* (1875)** the House of Lords held that a company did not have the capacity to enter into a contract outside the objects clause and therefore such a contract could not be enforced by either party. One consequence of this was that a company could escape liability when it had acted outside its objects clause.
2. The *ultra vires* rule was strengthened by the doctrine of constructive notice. Because the memorandum is a public document, anyone dealing with a company was deemed to know its contents, including its objects clause, so was deemed to know if a transaction was beyond the capacity of the company. This sometimes led to very harsh results. In *Re Jon Beauforte (London) Ltd* (1953) a fuel supplier was unable to claim for the price when it was used by the company for an *ultra vires* purpose. The court held that the supplier had constructive notice of what the fuel would be used for due to the registration of the company's memorandum, a public document.
3. The previous strictness of the *ultra vires* doctrine was ameliorated by s 9 of the European Communities Act 1972, consolidated as s 35 CA 1985. As mentioned above it was effectively abolished as far as transactions with outsiders were concerned in 1989. Security of transaction for those dealing with companies has been an important objective in the reform of the law in this area.
4. In ***Rolled Steel Products (Holdings) Ltd v British Steel Corporation* (1986)** the Court of Appeal reviewed and clarified the law, holding that where the directors exercise a power stated in the objects clause that is reasonably incidental to the company's substantive objects, this will be within the capacity of the company unless it amounts to a breach of fiduciary duty and the third party has knowledge of this. This covers, for example, things like company borrowing, so that the third party can assume that the company has capacity to make the contract.

4.2.3 Companies Act 2006

1 All companies registered under the 2006 Act will have unlimited objects, unless a clause specifically restricting a company's objects is included in the articles: s 31(1). Companies registered under earlier Acts may still have a statement of objects in their old-style memoranda.

2 Section 39(1) ensures that a person dealing with a company can be confident that the transaction cannot be called into question by virtue of anything in the company's constitution, whether or not he has notice of constitution.

3 This section protects both the third party and the company so that neither of them can plead *ultra vires* as a defence to a claim for breach of contract.

4 The *ultra vires* principle is still relevant in companies with restricted objects as an internal mechanism which limits the directors' authority to enter into an *ultra vires* transaction (see 4.4.2 below).

4.3 Agency principles and company law

4.3.1 Introduction: the general law of agency

1 Separate legal personality ensures that a company can contract with others, but being an artificial person, a company can only act through agents.

2 Section 39(1) CA 2006 refers to 'an act done by the company'. The law of agency and ss 40–41 CA 2006 must be considered in deciding whether an act is done by a company through an agent who has the requisite authority.

3 The law of agency enables a person with the appropriate authority (the agent) to create a contract with a third party that binds his or her principal. Most commercial transactions are carried out through the law of agency.

4 In the law of agency, an agent will only be able to make a contract which binds the principal if the agent is acting within the appropriate authority,

either actual or ostensible (see below) given to him by the principal. A company's articles will usually give directors the authority to manage the company and directors will in turn delegate authority to others within the company to make contracts that bind the company.

5 If a person purports to make a contract on the company's behalf without authority the company will not be bound and the contractor who suffers loss may be able to make a claim against the agent for breach of warranty of authority.

4.3.2 Types of authority

Authority may be either actual or ostensible (sometimes called apparent authority).

4.3.2.1 Actual authority

1 This is described by Lord Diplock in ***Freeman & Lockyer v Buckhurst Properties (Mangal) Ltd* (1964)** as 'a legal relationship between the principal and the agent created by a consensual agreement to which they alone are the parties'.

2 It is the authority that is given to the agent by the principal by way of a contact which sets out the scope of that authority. This may be done expressly, in writing or orally, in which case it is known as express actual authority.

3 It is also possible for the principal to confer on the agent implied actual authority. This may arise:

- when an agent has express authority to perform a certain task; authority may be implied by virtue of the fact that it is necessary to enable the agent to complete the task;
- when implied authority is inferred by the conduct of the principal, for example a person appointed to a certain position may have implied actual authority to carry out the tasks usually associated

with that position (***Hely-Hutchinson v Brayhead Ltd* (1967)**): ***SMC Electronics Ltd v Akhter Computers Ltd* (2001)**; ***Smith v Butler* (2012)**.

Both express and implied actual authority are conferred on the agent by th principal and the perceptions of the third party contactor are irrelevant.

4 A company's constitution may limit the authority of directors to bind the company if the company has limited objects or if the articles or a resolution limit the authority of directors in some other way, for example by putting a limit on company borrowing. In such cases s 40(1) applies (see below).

4.3.2.2 Ostensible (or apparent) authority

1 **Ostensible authority** is the authority which the agent appears to the third party contractor to have by virtue of a representation made by the principal.

2 In ***Freeman & Lockyer v Buckhurst Properties (Mangal) Ltd* (1964)** Lord Diplock set out four requirements for ostensible authority:

(a) There must be a representation made to the third party by words or conduct that the agent has authority. In other words, the company must act in such a way that it appears to the third party that the agent has authority.

(b) The representation must be made by the principal or by persons who had actual authority.

(c) The third party must rely on the representation in entering into the contract.

(d) The company must have capacity to enter into the contract. The provisions now contained in s 39 and s 40 CA 2006 mean that this requirement is no longer relevant.

3 In *Armagas Ltd v Mundogas SA* (1986), Lord Keith of Kinkel said, 'Ostensible authority comes about where the principal, by words or conduct, has represented that the agent has the requisite actual authority, and the party dealing with the agent has entered into a contract with him in reliance on that representation.' It is important to note that ostensible authority depends on the perceptions of the third party contractor, not on the intentions of the principal. Further, an agent cannot represent himself as having authority: representation must come from the principal.

4 Ostensible authority may be conferred by a particular job title, for example company secretary: ***Panorama Developments v Fidelis Furnishing Fabrics* (1971)**; and in certain circumstances to directors with particular responsibilities, such as a Finance Director. See also ***First Energy (UK) Ltd v Hungarian International Bank Ltd* (1993)**.

5 The company may withdraw authority from a person who has acted with ostensible authority but third parties may continue to rely on the representation until they are notified of the change: *AMB Generali Holding AG v Manches* (2005).

6 An important difference between actual and ostensible authority is that a company can enforce a contract made where the agent has actual authority, express or implied, but cannot rely on ostensible authority of an agent to enforce a contract: *Re Qintex Ltd No 2* (1990).

7 Ostensible authority does not protect a person who is aware of the purported agent's lack of actual authority.

◗ 4.4 Section 40 Companies Act 2006

4.4.1 The board of directors

1 Articles of association usually provide that the company's business shall be managed by the board of directors (Art 3 in the model articles for both public companies and private companies limited by shares) so all powers of management are delegated to the board. In this way the company appoints its agents and gives them authority.

2 The directors of a company have actual authority to bind the company if they are acting for the company or, in the case of a company with restricted objects, for the purpose of attaining the company's objects: ***Rolled Steel Products (Holdings) Ltd v British Steel Corporation*** **(1986)** (see above at 4.2.2).

3 The directors, acting as a board, are agents of the company and a third party can usually rely on the actions of the directors in accordance with the ordinary principles of the law of agency. The board of directors may delegate authority to others. Such delegation, to a single director, employees or others, is common practice.

4 However, difficulties may arise if the authority of the board is limited in some way by the company's constitution; for example the general meeting may have the right to veto the sale of certain assets. In such situations, s 40 CA 2006 applies and will usually provide security of contract to the third party.

4.4.2 The scope of s 40

1 Section 40 CA 2006 deals with the authority of directors to bind the company and, like s 39, it is intended to increase the security of persons dealing with a company.

2 Section 40(1) CA 2006 provides:

> (1) In favour of a person dealing with a company in good faith, the power of the directors to bind the company, or to authorise others to do so, is deemed to be free of any limitation under the company's constitution.

- 3 The meaning of 'person' in this section was considered in ***Smith v Henniker-Major & Co* (2002)**, a case brought under the predecessor to s 40 (s 35A CA 1985). The claimant was a director and chairman of the company and the court considered whether a director of the company could rely on the section. It was held that in some circumstances a director would be covered by the section, but that a director who had a duty to ensure that the constitution was observed and had taken part without authority in causing the company to enter into the transaction (as in this case) could not rely on s 40 to enforce it.
- 4 The decision to enter into the transaction in this case was made by an inquorate board and the question also arose whether the section covered procedural irregularities as well as limitations under the constitution. The Court of Appeal was divided on the issue, which remains unresolved.
- 5 In ***EIC Services Ltd v Phipps* (2004)**, it was held that neither a shareholder of the company, nor the company itself could be considered a person whom the legislation was intended to protect.
- 6 A person will only be covered by s 40 if he is acting in good faith, but see s 40(2)(b)(ii), considered below.
- 7 'Dealing' covers any transaction or act to which the company is a party (s 40(2)(a)), overruling the decision in *International Sales and Agencies Ltd v Marcus (1982)*.
- 8 Under s 40(2)(b) a person dealing with a company:

> (i) is not bound to enquire as to any limitation on the powers of the directors to bind the company or authorise others to do so;
> (ii) is presumed to have acted in good faith unless the contrary is proved (the burden of proving bad faith is placed on the company);
> (iii) is not to be regarded as acting in bad faith by reason only of his

knowing that an act is beyond the powers of the directors under the company's constitution.

- 9 Note that s 40(2)(b)(i) above does not protect a contractor when the circumstances suggest that enquiries about other matters should have been made, for example whether the person who purported to act for the company had authority to do so: ***Wrexham Association Football Club Ltd v Crucialmove Ltd* (2007)**.
- 10 Section 40(3) makes it clear that the limitations on the directors' power under the company's constitution in s 40(2)(b)(i) include limitations arising from:

  (i) a resolution of the company or any class of shareholder; and
  (ii) any agreement between the members of the company or any class of shareholder.

- 11 A member can bring proceedings to restrain an act which is beyond the powers of the directors, unless the act has given rise to legal obligations: s 40(4).
- 12 The section does not affect any liability incurred by the directors, or other person, as a result of exceeding their powers: s 40(5).
- 13 These provisions apply only to 'a person dealing with the company' – the company itself cannot enforce a contract entered without actual authority unless it ratifies the transaction.

4.4.3 Other agents

1 Under s 40 CA 2006 a person dealing with the company in good faith will be able to rely on the authority of the board to bind the company and its ability to authorise others to do so.
2 This means that the board may delegate authority to others, for example to a single director or an employee of the company, and this is common practice. But in order to decide whether the board has in fact given

authority to another person application of the general law of agency will be necessary, as discussed above in section 4.3.

4.4.4 Section 41: Transactions involving directors

1 Section 40 does not protect a third party dealing with the company if the third party is one of its directors. This position is dealt with in section 41.

2 Section 41 CA 2006 restricts the protection given to persons dealing with a company in certain circumstances, providing that the transaction may be voidable by the company when the parties to the transaction include:

- a director of the company or its holding company;
- a person connected with such a director;
- a person connected with a company with whom such a director is associated.

3 The transaction will not be voidable in the following circumstances:

- if restitution is no longer possible;
- if the company is indemnified for any loss;
- if avoidance of the transaction would affect rights that have been acquired *bona fide*, for value and without notice that the directors had exceeded their powers;
- if the transaction is ratified by the company in general meeting.

4 Whether or not the contract is avoided the person dealing with the company and any director who authorised the contract will be liable to account to the company for any profit and to indemnify the company for any loss arising from the contract.

4.5 The indoor management rule

4.5.1 The rule in *Turquand*'s case

1 The application of agency rules has always caused some difficulties in company law, particularly in the context of limitations on the authority of directors imposed by the company's constitution.

2 This is because persons dealing with a company will not usually be aware of such limitations and under the doctrine of constructive notice anyone dealing with a company was deemed to know the contents of the memorandum and articles of association, whether or not they had actually seen these documents.

3 The rule in *Turquand*'s case (the indoor management rule) developed alongside the doctrine of constructive notice and mitigates its effect.

4 Under this rule, where:

- the directors have power to bind the company, but certain preliminaries must be gone through, and
- there are no suspicious circumstances,

a person dealing with a company is entitled to assume that all matters of internal procedure have been complied with: ***Royal British Bank v Turquand*** **(1876)**; ***Mahoney v East Holyford Mining Company*** **(1875)**.

5 However, if a contract is made without authority, a director of the company who knew or ought to have known of the lack of authority cannot rely on the indoor management rule: ***B Liggit (Liverpool) v Barclays Bank Ltd*** **(1928)**; ***Morris v Kanssen*** **(1946)**.

4.5.2 Is the rule in *Turquand*'s case still relevant?

1 Section 40 CA 2006 is wider than the rule in *Turquand*'s case since knowledge of a defect prevents the third party contractor from relying on *Turquand*: ***Morris v Kanssen*** **(1946)**; while knowledge of limitations on

directors' powers does not stop a third party from relying on s 40. The introduction of s 40 (and its predecessors) has largely subsumed the rule in *Turquand*'s case.

2 However, the rule may still have application where the limitation on the board's power to act is not strictly constitutional, such as when a decision to enter into a transaction is made by an inquorate board: *Smith v Henniker-Major & Co* (2002). But note that in this case the person seeking to enforce the contract was a director of the company and the rule in *Turquand*'s case does not apply where the person seeking to rely on it knew or should have known of the irregularity.

Key Cases Checklist

Corporate Capacity and Reform of The *Ultra Vires* Doctrine

Historical Perspective

Ashbury Railway Carriage & Iron Co Ltd v Riche (1875) A company has no capacity to enter into a contract outside its objects *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* (1986) Distinction made between powers and objects: if a power is capable of falling within a company's objects the transaction is not *ultra vires* Section 108(1) CA 1989 (now s 39(1) CA 2006) effectively abolished the *ultra vires* doctrine

Agency Principles and Company Law

Authority of Agents

Freeman & Lockyer v Buckhurst Properties (Mangal) Ltd (1964) Differences between actual authority and ostensible authority described Note requirements for ostensible authority *Hely-Hutchinson v Brayhead Ltd* (1967) Actual authority may be express or implied: it is implied when it is inferred from the conduct of the parties *SMC Electronics Ltd v Akhter Computers Ltd* (2001) A contract of employment provided for express actual authority *Smith v Butler* (2012) Contract provided no express delegation of specific authority: managing director had implied actual authority consistent with the role but this did not cover the act in question *Panorama Developments v Fidelis Furnishing Fabrics* (1971) Ostensible authority may be conferred by a particular role, for example company secretary *First Energy (UK) Ltd v Hungarian International Bank Ltd* (1993) Directors with a specific title may have ostensible authority by virtue of that role

The Board of Directors and the Scope of S 40 CA 2006

Smith v Henniker-Major & Co (2002) A director who had a duty to ensure the constitution was observed could not rely on s 40 CA 2006 to enforce the contract made without authority *EIC Services Ltd v Phipps* (2004) A shareholder receiving bonus shares is not a person 'dealing with the company' in that transaction and cannot rely on s 40

The Rule in *Turquand's* Case

Royal British Bank v Turquand (1876) Where a transaction requires a special internal procedure, a third party is entitled to assume that the requirement has been complied with. This is known as the indoor management rule *Mahoney v East Holyford Mining Company* (1875) A person dealing with the company may assume that directors have been properly appointed *B Liggit (Liverpool) v Barclays Bank Ltd* (1928) If a person dealing with the company should have made enquiries, they will not be able to rely on the indoor management rule *Morris v*

Kanssen (1946) Knowledge of a defect prevents a person from relying on the rule

4.2.2 *Ashbury Railway Carriage and Iron Co v Riche* (1875) LR 7 HL 653 HL

Key Facts

The objects of the railway company were essentially to make railway equipment and to act as mechanical engineers and general contractors. It entered into a contract to build a railway in Belgium but later repudiated the agreement. When sued by Riche the company argued the contract was beyond its objects clause.

Key Law

The contract was *ultra vires* and void as it was outside the objects. Ratification by the members was irrelevant. The contract could not be enforced by Riche.

Key Comment

Shortly after this decision the House of Lords held that the doctrine of *ultra vires* was to be applied reasonably so that a company was to have all the powers which were incidental to carrying out the objects, such as the power to borrow money: *A-G v Great Eastern Railway Ltd* (1880). Drafting techniques developed by lawyers meant that the doctrine had limited application.

In *Cotman v Brougham* (1918), the court upheld an 'independent objects' clause which provided that each of the many paragraphs containing objects were not to 'be in any wise limited or restricted by reference or inference from the terms of any other sub-clause or objects therein specified'.

In *Bell Houses v City Wall Properties* (1966), the court upheld a 'subjectively worded objects' clause, which allowed the company to carry on any other trade or business, 'which in the opinion of the board of directors can be advantageously carried on by the company in connection with' its existing business.

4.2.2 *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] Ch 246 CA

Key Facts

The objects of RSP allowed it to give guarantees. It guaranteed a debt owed by S Ltd to BSC. This was of no benefit to RSP but did benefit its director and this was known to be the case by BSC. The liquidator of RSP claimed the guarantee was *ultra vires* and not binding on him.

Key Law

Despite the existence of an independent objects clause, the guarantee clause was a power and not an object. Where the exercise of a power is capable of falling within the objects, but directors exercise the power for a purpose outside the objects, then it is not *ultra vires* but merely in excess of the directors' authority. BSC knew the guarantee was in excess of the directors' powers in RSP and so the liquidator was entitled to ignore BSC's claim in the liquidation.

Key Comment

This case significantly reduced the chances of a transaction being *ultra vires*.

4.3.2.1/4.3.2.2 *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480 CA

Key Facts

K was a director of the defendant company. Although never appointed to the position, he acted as the managing director and this was known by the board, who agreed to this practice. K instructed the claimant firm of architects but the company denied he had authority to engage them and refused to pay their fees.

Key Law

K had no actual authority as he was never appointed but he had ostensible authority to bind the company. The company had held him out to be the managing director and he had acted within the scope of authority normally conferred on a managing director in engaging the services of the firm of architects.

Key Judgment

Lord Diplock 'Actual authority and apparent authority are quite independent of one another. Generally they co-exist and coincide, but either may exist without the other and their respective scopes may be different.'

Key Comment

This case shows that ostensible authority can be wider than actual authority.

4.3.2.1 *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549 CA

Key Facts

R was the chairman and also acted as the *de facto* managing director of B Ltd. He would often commit the company to contracts and then report back to the board, which agreed to this practice. Acting on behalf of the company, R agreed to indemnify H-H against personal liability in respect of loans made by him. On this occasion the board refused to agree to what R had done on the grounds that he lacked authority to do so.

Key Law

B Ltd was bound by R’s actions. He had implied actual authority to bind the company as a result of the board, over many months, acquiescing in his acting as chief executive and committing the company to contracts without the necessary sanction of the board.

Key Judgment

Lord Denning MR explained the difference between actual and ostensible authority: ‘Actual authority may be express or implied. It is express when it is given by express words, such as when a board of directors pass a resolution which authorises two of their number to sign cheques. It is implied when it is inferred from the conduct of the parties and the circumstances of the case, such as where the board of directors appoint one of their number to be the managing director. They thereby impliedly authorise him to do all such things as fall within the usual scope of that office . . . Ostensible or apparent authority is authority as it appears to others.’

Key Comment

R was also held to have no authority to bind the company in his capacity as chairman, as that office, in itself, did not give him authority to enter this type of contract without the sanction of the board.

4.3.2.1 *SMC Electronics Ltd v Akhter Computers Ltd* [2001] 1 BCLC 433 CA

Key Facts

An employee of AC Ltd was employed to sell power supply units (PSUs). He sometimes described himself as 'director' on company notepaper and his job title was 'Director PSU Sales'. He entered into a profit-sharing contract with SMC for the sale of PSUs and the court had to decide if he had authority to do so.

Key Law

Based on the terms of his contract he had express actual authority to enter into the contract. The court also decided, *obiter*, that he had implied actual authority as the profit-sharing contract was normally incidental to his duties as 'Director of PSU Sales', and that he could have had ostensible authority, although this point was not fully argued.

4.3.2.1 *Smith v Butler* [2012] EWCA Civ 314; [2012] Bus LR 1836 CA

Key Facts

B was the managing director and held 31.2 per cent of the shares in the company while S was the chairman and held the remaining 68.8 per cent of the shares. B suspected S of improperly using the company credit card, spending £78,000 on it. Without obtaining a board resolution, B suspended S as chairman and excluded him from the company's premises. S sought a declaration that B lacked the authority as managing director to do this.

Key Law

The declaration was granted. B was appointed by the board as managing director under a contract of employment which contained no express delegation of any specific powers to B. B had implied actual authority to do all things that fall within the usual scope of that office but that did not extend to suspending S as chairman.

Key Problem

S controlled the board of directors and could have prevented an investigation into the use of the credit card but the court did not think it would have left B without a remedy – he could bring a petition under s 994 CA 2006 or a derivative action (see Chapter 11).

4.3.2.2 *Panorama Development (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd* [1971] 2 QB 711 CA

Key Facts

The company secretary of the defendant company hired some cars from the claimant. He falsely claimed they were needed to pick up the company's customers from the airport and signed the forms 'company secretary'. In fact, he used the cars for his own purposes. The defendant refused to pay the hire charges on the grounds that he lacked authority.

Key Law

The defendant was liable. The secretary was held out by the company as having ostensible authority to make administrative contracts, such as hiring cars.

Key Judgment

Lord Denning MR

'He is certainly entitled to sign contracts connected with the administrative side of a company's affairs, such as employing staff, and ordering cars and so forth. All such matters now come within the ostensible authority of a company's secretary.'

Key Comment

The secretary does not have authority to bind his company to a commercial contract such as a contract to buy and sell goods in which the company deals.

Key Link

A private company is no longer required to have a secretary under s 270 CA 2006.

4.3.2.2 *First Energy (UK) Ltd v Hungarian International Bank Ltd* [1993] BCLC 14090 CA

Key Facts

A senior branch manager of the Bank's Manchester office had no actual authority to sanction loans and this lack of authority was known by the claimant. He signed a letter offering credit facilities to the claimant and they accepted.

Key Law

The Bank was bound by the offer. Although he lacked actual authority to grant loans he was, by virtue of his position, held to have ostensible authority to communicate head office approval of loans by signing letters.

4.4.2 *Smith v Henniker-Major & Co* [2002] EWCA Civ 762; [2002] Ch 182 CA

Key Facts

S was a 30 per cent shareholder, director and chairman in a company. At a board meeting attended only by himself he assigned to himself a cause of action belonging to the company against the defendant firm of solicitors. The articles of the company required a quorum of two directors but S mistakenly thought he could act alone. S relied on s 35A(1) CA 1985 [s 40(1) CA 2006] to save the assignment. This allows a third party dealing with a company in good faith to assume the board of directors are free of any limitation in the company's constitution. It implements Art 9 of the First Company Law Directive 68/151 EEC.

Key Law

S could not rely on the section. Although it was wide enough to include a director, in this case S was not just a director but also the chairman and as such under a duty to ensure that the constitution was observed. He was treated as an 'insider' for the purposes of the section.

Key Comment

Robert Walker LJ dissented and would have allowed S to claim the protection of the section.

Key Problem

This approach seems to suggest that a director can rely on the section but not if he occupies an important constitutional role such as the chairman. Whether a newly appointed, inexperienced director can rely on the section is uncertain.

Key Link

Section 40(1) CA 2006 refers to 'the directors' and this is wider than the words 'the board of directors' in s 35A(1) 1985.

4.4.2 *EIC Services Ltd v Phipps* [2003] 1 WLR 2360 CA

Key Facts

The directors of the company improperly issued some bonus shares to ordinary shareholders whose shares were not fully paid up. This was contrary to the company's articles. P, a shareholder, sought to rely on s 35A(1) CA 1985 [s 40(1) CA 2006] and argued that he had dealt with the company in good faith so that the allotment was valid notwithstanding that the directors had breached the articles.

Key Law

P's claim failed. A shareholder receiving bonus shares is not 'a person dealing with a company' within s 35A(1). The nature of a bonus issue of shares requires no action by a shareholder and in a company context, the term 'third parties' naturally refers to persons other than the company and members. This decision was arrived at by looking at the meaning of the First

Company Law Directive which s 35A implemented.

4.5.1 *Royal British Bank v Turquand* (1856) 6 E & B 327 Exch

Key Facts

A company's deed of settlement (equivalent to the articles) required the directors to obtain an ordinary resolution of the members before the company could borrow money. Without doing so they borrowed £2,000 from the Bank, who claimed in the company's liquidation.

Key Law

The Bank was entitled to assume that 'matters of indoor management' relating to the loan had been complied with. The company was liable whether or not the resolution was passed.

Key Comment

The rule was developed to mitigate the harshness of constructive notice.

4.5.1 *Mahony v East Holyford Mining Co* (1875) LR 7 HL 869 HL

Key Facts

A bank was instructed to honour the company's cheques if signed by two of three named directors and countersigned by the company secretary. The liquidator of the company sought to have the bank repay the monies paid out on the cheques as the directors were never properly appointed.

Key Law

Relying on *Turquand*'s case, the bank was entitled to assume the directors had been appointed. The bank was not liable.

4.5.1 *B Ligget (Liverpool) Ltd v Barclays Bank Ltd* [1928] 1 KB 48 KBD

Key Facts

The company had two directors, L and M. The Bank was instructed to honour cheques only if signed by two directors but a practice developed of honouring cheques when signed only by L. M then wrote to the Bank instructing them not to honour them without his signature. L then wrote to the bank informing them that his wife had been appointed another director and cheques were subsequently honoured with their signatures.

Key Law

The Bank could not rely on the indoor management rule to assume that L's wife had been properly appointed. The circumstances were such that they were put on enquiry and ought to have investigated L's wife's 'appointment'.

4.5.2 *Morris v Kanssen* [1946] AC 459 HL

Key Facts

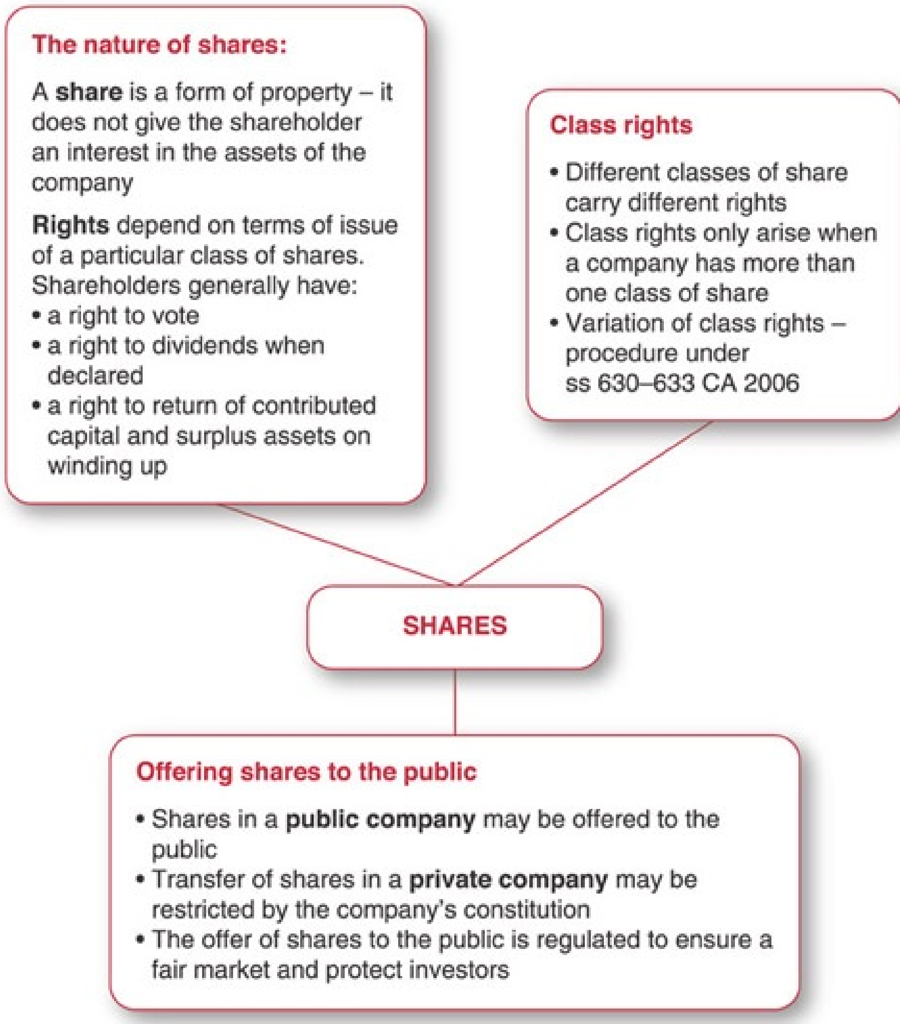
A company allotted some shares to M, one of its directors, at a board meeting but none of the directors had been appointed. M relied on s 143 CA 1929 [s 161 CA 2006] and also the indoor management rule to validate the issue.

Key Law

M could not rely on s 143 as it only validates acts of a director where there is a defect in the appointment and not where there is no appointment at all. The indoor management rule also had no application as it cannot be relied on by an insider such as a director; it is his duty to know of the correct procedure for appointments.

5

Share capital



5.1 Shares

5.1.1 The nature of shares

1 A company can raise capital either by issuing equity securities (shares) or by borrowing.
2 Shareholders undertake to contribute an agreed amount of capital to the company and, if the company is limited by shares, this is then the limit of the shareholders' liability.
3 A share is a way of measuring each member's interest in the company. So

if a company has an issued share capital of £10,000 divided into £1 ordinary shares and shareholder A owns 1,000 shares, he will have a 10 per cent interest in the company.

4 In *Borlands Trustee v Steel Bros & Co Ltd* (1901) Farwell J said: ‘The share is the interest of the shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and interest in the second, but also of a series of mutual covenants entered into by all the shareholders *inter se* in accordance with section 16 of the Companies Act 1862 [s 33 CA 2006], the contract contained in the articles of association is one of the original incidents of a share.’

5.1.2 Effects of shareholding

1 Shareholders have a right to a distribution of profits by way of a dividend declared on the shares.

2 Except in the case of non-voting shares, each shareholder has the right to vote.

3 If the company is wound up when not insolvent, capital is returned to members in proportion to their shareholding.

4 Shares are transferable and may, in the case of a plc, be offered to the public. In a private company there may be restrictions on the transfer of shares if so provided in the articles.

5 Shareholders have rights and obligations as defined in the company’s constitution by virtue of s 33 CA 2006 (see Chapter 3, section 3.3 above).

5.1.3 Share capital

1 Under s 9(4) CA 2006 an application for registration of a company that is to have a share capital must contain a statement of share capital and initial holdings.

2 Section 542 provides that all shares must, as under the 1985 Act, have a fixed nominal value. The nominal value or ‘par’ value is fixed by the promoters of the company and is typically £1.

3 The nominal value of a share is not the same as the market value, which may be more or less than the nominal value.

4 Section 10 CA 2006 provides that the statement of share capital must give details of:

- the total number of shares to be taken by the subscribers on formation;
- the aggregate nominal value of those shares;
- details with respect to each class of share;
- the amount to be paid and the amount (if any) unpaid on each share. Details of the subscribers will also have to be given as well as the number, nominal value and class of share taken by each subscriber and the amount paid up.

5 A company may issue different classes of shares, each class having different rights (see section 5.3 below).

6 *Paid up share capital* is the amount actually contributed to the share capital of the company, excluding any premium and excluding calls made but not yet paid. If partly paid shares are issued, the shareholder will pay part of the price when the shares are issued and will be liable to pay the remainder at some time in the future. In a public company shares must be paid up at least to one quarter of their nominal value plus any premium: s 586 CA 2006.

7 A premium is any additional amount paid over and above the nominal value of the shares. The premium must be paid into a special share premium account, which can only be used for a limited number of specified purposes. See s 610 CA 2006.

8 *Called up share capital* is the total amount already paid plus any share capital that must be paid on a future date as specified in the articles or terms of allotment.

5.1.4 Alteration of share capital

Under s 617 CA 2006 share capital may be altered in a number of ways, including:

- new shares may be allotted to increase the share capital;
- reduction of capital (see Chapter 6);
- subdivision, for example £1 shares subdivided into two 50p shares;
- consolidation, for example two 50p shares consolidated into one £1 share;
- redenomination, by which the shares are denominated in a different currency. Associated with this, capital may be reduced by up to 10 per cent in order to arrive at a sensible, rounded amount.

The Act sets out detailed provisions associated with all of these procedures.

5.1.5 Types of share

1. *Ordinary shares* will usually carry one vote per share on a poll. The dividend is that recommended by the directors, and the amount payable on a distribution of assets on a winding up is proportional to the nominal value of the shares.
2. *Preference* shares usually entitle the holders to a dividend of a fixed amount per share to be paid in priority to other shareholders. Note, however, that there is no entitlement until the dividend is declared. Preference shares may be:

    - cumulative: if the dividend is not paid in one year, then the shareholder will be entitled to receive the arrears from profits in subsequent years. Unless the articles or terms of issue provide otherwise, preference shares are cumulative: ***Webb v Earle* (1875)**. See also *Birch v Cropper* (1889) and *Will v United Lankat Co Ltd* (1914).
    - non-cumulative: the dividend will lapse if the company is unable to pay it in any one year.

    Preference shares may also entitle the holder to prior return of capital on a winding up where the company is solvent.

3 *Deferred shares* (sometimes called *founders' shares*) are now rare. Promoters used to take shares which would not qualify for a dividend until the ordinary shareholders had received one.
4 *Redeemable shares* are issued with a provision that they may be bought back by the company at a later date, at the option of either the company or the shareholder.
5 *Non-voting shares* carry similar rights to ordinary shares, but no right to vote.
6 *Bonus shares* are shares which are allotted to members with the value paid out of the company's profit. A decision to issue bonus shares may be taken by the directors, authorised by an ordinary resolution (Model Articles for Private Companies Limited by Shares Art 37; Model Articles for Public Companies Art 78).

5.2 Allotment of shares

5.2.1 Allotment and transfer

1 Shares are allotted when a person acquires the unconditional right to be entered in the register of members in respect of that share (s 558 CA 2006).
2 Shares are issued when the holder's name is entered in the register of members: *Re Heaton's Steel and Iron Co, Blythe's Case* (1876); *National Westminster Bank plc v Inland Revenue Commissioners* (1995).
3 Members have some control over how directors allot new shares. The CA 2006 provides:

   (a) Section 550 – in the case of a private company with only one class of shares the directors will have unrestricted power to allot new shares unless there are restrictions in the articles.
   (b) Section 551(1) – in the case of any other company the directors cannot allot new shares unless they are authorised to do so either

by the articles or by ordinary resolution. A public company cannot give such authority for a period of more than five years at any one time.

(c) Section 551(8) – authority to allot shares can be given, varied, revoked or renewed by ordinary resolution, even if such authority is provided by the articles.

(d) Resolutions authorising directors to allot shares and resolutions revoking authority must be notified to the Registrar.

(e) Directors must exercise their power to allot shares for a proper purpose under s 171(b) CA 2006 (see Chapter 10, section 10.2.1).

4 It is an important principle that shares are transferable. Section 544(1) CA 2006 provides that 'The shares or other interests of any member in a company are transferable in accordance with the company's articles.'

5 In a private company the articles may place restrictions on membership or give directors discretion on the transfer of shares: ***Smith v Fawcett* (1942)**.

5.2.2 Payment for shares

1 Shares may be issued in exchange for cash or for other forms of property; for example in a takeover the offeror company may offer its shares in return for shares in the offeree company.

2 Shares may not be allotted at a discount. This means that the company must receive at least the nominal value for the shares: ***Ooregum Gold Mining Co of India Ltd v Roper* (1982)**. This is now covered by s 580(1) CA 2006. A breach of this 'no discount' rule results in the allottee having to pay the amount of the discount plus interest at five per cent.

3 There are some differences between the rules that apply to all companies and those applying to public companies only:

- shares taken by a subscriber to the memorandum of a public company must be paid for in cash: s 584 CA 2006;

- a public company cannot accept an undertaking to do work or perform services as payment for its shares: s 585 CA 2006;
- a public company may not accept a long-term undertaking which is to be performed more than five years after the date of allotment as payment for its shares. For example, an undertaking to transfer a piece of land six years after the date of allotment: s 587 CA 2006.

4 For public companies where payment is made by means of a non-cash asset, the asset must be independently valued in accordance with CA 2006 Chapter 6 of Part 17. There are some exceptions, including takeovers. If these provisions are not followed and the allottee knew or ought to have known this, then he will be required to pay for the shares in cash with interest. The court has power to grant exemption if it considers it just and equitable to do so: ***Re Ossory Estates plc* (1988)** and, by comparison, *Re Bradford Investments plc* (1991).

5 In the case of private companies, there is no requirement for independent valuation and the value placed on the asset at the time of allotment will be accepted unless there is evidence of dishonesty: ***Re Wragg* (1897)**.

5.2.3 Pre-emption rights

1 Further capital can be raised by way of a rights offer. The Companies Act 2006 sets out the procedures that must be followed if a company already has ordinary shareholders. Those shareholders must be offered shares in proportion to their existing holdings before the shares are offered to outsiders, giving them a right of first refusal, or ‘right of pre-emption’.

2 A member’s influence within a company depends upon the proportion of shares held. The provisions governing pre-emption rights are complex and are contained in ss 561–573 CA 2006. They aim to ensure that the interests of existing shareholders are not diluted, while allowing for certain exceptions to the general rule and also, under s 567 CA 2006,

allowing private companies to exclude the right of pre-emption in the articles.

(a) Section 561 provides that before any equity securities are allotted in exchange for a cash contribution, they should first be offered to existing shareholders on the same or more favourable terms.
(b) Section 562 provides that the offer must be communicated to shareholders and sets out how this should be done.
(c) Section 563 – failure to comply with the above sections is a criminal offence and the company and any officer in default must compensate shareholders to whom the offer should have been made.
(d) Sections 564–566 provide for certain exceptions:

- allotment of bonus shares;
- where shares are issued, wholly or partly, for a non-cash consideration;
- where shares are held under an employees' share scheme.

(e) Section 569 provides that in the case of private company with only one class of share the right of pre-emption may be disapplied.
(f) Under s 570 if directors of any public or private company are generally authorised under s 551 to allot shares, they may be given power in the articles or by special resolution to allot new shares as if s 561 does not apply.
(g) Section 571 allows for the disapplication of s 561 by special resolution in relation to a specific allotment of equity securities.

5.3 Class rights

5.3.1 General details

1 Companies may issue shares with different rights attached to them. The CA 2006 now provides a definition of a class: s 629 (1) 'For the purposes of the Companies Act shares are in one class if the rights attached to them are in all respects uniform.'

2 Different classes of share will have different rights attached to them, which may be set out in the articles of association, terms of issue or unanimous shareholder agreement.

3 Section 21 of the CA 2006 provides that, subject to the provisions of the Act and to conditions contained in the articles, a company may, by special resolution, alter its articles of association. A company cannot deprive itself of its statutory power to alter the articles (*Allen v Gold Reefs of West Africa Ltd* (1900)), but if any alteration involves the variation of class rights then ss 630–635 (designed to give protection to minorities in relation to their class rights) will apply and such rights can only be varied if the proper procedures are followed.

4 Class rights will only arise if the company has more than one class of share.

5 The nature of class rights was considered in ***Cumbrian Newspapers Group Ltd v Cumberland and Westmorland Herald Newspaper and Printing Co Ltd* (1986)**. It was held that rights and benefits may be:

- rights annexed to particular shares such as the right to a dividend or voting rights;
- rights conferred on individuals not in their capacity as members, *i.e.* outsider rights. These are not class rights;
- rights conferred on individuals in their capacity as members, but not attached to shares.

The first and third categories only may be described as class rights.

5.3.2 Variation of class rights

5.3.2 Variation of class rights

1 The general rule is that rights of one class of shareholders should not be altered by another class by just amending the articles.

2 The CA 2006 restated the previous law with some amendments intended to simplify the procedure and to take into account the fact that the articles are the main constitutional document under the 2006 Act. It also extended protection of class rights to companies without a share capital.

5.3.3 Meaning of ‘variation of rights’

1 The legislation does not make it clear what is meant by ‘variation of class rights’.

2 The courts have taken a restrictive view and have sought to distinguish between the rights themselves and the ‘enjoyment of the rights’.

3 It may thus be possible to make rights less effective without any technical ‘variation’ of rights: ***Greenhalgh v Arderne Cinemas*** **(1946)**; ***Scottish Insurance Corporation Ltd v Wilson & Clyde Coal Company Ltd*** **(1949)**; ***White v Bristol Aeroplane Co*** **(1953)**.

5.3.4 Procedure for variation

1 Section 630 sets out the procedure for companies with a share capital.

2 If the articles provide for a variation of rights procedure, this must be complied with: s 630(2)(a). Provision in the articles may be more or less demanding than the statutory procedure.

3 Neither the model articles for public companies nor those for private companies limited by shares make provision for the variation of class rights.

4 In the absence of any procedure in the articles, class rights may only be varied with the consent of the members of that class.

5 Consent can be given:

- by the holders of at least three-quarters of the nominal value of the issued shares in that class signifying their agreement in writing: s 630(4)(a) CA 2006; or

- by special resolution passed at a separate general meeting of that class: s 630(4)(b).

6 Section 631 CA 2006 sets out the procedure required for companies without a share capital. In this case, in the absence of any provision in the articles, consent may be given:

- in writing by three quarters of the membership of that class: s 631(4) (a); or
- by special resolution passed at a separate general meeting of that class: s 631(4)(b).

7 Section 633 CA 2006 gives dissenting members of a class who hold not less than 15 per cent of shares of that class the right to apply to the court to have the variation cancelled. However, they must act within 21 days of the variation, which may cause difficulties in large companies.

8 The court may disallow the variation if it can be shown that the variation would unfairly prejudice the class. Otherwise the court must confirm the variation.

5.4 Offering shares to the public

5.4.1 Introduction

1 Only a public company may offer its shares to the public. Most companies are set up as private companies, so if a company wishes to offer its shares more widely it will have to 'go public'. There are a number of reasons

why a company may wish to do this, including to enable the company to raise capital from new investors and to provide a market for existing shareholders to sell their shares. Because there is a ready market for the sale of the shares, public companies are attractive to investors.

2 There are also disadvantages. A public company is subject to more rigorous disclosure requirements and much greater public scrutiny by the press. It may also be an easier target for a takeover bid.

5.4.2 Listing and markets

1 The public offer of shares is subject to regulation under the Financial Services and Markets Act (FSMA) 2000, as amended by the Financial Services Act 2012. The purpose of regulation is to ensure that there is investor confidence in the markets on which shares can be traded. All investments carry a risk and in the trading of shares a key feature of investor protection is to ensure that accurate information is readily available so that potential investors can evaluate the risk involved.

2 The European Union has had a significant influence on legislation relating to public offer of shares, as free movement of capital within the EU depends upon efficient capital markets, which in turn requires a harmonised system of regulation. The requirements relating to public offers of shares are now regulated by a series of EC Directives, the Public Offers of Securities Regulations 1995 and the Financial Services and Markets Act (FSMA) 2000, as well as the Stock Exchange Listing Rules.

3 The FSMA 2000 now provides that the Financial Conduct Authority (FCA) is the United Kingdom's regulator with responsibility for financial markets and listings. Its role is:

- to maintain confidence in the financial system;
- to promote public awareness in the financial system;
- to protect consumers;
- to reduce the extent to which financial services can be used for financial crime.

4 In order to be traded on an organised market, securities must be listed and every member state of the EU must have a Listing Authority, responsible for listing.
5 Under the FSMA 2000, the Financial Conduct Authority is designated as the United Kingdom Listing Authority.
6 The United Kingdom Listing Authority (UKLA) maintains an Official List of those securities that are deemed suitable for trading on stock exchanges and are admitted to trading on at least one Recognised Investment Exchange (RIE). Of some 2.2 million registered companies in the United Kingdom, only about 2,700 are listed by the UKLA.
7 Listing is a separate process from admitting a company to trading on a stock exchange. A company that is admitted to official listing on a stock exchange must have completed both processes.
8 The London Stock Exchange operates a number of markets for the trading of securities: two of the most important are the Main Market, which is a 'regulated market' and is for listed companies, and the Alternative Investment Market (AIM), designed for younger, growing companies not admitted to the official list.

5.4.3 The regulatory framework: the prospectus and listing particulars

1 The principle underlying the regulation of public issues of shares is to ensure that investors are provided with full and accurate information about the issue.
2 Any company wishing to be traded on an organised market must go through the listing process. Under the Listing Particulars Directive (80/390 EEC), a company requiring listing must submit a set of listing particulars, which is a public document, to the UKLA. Detailed rules in relation to this are set out in the Listing Rules with additional provisions in the Financial Services and Markets Act 2000.
3 This is a separate process from admission to a regulated market and when a company applies for admission to a regulated market it must produce a

prospectus.

4 A prospectus must also be made available to investors when a company (whether listed or not) proposes to offer shares to the public for the first time: Public Offers of Securities Regulations 1995.

5 The matters to be covered in the listing particulars and the prospectus are laid down in Chapters 5 and 6 of the Listing Rules.

6 Note that listing itself is a regulatory process, but the prospectus forms the basis of a contract for the sale of shares.

7 In general, the prospectus must disclose all the information which investors and their professional advisers would reasonably need in order to make an informed decision of whether to invest.

8 A prospectus must be approved by and filed with the FCA and made available to the public.

9 In July 2005 the New Prospectus Directive 2003/71/EC came into force. The purpose of the Directive is to improve regulation for raising capital on an EU-wide basis.

5.4.4 Remedies for misleading statements and omissions in listing particulars and prospectus

1 In relation to a prospectus or listing particulars, s 90 Financial Services and Markets Act 2000 provides that the person or persons responsible for any of the following is liable to pay compensation to a person who has acquired securities to which the particulars or prospectus apply for loss as a result of:

- including a false or misleading statement in a prospectus or set of listing particulars;
- failure to disclose information required to be included;
- failure to publish a supplementary prospectus or set of listing particulars if required to do so.

2 Other remedies are also available to people induced to subscribe for shares by misleading or untrue statements under:

- the common law, in both contract and tort;
- Misrepresentation Act 1967;
- Public Offers of Securities Regulations 1995, Regulations 13–15 if the misleading statement is in the prospectus.

Key Cases Checklist

Shares

Webb v Earle (1875)
There is a presumption that preference shares are cumulative
Birch v Cropper (1889)
Unless there is express provision about class rights, all members have the same rights
Will v United Lankat Plantations Co Ltd (1914)
If there is specific provision about certain rights that is deemed to be exhaustive

Allotment and Transfer of Shares

Smith v Fawcett (1942)
The articles of a private company may contain provisions restricting the allotment and transfer of shares
Ooregum Gold Mining Co of India Ltd v Roper (1982)
Shares may not be allotted at a discount

Re Bradford Investments plc (1991)
If a non-cash asset is used to pay for shares in a public company the asset must be independently valued otherwise the allottee must pay for the shares in cash with interest.
Re Ossory Estates plc (1988)
The court has power to grant relief
Re Wragg (1897)
There is no requirement of valuation of non-cash assets for private companies unless there is evidence of dishonesty

Class Rights

Cumbrian Newspapers Group Ltd v Cumberland and Westmorland Herald Newspaper and Printing Co Ltd (1986)
Class rights considered and defined
Greenhalgh v Arderne Cinemas (1946)
An alteration of the articles can in certain situations affect the enjoyment of class rights without varying the rights themselves
White v Bristol Aeroplane Co (1953)
A new issue of shares to ordinary shareholders is not a variation of the class rights of preference shareholders
Scottish Insurance Corporation Ltd v Wilson & Clyde Coal Company Ltd (1949)
Preference shareholders may be paid before ordinary shareholders in a winding up and will have no rights to a share in any further surplus. This is not a variation of class rights

5.1.5 *Webb v Earl* (1875) LR 20 Eq 556 CH

Key Facts

An ordinary shareholder claimed that if there were insufficient profits to pay the preference dividend then the right should not be carried forward.

Key Law

There is a presumption that the right to a preferential dividend is cumulative; if it is not paid in one year it is carried forward to the next.

Key Links

In the absence of specific rights, all shares have the same rights: *Birch v Cropper* (1889) 14 App Cas 525.
Rights specifically given to shareholders are deemed to be exhaustive: *Will v United Lankat Plantations Co Ltd* [1914] AC 11.

5.2.1 *Re Smith and Fawcett Ltd* [1942] 1 Ch 304 CA

Key Facts

The company's articles gave the directors 'an absolute and uncontrolled discretion to refuse to register a transfer of shares'. F died and his executor applied to have the shares registered in his name. The directors, including S, refused but did offer to register half of the shares if he could buy the other half. The executor applied to have the register of members rectified to register all of the shares in his name.

Key Law

The application was refused. The articles gave a very wide discretion to the directors and the exercise of it was only subject to the requirement to act *bona fide* in what they believed to be in the interests of the company. There was no evidence to suggest they had not acted *bona fide.*

Key Link

Under s 771(1) CA 2006 the company must give notice of a refusal to register a transfer of shares to the transferee within two months of receiving the transfer request.

5.2.2 *Ooregum Gold Mining Co of India Ltd v Roper* [1892] AC 125 HL

Key Facts

The company issued preference shares with a nominal value of £1 with 75p credited as having been paid, leaving a liability of only 25p a share.

Key Law

Although the directors had acted in good faith the shares were issued at a discount and this is prohibited. The shareholders were liable for the full nominal amount of the shares.

Key Link

The ‘no discount’ rule is now found in s 580 CA 2006. The rule does not, however, prohibit commissions paid to underwriters as long as this is authorised by the articles and does not exceed 10 per cent of the issue price: s 553 CA 2006.

5.2.2 *Re Ossory Estates plc* (1988) 4 BCC 460 CH

Key Facts

The company bought properties for £3.5 million, paying by a mixture of cash and shares. The company failed to obtain a report valuing the non-cash consideration (the properties) for the shares as required by s 103 CA 1985 [ss 593–595 CA 2006]. Despite having transferred the properties to the company, the vendor was *prima facie* liable to pay the nominal value of the shares, together with the premium plus interest. The vendor sought to be excused from this liability as permitted by s 113 CA 1985 [ss 589, 696 CA 2006] on the grounds that it was just and equitable to do.

Key Law

It was just and equitable to relieve the applicant of liability. The court was persuaded because the properties had been sold on by the company for substantial profits.

Key Link

Contrast *Re Bradford Investments plc (No 2)* [1991] BCC 740, where allottees of shares had to pay £1,059,000 plus interest after the company failed to have the non-cash asset (a partnership business) valued.

5.2.2 *Re Wragg Ltd* [1897] 1 Ch 796 CA

Key Facts

A coach business was sold to the company for £46,300. It was paid for by the company issuing £20,000 in shares together with cash, debentures and mortgages. The company went into liquidation and the liquidator claimed the shares were issued at a discount, as the property received by the company was worth less than the £20,000 shares received by the vendors of the business.

Key Law

The shares were not issued at a discount. A private company can buy property at any price it thinks fit and pay for it in fully paid up shares providing there is no dishonesty.

5.3.1 *Cumbrian Newspapers Group Ltd v Cumberland and Westmorland Herald Newspaper and Printing Co Ltd* [1987] Ch 1 CH

Key Facts

CN owned 10.67 per cent of the shares in CW. When CN bought the shares in 1968 the articles of CW were altered to give CN various rights including the right to appoint a director as long as CN held 10 per cent of the shares. The directors of CW proposed to alter the articles to delete CN's rights, who now claimed that they were class rights and could only be altered with their consent in writing or by an extraordinary resolution under s 125 CA 1985 [s 630 CA 2006].

Key Law

Although the rights were not attached to particular shares, they were conferred on CN in their capacity as a member of the company and were, therefore, class rights. They could only be altered by the procedure in s 125 CA 1985 [s 630 CA 2006], which required the consent of CN at a separate class meeting.

Key Judgment

Scott LJ held that rights contained in the articles can be divided into three categories.

Category 1: 'Rights or benefits annexed to particular shares. Classic examples are dividend rights and the right to participate in surplus assets on a winding up.'

Category 2: 'Rights or benefits conferred on individuals . . . for ulterior reasons connected with the administration of the company's affairs.'

Category 3: 'Rights or benefits that, although not attached to particular shares, were nonetheless conferred on the beneficiary in the capacity of member or shareholder of the company.'

Only categories 1 and 3 are class rights and the rights given to CN fell within category 3.

Key Link

Extraordinary resolutions were abolished by the CA 2006. Section 630 CA 2006 requires a special resolution.

5.3.3 *Greenhalgh v Arderne Cinemas Ltd* [1946] 1 All ER 512 CA

Key Facts

The company had two classes of shares: 50p ordinary shares and 10p ordinary shares. Both classes had one vote per share. The company proposed to subdivide the 50p shares into five 10p shares with one vote per share. The holders of the 10p shares argued that this would vary their class rights as it would dilute their voting power, and that their consent was therefore needed.

Key Law

The subdivision would not vary their class rights as they would have the same rights after the subdivision as they had before. Although the enjoyment of their class rights had been affected they had not been varied as they still had one vote per share.

Key Comment

The difference between variation and enjoyment of rights is very artificial and can lead to subtle distinctions. For example, if the proposal was to provide that the 10p shareholders would have one vote for every five shares held, this would have been a variation of class rights.

5.3.3 *Scottish Insurance Corporation Ltd v Wilson & Clyde Coal Company Ltd* [1949] AC 462 HL

Key Facts

The Coal Company was nationalised in 1947 and it decided to go into voluntary liquidation but decided to wait until it received its compensation.

In the meantime it decided to reduce its share capital by paying off the 7 per cent preference shareholders. These shareholders argued that this varied their class rights as it deprived them of the advantages of their investment and their right to receive a share of the surplus assets in the winding up of the company.

Key Law

The court confirmed the reduction in capital. There was no variation of class rights. The preference shareholders had no right to share in the surplus assets of the company and they could not, therefore, complain about being repaid their capital earlier than they had expected. Where a company decides to reduce its share capital by returning it to the shareholders, it is free to return the capital to those who would be entitled in a winding up of the company to receive a return of their capital first. This will normally be the preference shareholders and the articles provided for this in this case.

Key Link

In *Re Saltdean Estate Co Ltd* [1968] 3 All ER 829 Buckley J said, 'This vulnerability is, and has always been, a characteristic of the preferred shares'.

5.3.3 *White v Bristol Aeroplane Co Ltd* [1953] Ch 65

CA

Key Facts

The ordinary and preference shares carried the same voting rights. The company made a bonus issue of shares to the ordinary shareholders and the preference shareholders argued that this was a variation of their class rights as it would reduce their voting power.

Key Law

The issue of new shares is not a variation of the class rights of the existing shareholders. Their enjoyment is affected but their rights are not varied.

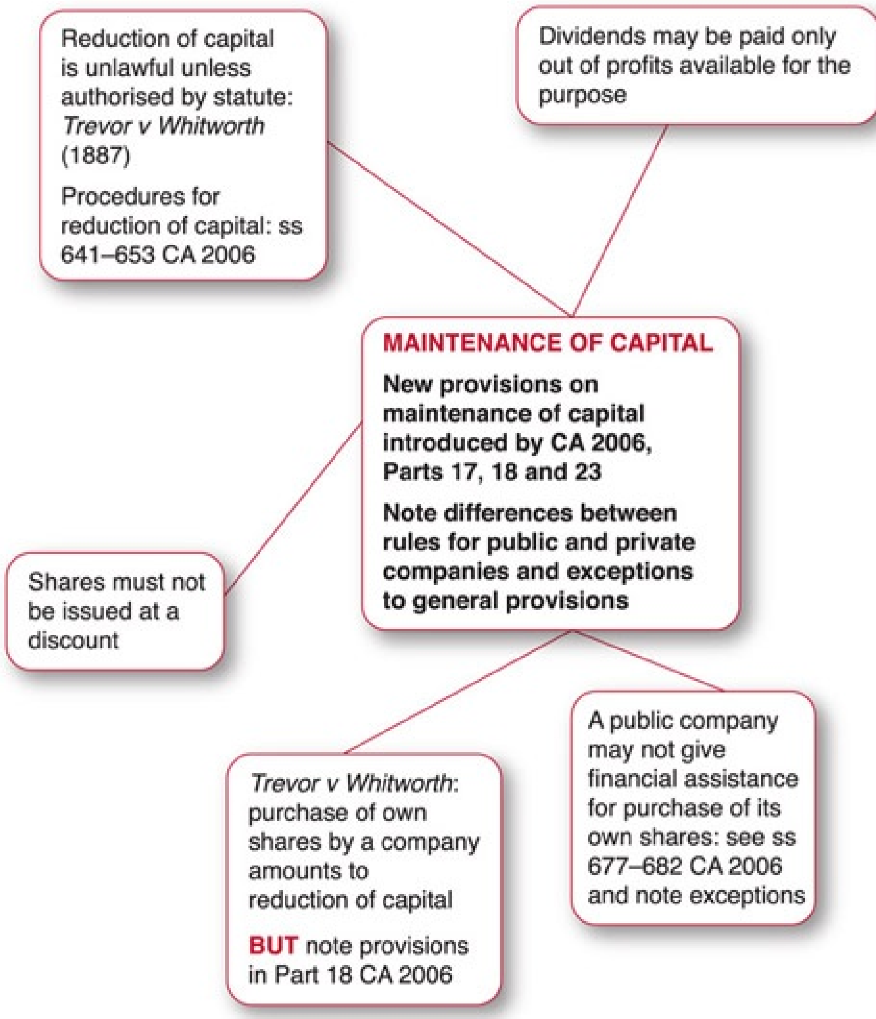
Key Judgment

Evershed MR
'There is a sensible distinction between an affecting of the rights and an affecting of the enjoyment of the rights.'

Key Comment

The cases on variation of class rights would today be better argued under s 994 CA 2006, which deals with unfairly prejudicial conduct.

6
Maintenance of capital



6.1 General principles

1 The principle on which the rules relating to maintenance of capital are based is that a company should not pay share capital back to shareholders, except in circumstances permitted by statute.

2 Historically the capital contribution of shareholders was intended to provide some security for the company's creditors, and the law therefore lays down strict and complex rules in relation to the reduction of capital.

3 Share capital now often plays a relatively minor role in the financing of companies and the capital maintenance rules provide little protection for creditors.

4 In response to recommendations made in the course of the Company Law Review, the Companies Act (CA) 2006 has made some significant changes in this area, which are described below. The statutory provisions are now contained in Parts 17, 18 and 23 CA 2006.

5 Share capital in this context means the money raised by the issue of shares and bears little relationship with the net worth of the company as a going concern.

6 There is no minimum share capital requirement for a private company; a public company must have an authorised minimum nominal value of allotted share capital of at least £50,000: s 763 CA 2006. Linked to this are the detailed rules on the payment for shares to ensure a company starts off with the correct amount of share capital.

7 Capital can be spent (and lost) in the course of carrying on the company's business, but it cannot be returned to members as this would amount to a reduction of capital with the result, in theory, that creditors would have less security.

8 In the case of a company not in liquidation, payments to shareholders can only be made out of profits, usually by way of dividend.

9 There are a number of rules that have developed to ensure that a company's capital, in the narrow sense used here, is maintained. These are described below. However, there are circumstances when a company will wish to reduce its capital and ss 641–653 CA 2006 set out the procedures by which this may be done.

6.1.1 The main rules relating to the maintenance of capital

Relevant provision: CA 2006	General rule	Main exceptions
Part 17, Chapter 10	A company may not reduce its share capital: *Trevor v Whitworth* (1887)	A private company may reduce its capital by special resolution supported by solvency statement: s 641(a). Any company may reduce its share capital by special resolution confirmed by the court: s 641(b)
Part 23, s 831(1)	Distributions, including dividends may only be made out of profits available for the purpose	Except as provided for in Part 23
Section 580(1)	Shares may not be allotted at a discount	This does not prevent the company from paying commission for underwriting fees or brokerage fees for finding subscribers for the shares: ss 552, 553 CA 2006
Section 593	In the case of a public company, if shares are issued for a non-cash asset, the asset must be valued before allotment (see paragraph 5.2.2 above)	
Section 658	A limited company may not purchase its own shares except in accordance with Part 18	Section 659 – purchase of own shares is not prohibited in a 'reduction of capital duly made'; in pursuance of an order of the court

		Section 692 – a private company may purchase its own shares out of capital. A public company may only purchase its own shares out of distributable profits
Section 678	A ***public company*** may not give financial assistance for the purchase of its own shares	Section 678 – it is not unlawful where the principal purpose in giving assistance is not for the acquisition of shares, but is for a larger purpose of the company, and the assistance is given in good faith in the interests of the company
Section 677	Defines financial assistance	Section 681 sets out certain transactions that do not amount to unlawful giving of financial assistance, for example a dividend lawfully made

6.2 Reduction of capital

6.2.1 The general rule

1 The general rule that a reduction of capital is unlawful unless authorised by statute was established in ***Trevor v Whitworth* (1887)**. This is the case even if the distribution is approved by shareholders: ***Aveling Barford Ltd v Perion Ltd* (1989)**.

2 The statutory provisions relating to reduction of capital are contained in ss 641–653 CA 2006. There are important differences in the provisions relating to private companies on the one hand and public companies on the other.

3 Under s 641:

- any company may reduce its share capital by special resolution confirmed by the court: s 641(1)(b);
- a private company limited by shares may reduce its share capital

by passing a special resolution supported by a solvency statement: s 641(1)(a) and ss 642–644.

4 Thus, a private company may seek confirmation of the court but is no longer obliged to do so, while a public company can only reduce its capital with the authority of the court.

5 Note that under s 656, if the net assets of a public company are half or less than its called-up share capital, the directors must convene a general meeting of the company to decide what to do, which may include proposing a reduction of capital. The meeting must be convened within 28 days and held no later than 56 days from the directors becoming aware of this serious loss of capital.

6.2.2 Private companies: the solvency statement

1 The solvency statement must be made not more than 15 days before the special resolution to reduce capital is passed.

2 Section 643 CA 2006 lays down requirements with respect to the solvency statement which must state *inter alia* that each of the directors is of the opinion that there is no ground on which the company could be found unable to pay its debts. If the directors make a solvency statement without having reasonable grounds for the opinion expressed, each director will be guilty of an offence.

3 The solvency statement, a statement of capital and the special resolution must be sent to the Registrar: s 644 CA 2006.

6.2.3 The role of the court

1 The court's main concern in approving reductions of capital is the protection of creditors, and the legislation provides opportunities for creditors to object: s 646 CA 2006.

2 In deciding whether to confirm a resolution for the reduction of capital the court must:

- be assured that the interests of existing creditors are protected;
- ensure that the procedure by which the reduction is carried out is correct: *Scottish Insurance Corporation Ltd v Wilson & Clyde Coal Co Ltd* (1949).

3 The court will not sanction a scheme if it is unfair. It must consider whether the scheme is fair and equitable between shareholders of different classes and between individual shareholders of the same class: ***Re Old Silkstone Collieries Ltd* (1954)**; ***Re Holders Investment Trust Ltd* (1971)**; ***Re Northern Engineering Industries plc* (1994)**.

4 The court must be satisfied that the shareholders have received sufficient information to exercise an informed choice in voting on the special resolution.

6.3 Dividends

1 Distributions are defined widely in s 829 CA 2006 to include 'every description of distribution of a company's assets to its members, whether in cash or otherwise'. A dividend is distribution and can only be made out of profits (not capital) available for the purpose (s 830(1)): ***Precision Dippings Ltd v Precision Dippings Marketing Ltd* (1986)**.

2 Procedures for distributions are laid down in Part 23 CA 2006. The Act lays down complex rules by which distributable profits are calculated.

3 Dividends may be declared as provided in the articles. Usually a declaration will be recommended by the directors and approved by the shareholders at the annual general meeting. Articles may also provide for an interim dividend to be declared by directors.

4 Members have a right to receive a dividend once it has been declared.

5 A public company cannot make a distribution which would result in the amount of the net assets becoming less than the aggregate of its called-up share capital and undistributable reserves: s 831(1) CA 2006.

6 Directors who authorised an unlawful distribution may be liable to repay the money to the company: ***Bairstow v Queen's Moat Houses plc* (2001)**.

7 Under s 847 a shareholder may be liable to repay an unlawful dividend if the shareholder knew or had reasonable grounds for believing that the distribution was made in contravention of Part 23: *It's a Wrap UK Ltd v Gula* (2006).

8 Distributions, other than dividends, have been challenged by the courts on the basis that they are a disguised and 'dressed up return of capital': *Re Halt Garage* (1964) (remuneration paid to an inactive director of an insolvent company).

9 Whether a distribution of a company asset is a disguised return of capital is determined by looking at the substance and not the form of the transaction: ***Progress Property Co Ltd v Moorgarth Group Ltd* (2010)**.

6.4 Issues at a discount

1 Shares can be issued at below their market value, but members must pay at least the full nominal (or par) value for their shares. Section 580(1) provides that shares may not be allotted at a discount: *Ooregum Gold Mining Co of India Ltd v Roper* (1892) (see Chapter 5, section 5.2.2). Section 580(2) CA 2006 provides that in the event of contravention of this rule the allottee must pay the amount of the discount plus interest.

2 If shares are paid for by a non-cash asset or assets, the rule may be difficult to enforce.

3 In the case of public companies, s 593 requires that if shares are issued for a consideration other than cash, the consideration must be valued before allotment. The section provides also that the valuer's report must be made to the company during the six months before the allotment and must be

sent to the allottee.

4 In the case of private companies, there is no requirement that non-cash assets should be formally valued: *Re Wragg* (1897).

6.5 Purchase by a company of its own shares

1 *Trevor v Whitworth* (1887) established the principle that a company may not purchase its own shares – this would amount to a reduction of capital.

2 This principle was inconvenient in a number of situations, especially for private companies, and some exceptions were introduced.

3 Section 658 CA 2006 now contains a provision to the effect that a limited company must not acquire its own shares except in accordance with the provisions in Part 18 of the Act. Part 18 lays down a complex set of rules enabling purchase by a company of its own shares. Section 658(2) provides that if a company acts in contravention of this section an offence is committed by the company and every officer in default and the purported acquisition is void.

4 Section 690 allows a limited company to purchase its own shares (including redeemable shares) subject to:

- the provisions of Part 18 Chapter 4 of the Act; and
- any restrictions in the company's articles.

5 The Act further provides that:

- a company may only purchase shares that are fully paid up: s 691. This means that it may only purchase shares from existing shareholders, not subscribe for its own shares;
- a company may not purchase its own shares if this would result in only redeemable or treasury shares remaining: s 690(2).

6 The terms of purchase must be approved by members and there are different provisions for an ‘off-market’ purchase (ss 692–694) on the one hand and a ‘market purchase’ on the other (s 700).

7 In the case of public companies such purchases must be made out of distributable profits.

8 Private companies only may purchase their own shares out of capital, subject to any restriction in the articles and to safeguards for creditors (s 709).

9 Note: a company may not own shares in its holding company (s 136 CA 2006). This rule was intended to prevent a company evading the rule that it may not purchase its own shares. There are some exceptions.

6.6 Redeemable shares

1 A company can, subject to certain conditions, issue redeemable shares:

- a public company can only issue redeemable shares if authorised by its articles;
- a private company does not require authorisation by the articles, but the articles may limit or prohibit the issue of redeemable shares.

2 A public company can only redeem shares out of distributable profits or out of the proceeds of a fresh issue of shares made for the purpose of redemption. A private company may redeem shares out of capital.

6.7 Financial assistance for purchase of own shares

1 The law in this area has been significantly changed by the Companies Act 2006. The general rule that a company may not give financial assistance

for the purchase of its own shares has been abolished for private companies and applies now only to public companies.

2 Section 677 provides that unlawful financial assistance may occur when a company:

- lends or gives money to someone to buy its shares: ***Heald v O'Connor* (1971)**;
- lends or gives money to someone to pay back bank finance raised to buy its shares;
- releases a debtor from liability to the company to assist the debtor to buy its shares;
- guarantees or provides security for a bank loan to finance a purchase of its shares;
- buys assets from a person at an overvalue to enable that person to purchase its shares: *Belmont Finance Corporation v Williams Furniture Ltd (No 2)* (1980).

3 Section 678(1) provides that it is unlawful for a public company or its subsidiary to give financial assistance for the acquisition of shares in that company. The provision of such financial assistance is a criminal offence (s 680).

4 Under s 678(2) certain transactions are not unlawful. Financial assistance is not prohibited if:

- it is given in good faith and in the interests of the company; and
- the acquisition of shares is not the principal purpose, but is 'an incidental part of some larger purpose'.

5 This section has caused great difficulty in practice and the House of Lords' decision in ***Brady v Brady* (1988)** restricted its use. This restrictive interpretation of the larger purpose exemption makes it very difficult to know what circumstances will fall within the exemption.

6 Note that the fact that a loan is made by directors *bona fide* in the interests of the company does not on its own make the transaction legal: ***Chaston v SWP Group plc* (2002)**.

7 In some recent cases the courts have sought to give effect to the 'commercial reality' of the situation and in a number of cases have found on that basis that financial assistance had not been given: for example ***Dyment v Boydon* (2004)**; *MT Realisations Ltd v Digital Equipment Co Ltd* (2003); *Anglo Petroleum v TFB (Mortgages) Ltd* (2006). In ***Progress Property Co Ltd v Moorgarth* (2010)** the Supreme Court held that whether the transaction infringed the rule against unlawful distributions was a matter of the substance rather than the form of the transaction and how the parties had described it was irrelevant.

8 Under s 681 certain situations are not covered by the provisions above, including:

- a distribution by way of a dividend or in the course of a winding up;
- an allotment of bonus shares;
- reduction of capital under Part 17 CA 2006;
- anything done in the course of a compromise or arrangement under Part 26;
- anything done under s 110 Insolvency Act 1986;
- anything done under an arrangement between the company and its creditors under Part 1 Insolvency Act 1986.

9 Further exceptions, which apply subject to certain conditions, are set out in s 682. These include:

- where the lending of money is part of the company's ordinary business and the money is lent in the ordinary course of business;
- provision by the company of financial assistance for the purposes of an employees' share scheme;
- loans to employees, other than directors, to enable them to acquire

shares in the company or its holding company.

6.7.1 Remedies and sanctions

These are as follows:

- a prohibited loan agreement will be void and unenforceable by either party: *Heald v O'Connor* (1971);
- however, if the financial assistance element can be severed from the agreement, the agreement itself may still be enforced: *Carney v Herbert* (1985);
- the company and its officers may be fined: s 680 CA 2006;
- directors may be liable to the company for misfeasance and breach of trust;
- persons receiving funds who knew or ought to have known of the directors' breach of duty will be liable as constructive trustees: *Belmont Finance Corporation v Williams Furniture Ltd (No 2)* (1980).

Key Cases Checklist

Maintenance of Capital

The General Rule

Trevor v Whitworth (1887)
It is unlawful for a company to reduce its capital unless authorised by statute; this rule is subject to exceptions

Aveling Barford Ltd v Perion Ltd (1989)
Capital may not be reduced even if the reduction is approved by shareholders

The Role of The Court in Capital Reduction Schemes

Re Old Silkstone Collieries Ltd (1954)
The courts will not approve a reduction if it is unfair or inequitable
Re Holders Investment Trust Ltd (1971)
A reduction could not be sanctioned; when voting shareholders must consider the interests of the class as a whole not their own personal interests
Re Northern Engineering Industries plc (1994)
A provision in the articles that a reduction of capital was deemed to be a variation of class rights was upheld

Dividends

Precision Dippings Ltd v Precision Dippings Marketing Ltd (1986)
A distribution may only be made out of profits available for the purpose
Bairstow v Queen's Moat Houses plc (2001)
Directors who authorise an unlawful distribution are liable to repay the money to the company
It's a Wrap UK Ltd v Gula (2006)
A shareholder may be liable to repay an unlawful distribution if he knew or had reasonable grounds to believe it was unlawful; ignorance of the law is no defence

Financial Assistance for Purchase of a Company's Own Shares

Heald v O'Connor (1971)
It is unlawful for a company to lend or give money for the purchase of its own shares
Brady v Brady (1988)
The House of Lords considered the 'larger purpose exemption' in s 678(2) CA 2006 and restricted its use
Chaston v SWP Group plc (2002)
Paying the professional fees of a takeover bidder amounts to giving financial assistance
Dyment v Boydon (2004)
Financial assistance is not unlawful if it is not given for the acquisition of shares, even if it is given in connection with the transaction
Progress Property Co Ltd v Moorgarth (2010)
The court must consider the true purpose of the transaction – the label given to it by the parties is irrelevant

6.2.1 *Trevor v Whitworth* (1887) 12 App Cas 409 HL

Key Facts

A company purchased the shares of a member but did not pay for them. The executors of W claimed the price from the liquidator.

Key Law

The company had no power to purchase its own shares.

Key Judgment

Lord Herschell

'The capital may, no doubt, be diminished by expenditure upon and reasonably incidental to all the objects specified. A part of it may be lost in carrying on the business operations authorized. Of this all persons trusting the company are aware, and take the risk. But I think they have a right to rely, and were intended by the Legislature to have a right to rely, in the capital remaining undiminished by any expenditure outside these limits, or by the return of any part of to the shareholders.'

6.2.1 *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626 CH

Key Facts

Both companies were controlled by L. He caused AB Ltd to sell land to P Ltd at a substantial undervalue amounting to £300,000. It was resold within a year for over £1.5m.

Key Law

This was an unauthorised and disguised return of capital. It was therefore *ultra vires* and void. It could not be ratified by the members of AB Ltd and L held the proceeds of sale as a constructive trustee for the benefit of AB Ltd.

Key Judgment

Hoffman J

'The general rule is that any act which falls within the express or implied powers of a company conferred by its memorandum of association, whether or not a breach of duty on the part of the directors, will be binding on the company if it is approved or subsequently ratified by the shareholders. . . . But this rule is subject to exceptions and one such exception is that a company cannot, without the leave of the court or the adoption of a special procedure return capital to its shareholders. It follows that a transaction that amounts to an unauthorised return of capital is *ultra vires* and cannot be validated by shareholder ratification or approval.'

6.2.3 *Re Old Silkstone Collieries Ltd* [1954] Ch 169 CA

Key Facts

Following the nationalisation of the coal industry the company proposed to reduce its share capital as it was now in excess of its needs. This was to be done in stages and it had twice returned capital to the preference shareholders with the promise, in resolutions, that it would not pay them off completely. This was so that they could participate in a statutory compensation scheme. They then decided to return the remaining capital to the preference shareholders.

Key Law

The court would not confirm the reduction as it was not fair and equitable as between the classes of ordinary and preference shareholders.

6.2.3 *Re Holders Investment Trust Ltd* [1971] 1 WLR 583 ChD

Key Facts

The company proposed a reduction of capital by cancelling the 5 per cent redeemable preference shares and replacing them with 6 per cent redeemable loan stock. The consent of the preference shareholders had been agreed at a separate class meeting and the court was now being asked to confirm the reduction.

Key Law

The court refused. Ninety per cent of the preference shareholders voted in favour of the reduction. They did so, however, because they were advised that, as holders of 52 per cent of the ordinary shares, they would substantially benefit from the reduction. When voting, therefore, they did not have the interests of the class as a whole in mind, but their own personal interests.

6.2.3 *Re Northern Engineering Industries plc* [1994] BCC 618 CA

Key Facts

The company wanted to reduce its share capital by paying off the preference shares and cancelling them. A preference shareholder objected. The articles of the company stated that 'The rights attached to any shares shall be deemed to be varied by a reduction of the capital paid upon such shares', unless the shareholder consented.

Key Law

The court refused to confirm the reduction under s 135 CA 1985 as this would amount to a variation of the preference shareholder's class rights. His consent was required under the articles but this had not been obtained. Normally a preference shareholder cannot argue that his class rights are varied in such circumstances but here the articles of the company expressly provided that this would be the case.

6.3 *Precision Dipping Ltd v Precision Dippings Marketing Ltd* [1986] Ch 447 CA

Key Facts

PDL paid a dividend to PDM, its parent company, of £60,000 when there were no distributable profits available to do so. PDL then went into liquidation and the liquidator sought repayment of the £60,000 from PDM.

Key Law

PDM held the £60,000 as a constructive trustee for PDL and was accountable to PDM for that amount.

6.3 *Bairstow v Queen's Moat Houses plc* [2001] EWCA Civ 712; [2001] 2 BCLC 531 CA

Key Facts

Three directors appealed against the judge's ruling that they had to account for unlawfully paid dividends amounting to £78.5 million.

Key Law

The appeal was dismissed.

1. The requirements in s 270 CA 1985 [now s 837 CA 2006] that dividends can only be paid based on properly drawn up accounts, laid before the general meeting, are strict and mandatory. A breach cannot be regarded as a mere technicality so it makes no difference that the group of companies as a whole has enough distributable reserves to pay a dividend.
2. The liability on directors to pay illegally paid dividends applies to both solvent and insolvent companies.
3. Liability is not limited to the difference between the amount of the unlawfully paid dividend and the amount of dividend the company

could in fact have lawfully paid.

Key Comment

In *Revenue and Customs Commissioners v Holland* (2010), **Lord Hope** (*obiter*) said:

- the liability of a director to repay unlawfully paid dividends was strict, subject to a right to claim relief under s 1157 CA 2006;
- relying on *Bairstow*, the liability of the director is to account for the full amount of the dividend unlawfully paid; and
- if the claim for repayment is by a liquidator bringing misfeasance proceedings under s 212 Insolvency Act 1986, the remedy may be limited to what is required to make up the deficiency of a particular creditor, in this case Her Majesty's Revenue and Customs.
- Section 212(3) IA 1986 does not give the court a discretion to order that directors should pay nothing following an unlawful payment of a dividend.

Key Problem

The extent to which a director has to repay unlawfully paid dividends is far from clear.

Key Link

Ignorance of the Companies Act provisions is no defence to a claim for repayment of improperly paid dividends: *It's a Wrap (UK) Ltd v Gula* [2006] EWCA Civ 554; [2006] 2 BCLC 634.

6.7 *Progress Property Co Ltd v Moorgarth* [2010] UKSC 55;[2011] 1 WLR 1 SC

Key Facts

The appellant company (P) sold shares it owned in a subsidiary (Y) to another company (M). The companies were controlled by the same investor. The shares were sold at a reduced market price on the basis that P was released from indemnities it had owed in respect of property repairing obligations. In fact, the indemnities could not be established and P argued that the sale was *ultra vires* and void as being at a gross undervalue and a disguised return of capital.

Key Law

P's argument failed. Whether a transaction is a disguised return of capital is a matter of substance not form and the label the parties give to it is not conclusive. Here, all parties had acted in good faith, at arm's length and had concluded a genuine commercial sale although, with hindsight, P had made a bad bargain.

Key Judgment

Lord Walker favoured a qualified objective approach to characterising the transaction:

‘If there were a stark choice between a subjective and an objective approach, the least unsatisfactory choice would be to opt for the latter. But in cases of this sort the court’s real task is to inquire into the true purpose and substance of the impugned transaction. That calls for an investigation of all the relevant facts, which sometimes include the state of mind of the human beings who are orchestrating the corporate activity.’

6.7 *Heald v O’Connor* [1971] 1 WLR 497 QBD

Key Facts

Mr and Mrs H sold the share capital in their company to O for £35,000. To help him purchase the shares they lent him £25,000 which was secured by a floating charge over the company’s assets. If he defaulted on the loan they could enforce the charge against the company’s assets.

Key Law

The floating charge amounted to financial assistance for the purchase of the company’s shares and was unlawful and void.

6.7 *Brady v Brady* [1989] AC 755 HL

Key Facts

T Brady & Sons Ltd (Brady) was run by two brothers, Bob and Jack. Brady began to make losses because they could not work together so a scheme was devised whereby the business would be split up, with Jack taking the haulage side and Bob the drinks side of the business. The two sides were not of equal value and so Jack's new company, M Ltd, received assets from Brady which were then used by Jack to buy the shares in Brady. This amounted to the giving of financial assistance by Brady, contrary to s 151 CA 1985, and Jack relied on this when he was sued for specific performance by Bob under their agreement. Jack claimed the transaction fell within the 'larger purpose exemption' in s 153(1) CA 1985 [s 678(2) CA 2006].

Key Law

The transaction did not fall within the larger purpose exemption but specific performance was granted as it fell within the private company exemption for the giving of financial assistance within ss 155–158 CA 1985.

Key Judgment

Lord Oliver
'The scheme of reorganisation was framed and designed to give Jack and Robert control of Brady for the best of reasons, but to say that the "larger purpose" of Brady's financial assistance is to be found in the scheme of reorganisation itself is to say only that the larger purpose was the acquisition of the Brady shares on their behalf . . . I do not think that a larger purpose can be found in the benefits considered to be likely to flow . . . by the acquisition which it was the purpose of the assistance to facilitate. The

acquisition was not a mere incident of the scheme devised to break the deadlock. It was the essence of the scheme itself and the object which the scheme set out to achieve.'

Key Comment

Remember that the CA 2006 abolished the prohibition against a private company giving financial assistance for the purchase of its shares. The prohibition was retained for public companies to comply with the Second EU Company Directive (77/91 EEC)

6.7 *Chaston v SWP Group plc* [2002] EWCA Civ 1999; [2003] 1 BCLC 675 CA

Key Facts

SWP made a takeover bid for a company called DRCH. C was a director of a subsidiary of DRCH. He arranged for the professional fees of SWP in relation to the takeover to be paid by the subsidiary, amounting to £20,000. Following the takeover, SWP argued that C was in breach of his fiduciary duty by arranging for the subsidiary to provide financial assistance for the purchase of SWP's shares. C argued that this was not financial assistance within s 151 CA 1985 [s 678(1) CA 2006].

Key Law

Paying the professional fees of the takeover bidder is financial assistance and C was in breach of duty.

Key Judgment

Arden LJ

'As a matter of commercial reality, the fees in question smoothed the path to the acquisition of shares . . . Here the liability to pay the fees . . . was clearly incurred for the purpose of the acquisition by SWP of DRCH's shares. *Brady v Brady* makes it clear that an unlawful purpose is not removed by the fact that . . . the directors were motivated by the best interests of the company. Their motivation was only a reason for their acts, not a purpose in itself.'

6.7 *Dyment v Boydon* [2004] EWCA Civ 1586; [2004] All ER (D) 414 CA

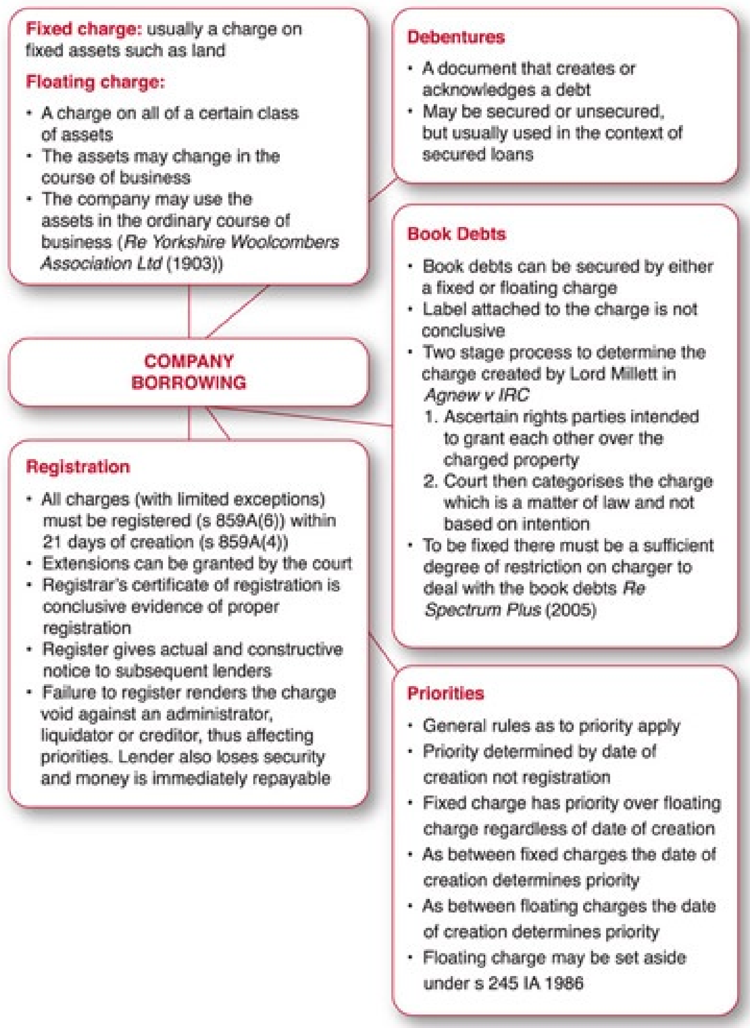
Key Facts

D, E and P ran a residential care home. They owned the premises in equal shares and were also equal shareholders and directors in the company. The local council threatened to deregister the company from operating the home due to the failure of E and P to disclose previous convictions. A scheme was devised so that E and P could sever their interests, allowing D to carry on the business. Under the scheme, E and P transferred their shares in the company to D who in return transferred her interest in the property to E and P. They then granted a lease back to the company for an above-market rent. D was sued for rent arrears but claimed the lease and the rent amounted to financial assistance to allow E and P to buy the shares.

Key Law

There was no financial assistance within s 151(2) CA 1985. The company's entry into the lease was 'in connection' with the acquisition by D of E and P's shares, but was not 'for the purpose of' that acquisition; the purpose was to obtain the premises.

7
Company borrowing



7.1 Introduction

1 Companies raise finance by the issue of shares. Public limited companies can raise finance by offering shares to the public but private companies are prohibited from doing so.

2 All companies can raise additional finance by borrowing and frequently do so. A company has an implied power to borrow money, but note that a company's power to borrow money may be limited by the articles of association.

3 Company borrowing can take many forms, including bank overdrafts, promissory notes, mortgages on property and by issuing debentures.

7.2 Debentures

1 Debentures are defined in s 738 CA 2006: ‘In the Companies Acts “debenture” includes debenture stock, bonds and any other securities of a company, whether or not constituting a charge on the assets of the company.’

2 This is an incomplete definition and the term ‘debenture’ has been given a wide meaning by the courts. Essentially, it has been held to mean any document issued by a company acknowledging a debt.

3 In *Levy v Abercorris Slate and Slab Co* (1887) Chitty J stated: ‘In my opinion a debenture means a document which either creates a debt or acknowledges it, and any document which fulfils either of these conditions is a “debenture”.’

4 A broad range of documents have been held to be a debenture.

- In *Lemon v Austin Friars Investment Trust Ltd* (1926), the company issued ‘income stock certificates’ to acknowledge a debt and these were held to be debentures.
- An irredeemable mortgage can also be a debenture: ***Knightsbridge Estate Trust Ltd v Byrne* (1940)**.

5 A debenture may be secured or unsecured. However, banks will usually require security for loans to companies and the term ‘debenture’ is generally used in the context of secured borrowing.

6 There are significant differences between shares and debentures:

- shares create rights of membership, for example the right to attend general meetings and vote; a debenture holder is a creditor of the company, whose rights are fixed by contract;
- a shareholder is entitled to a dividend if one is declared; a debenture holder is entitled to payment of interest in accordance with the contract;
- shares cannot be issued at a discount but debentures can; but not if

they are covertible into fully paid shares: ***Mosely v Koffyfontein Mines* (1904)**.

7.3 Secured and unsecured borrowing

1 Debentures are usually issued with some security attached to them.
2 Security may be by means of a fixed or floating charge.
3 A **fixed charge (also called a 'specific' charge)** may be created over specified identifiable company property not dealt with by the company in its day-to-day business, for example its land and buildings;
4 A **floating charge** may be created over fluctuating assets, such as stock in trade, book debts, machinery, tools and other chattels, allowing the company to deal with the property in the ordinary course of business until crystallisation: *Smith* ***(Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council* (2001)**.
5 A floating charge can be expressed to be over a company's 'entire undertaking' so that it covers all assets other than those which are subject to a fixed charge: ***Re Panama* (1870)**.

7.3.1 Is the charge fixed or floating?

1 Whether a charge is fixed or floating is a matter of substance rather than form. Neither the words used by the parties nor their intentions will necessarily be conclusive in deciding how a charge should be categorised: *Street v Mountford (1985)*; *Re ASRS Establishment Ltd* (2000). The distinction is important for a number of reasons:

- In applying the principles relating to priority of payment, a fixed charge will generally take precedence over a floating charge.
- Under provisions introduced by the Enterprise Act 2002, for

charges created from 15 September 2003 a proportion of the assets of a company subject to a floating charge must be set aside for unsecured creditors. This is not the case with fixed charges, which makes fixed charges more attractive to banks and other chargees. (See Chapter 12, section 12.5.4)

2 The main features indicating a floating charge have been expressed as:

- it is a charge on all of a certain class of assets, present and future;
- the assets may change in the ordinary course of business;
- the company is able to carry on its business using the assets in the ordinary way: *Re Yorkshire Woolcombers Association Ltd* (1903). Subsequent cases have emphasised that it is the third characteristic identified by Romer LJ that is the badge of a floating charge.

3 In *Illingworth v Houldsworth* (1904), Lord Macnaghten compared a fixed and floating charge in the following terms: 'A specific charge, I think, is one which without more fastens on ascertained and definite property or property capable of being ascertained and defined; a floating charge, on the other hand is ambulatory and shifting in nature, hovering over and, so to speak, floating with the property which it is intended to affect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.'

7.3.2 Book debts

1 Cases involving book debts have raised a number of issues in relation to the distinction between fixed and floating charges. Until the House of Lords' decision in ***Re Spectrum Plus Ltd* (2005)** there had been some confusion as to how book debts and their proceeds should be treated. The

problem was what degree of control the charge holder had to establish in order to make the charge a fixed one: ***Re Keenan Bros Ltd* (1986)**.

2 In ***Re Brightlife Ltd* (1987)** the company was not restricted from dealing with either the debts or the proceeds and it was held that this arrangement created a floating charge.

3 More difficult situations arise in cases where there are restrictions on assigning the book debts, but the company has freedom to draw on the account into which the proceeds of the debts are deposited. This was the case in ***Siebe Gorman & Co Ltd v Barclays Bank Ltd* (1979)**: there were restrictions on the company's use of its book debts and the proceeds were paid into an account held by the lender, although the company was free to draw on the account. It was held that this arrangement created a fixed charge. This case was followed, and relied upon by banks, until it was overruled by ***Re Spectrum Plus Ltd* (2005)**.

4 In ***Re New Bullas Ltd* (1994)**, while the book debts were expressed as a fixed charge, the proceeds were released from the charge and paid into a bank account controlled by the company. It was held that a distinction could be made between the book debts, which were subject to a fixed charge, and the proceeds, subject to a floating charge.

5 The Privy Council case ***Agnew v Commissioner of Inland Revenue* (2001)** clarified the law in this area. In this case a charge similar to that in *New Bullas* had been created in favour of a bank. The court held that *New Bullas* had been wrongly decided and expressed the opinion that separating the debt from the proceeds 'made no commercial sense'. Lord Millett set out a two-stage process for categorising fixed and floating charges:

- first the court must consider the intention of the parties as to their respective rights and obligations;
- the second stage requires the court to determine whether the charge is fixed or floating as a matter of law.

In *Agnew* the company was able to realise the debt and to pay the proceed into an account which it controlled. This was held to be a floating charge.

6 In ***Re Spectrum Plus Ltd* (2005)** the proceeds of the debts were paid into a

current account held by the bank but the company was able to draw on the account and make use of the overdraft facility, so this could not be a fixed charge. The commercial reality of the situation must be taken into account. *Siebe* and *New Bullas* were overruled, resolving many of the uncertainties in the law.

7 Note also that it is possible to charge only the proceeds of collection of the book debts without charging the debts themselves: *Re SSSL Realisations (2002) Ltd* (2004).

8 Cases on book debts have dried up since ***Spectrum*** but see:

- ***Re Beam Tube Products Ltd* (2006)** – charge over book debts held to be floating;
- ***The Russell Cooke Trust Co Ltd v Elliott* (2007)** – a floating charge held to be fixed;
- ***Re Harmony Care Homes Ltd* (2009)** – charge over book debts held to be floating.

7.3.3 Crystallisation

1 A floating charge crystallises and becomes fixed on the occurrence of certain events. The chargee takes possession or appoints an administrator or receiver.

2 A floating charge crystallises:

- on cessation of the company's business: ***Re Woodroffes (Musical Instruments) Ltd* (1986)**;
- when the security is enforced by virtue of a clause in the debenture: ***Re Brightlife Ltd* (1986)**;
- when the company goes into administration or receivership;
- when the company goes into liquidation.

7.4 Registration and priorities

7.4.1 Legal and equitable charges

1 A charge may be legal or equitable:

- a legal charge must be recognised by anyone who gains title to the charged property after the charge is created;
- an equitable charge must be recognised by anyone other than a person who acquires the property *bona fide* and for value, without notice (actual or constructive) of the charge.

7.4.2 Registration and its effect

1 All charges must be registered at Companies House with limited exceptions: s 859A(6) CA 2006.
2 The company or any person interested in the charge can register the charge by delivering a certified copy of the charge to the registrar: s 859A(3) CA 2006.
3 Specified particulars of the charge must also be delivered: s 859D CA 2006.
4 Submission can be in paper or electronic form.
5 The charge must be registered within 21 days of its creation starting with the day after its creation: s 859A(4) CA 2006.
6 An extension of the 21-day registration period can be granted by the court on the grounds specified in s 859F.
7 The registrar must give a certificate of registration which is conclusive evidence that the the correct documents and particulars have been submitted within the registration period s 859I CA 2006: ***Re CL Nye* (1971)**.
8 Registration provides actual notice of the charge to anyone who consults the register and constructive notice to others: ***Wilson v Kelland* (1910)**.

The register is open to public inspection. The requirement of registration ensures that a subsequent creditor seeking security by way of a floating charge (which is an equitable charge) has either actual or constructive notice of any existing charges on the property.

9 Note that a failure to register a charge is no longer a criminal offence but will effect its validity – see below.

7.4.3 Priorities

1 Charges created by a company are subject to the general rules governing priority.

2 A legal charge (fixed charge) will rank in priority over an equitable charge (floating charge). Thus a fixed charge will rank in priority before a floating charge, even if the fixed charge was created after the floating charge: ***Re Castell & Brown Ltd* (1898)**.

3 Between two floating charges the order of creation will determine priority, with the charge created first ranking ahead of the second, unless there is an express provision in the first charge that the company may create a second charge taking priority: ***Re Automatic Bottlemakers Ltd* (1926)**.

4 Registration affects priority. If a charge is not registered within the required 21 days it will lose all priority.

5 Under s 859H(3) CA2006, if a registerable charge is not registered, it will be void against an administrator of the company, a liquidator of the company and a creditor of the company. When a charge becomes void under this section, the money secured by it immediately becomes payable (s 859H(4)), but it will no longer be treated as a secured debt.

6 Even if properly registered, a floating charge may be set aside under s 245 Insolvency Act 1986 if it was granted to secure existing debt. The aim of the provision is to prevent lenders taking a later floating charge in order to give them priority over unsecured creditors: ***Power v Sharp Investments Ltd* (1993)**.

7 Liquidators can apply to the court to set aside such charges if they were granted to a connected person within two years prior to the

commencement of winding up and twelve months if the person is unconnected.

8 Connected persons are defined in s 249 IA 1986 and include directors and shadow directors of the company. An example of an unconnected person is a bank.

7.5 Reform

1 The current law on registration of charges, as set out in the CA 2006, has been the subject of criticism for some time, and a consultation on the registration of charges created by companies and limited liability partnerships was issued in May 2010.

2 This resulted in a new, simplified system of registration as outlined above at 7.4.2, which came into force on 6 April 2013 and is now contained in CA 2006, Part 25, Chapter A1 (ss 859A–859Q).

3 The reforms do not address the 'invisibility problem'. This occurs because the order of priority is determined by the date the charge is created and not the date of registration. This means that a search of the register will not reveal charges that have been created but have yet to be registered.

Key Cases Checklist

Debentures

Knightsbridge Estate Trust Ltd v Byrne (1940) A mortgage of freehold property is a debenture *Mosely v Koffyfontein Mines* (1904) A company cannot issue debentures on terms that they are convertible into shares

Company Charges

Fixed or Floating?

Re Panama (1870) The court recognised the concept of a floating charge for the first time *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council* (2001) The right to sell plant equipment was a badge of a floating charge

Charges Over Book Debts

Siebe Gorman & Co Ltd v Barclays Bank (1979) Charge over book debts which prevented the company from charging or assigning them without the bank's consent was held to be fixed *Re Keenan Bros Ltd* (1986) A 'blocked' bank account created a fixed charge over book debts *Re Brightlife Ltd* (1987) Freedom to deal with collected book debts is a badge of a floating charge *Re New Bullas Trading Ltd* (1994) Charge over book debts was fixed whilst uncollected and floating once debts paid *Agnew v Commissioner of Inland Revenue* (2001) Charge in similar terms to *New Bullas* but the Privy Council felt it was wrongly decided. Lord Millett established a two-stage test when deciding whether a charge was fixed or floating *Re Spectrum Plus Ltd sub nom National Westminster Bank plc v Spectrum Plus Ltd* (2005) Leading case on charges over book debts. A charge in similar terms to *Siebe Gorman* was held to be floating. *Siebe Gorman* and *New Bullas* cases were overruled *Re Beam Tube Products Ltd* (2006) A floating charge over book debts cannot be converted into a fixed charge by the later creation of a 'blocked' bank account *Russell Cooke Trust Co Ltd v Elliott* (2007) A 'floating deed' was held to be a fixed charge due to the severe restrictions on the chargor's right to deal with the property *Re Harmony Care Homes Ltd* (2009) The intention of the parties was that at its inception the charge over collected book debts was a fixed charge

Registration and Avoidance

Re CL Nye Ltd (1971) The registrar's certificate of registration is conclusive evidence of proper registration *Power v Sharp Investments Ltd* (1993) A floating charge was avoided under s245 IA 1986

Crystallisation and Priority of Charges

Re Woodroffes (Musical Instruments) Ltd (1986) Serving a notice or cessation of the company's business can crystallise a floating charge *Re Castell & Brown Ltd* (1898) A fixed charge has priority over an earlier floating charge *Wilson v Kelland* (1910) Registration of charges gives actual and constructive notice but subsequent lenders will not have constructive notice of a negative pledge *Re Automatic Bottlemakers Ltd* (1926) A later floating charge had priority over an earlier one because the earlier one expressly allowed for this

7.2 *Knightsbridge Estate Trust Ltd v Byrne* [1940] AC 613 HL

Key Facts

The company mortgaged freehold property to a friendly society to secure a loan of £310,000. The loan was to be repayable by half-yearly instalments over a 40-year period. The company claimed this was 'a clog on the equity of redemption' which prevented early repayment.

Key Law

It was not a 'clog on the equity of redemption'. The mortgage was an irredeemable debenture under what is now s 739 CA 2006, which could only be repaid at the end of the contract period.

7.2 *Mosely v Koffyfontein Mines* [1904] 2 Ch 108 CA

Key Facts

The company wanted to issue £1 debentures for 80p. Under the terms of issue the debenture holders were to be given the right to exchange the debentures for fully paid-up £1 shares at any time before the debentures were repaid.

Key Law

Companies can issue debentures at a discount but not if they are convertible into fully paid shares. It would allow companies to effectively issue shares at a discount which is prohibited under what is now s 580 CA 2006. This is because the debenture holder would have paid only 80p for a £1 share.

7.3 *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council* [2001] UKHL 58; [2002] 1 AC 336 HL

Key Facts

Cosslett (C) were employed by the council to clean up some land that was disfigured by derelict coal dumps. The council gave C £1.8 million to buy the equipment to do the work and this was to be repaid out of the money paid by the council for work done by C. If C abandoned the work the contract allowed the council to enter the site, sell the plant and equipment belonging to C and apply the proceeds of sale towards the debts C owed the council. C abandoned the site and went into administration. The administrator claimed the proceeds when the equipment was sold. The council claimed the contract created a floating charge which was void as against the administrator for non-registration.

Key Law

The right of the council to sell plant owned by C and then use the proceeds to pay off amounts owed by C was a charge. Because the plant was a fluctuating body of assets, which could be consumed or removed from the site in the ordinary course of C's business, it was a floating charge.

7.3 *Re Panama* (1870) 5 Ch App 318 CA

Key Facts

The company issued debentures to secure loans which charged the 'undertaking, and all sums of money arising therefrom, and all the estate, right, title and interest of the company therein'. The court had to decide if the debenture holders had priority over the unsecured creditors.

Key Law

The debenture holders did have priority.

Key Judgment

Giffard LJ
'I hold that under these debentures they have a charge upon all the property of the company, past and future, by the term "undertaking", and that they stand in a position superior to that of the general creditors, who can touch nothing until they are paid.'

7.3.2 *Re Keenan Bros Ltd* [1986] BCLC 242 SC (Ir)

Key Facts

The company granted what was expressed to be a fixed charge over its book debts in favour of a bank. The charge required the proceeds to be paid into a 'blocked' bank account, whereby the written approval of the bank was required before the company could make a withdrawal from the account.

Key Law

The charge was fixed as the company was not free to use the money in the account in the ordinary course of its business.

7.3.2 *Re Brightlife Ltd* [1987] 2 WLR 197 CL

Key Facts

Brightlife (B) granted a charge over its book debts 'by way of first specific charge'. The charge prevented B from dealing with the book debts other than to collect or realise them and to pay them into the bank. In the winding up of B, Customs and Excise claimed the charge was floating and that as preferential creditors they had priority to B's assets.

Key Law

The charge was floating, not fixed, as B had freedom to deal with the book debts. Once the collected debts were paid into the bank account they were outside the charge and at the free disposal of the company. A right to deal with the assets in this way was the badge of a floating charge and inconsistent with a fixed charge.

Key Comment

This case shows that the label the parties give to the charge is not conclusive.

Key Link

The Enterprise Act 2002 removed the Crown's preferential creditor status.

7.3.2 *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142 CH

Key Facts

The Bank claimed that it had a fixed charge over the book debts of a company. The debts were assigned to Siebe Gorman, who disputed that the charge was fixed. The charge provided that the book debts had to be paid into the company's bank account and also prevented the company from charging or assigning the debts without the consent of the Bank.

Key Law

The degree of control which the Bank exerted over the book debts was inconsistent with a floating charge and the charge over the book debts was therefore fixed.

Key Comment

This case established that it is possible to create a fixed charge over book debts.

Key Link

This was a landmark decision and stood for over a quarter of a century until overruled by *National Westminster Bank plc v Spectrum Plus* [2005] (see below).

7.3.2 *Re New Bullas Trading Ltd* [1994] 1 BCLC 485

CA

Key Facts

The company granted a debenture to 3i plc which purported to create a fixed charge over book debts whilst they were uncollected, but once collected they had to be paid into a designated bank account, which was to be dealt with in accordance with any directions given to the company. In the absence of directions (none were ever given) the money was to be released from the charge and became subject to a floating charge. The court had to decide whether the charge as created was fixed or floating.

Key Law

The charge was divisible in nature. The intention of the parties was given effect and it was open to the parties to provide that the book debts were subject to a fixed charge whilst uncollected and a floating charge on realisation.

Key Link

Criticised in *Agnew v Commisioner of Inland Revenue* [2001]; overruled in *National Westminster Bank plc v Spectrum Plus Ltd* [2005].

7.3.2 *Agnew v Commissioner of Inland Revenue* [2001] UKPC 28; [2001] 2 AC 710 PC

Key Facts

A company created a charge over its book debts in favour of a bank. The charge was in similar terms to the charge in the *New Bullas* case. Whilst the book debts were uncollected the charge was expressed to be fixed, but once collected the debts became the subject of a floating charge which the company could use in the normal course of its business. The company went into receivership and the receivers claimed the charge was fixed, but the Inland Revenue argued it was only floating and that they were entitled to the proceeds as preferential creditors.

Key Law

The charge was floating. The company's freedom to deal to collect the debts and then use them in the ordinary course of its business was inconsistent with the nature of a fixed charge. It was a floating charge from the outset and the case of *Re New Bullas Trading* (1994) was considered to have been wrongly decided.

Key Judgment

Lord Millett adopted a two-stage process to determine whether a charge is fixed or floating.

Stage 1: Construe the charge to find the parties' intention from the language they have used. The purpose of this is to ascertain what rights and obligations they intended to give each other, not to decide if the charge is fixed or floating.

Stage 2: The court then embarks on categorising the charge. This is a matter of law and does not depend on the intention of the parties or the label they have given to the charge.

7.3.2 *Re Spectrum Plus Ltd sub nom National Westminster Bank plc v Spectrum Plus Ltd* [2005] UKHL 41; [2005] 2 AC 680 HL

Key Facts

The company granted what was expressed to be a fixed charge over its present and future book debts. The wording of the charge was virtually identical to that used in *Siebe Gorman v Barclays Bank Ltd* (1979). The proceeds of book debts had to be paid into the company's Bank account. The company was not allowed to dispose of the debts by factoring, assigning, charging or discounting them without the Bank's consent. However, once the debts were paid into the account the company was free to draw on them in the ordinary course of its business. The Bank, relying on *Siebe Gorman*, argued that the charge was fixed. The liquidator argued that it was only floating.

Key Law

The charge was floating. The company's freedom to deal with the debts once collected and paid into the bank account was inconsistent with a fixed charge.

Key Judgment

Lord Hope of Craighead 'The company's continuing contractual right to draw out sums equivalent to the amounts paid in is wholly destructive of the argument that there was a fixed charge over the uncollected proceeds because the account into which the proceeds were to be paid was blocked.'

Lord Scott of Foscote 'Spectrum was free to draw on the account. Its right to do so was inconsistent with the charge being a fixed charge and the label placed on the charge cannot be prayed in aid to detract from the right.'

Key Comment

Siebe Gorman v Barclays Bank Ltd (1979) and *Re New Bullas Trading Ltd* (1994) were overruled.

Key Problem

The decision does not tell us what degree of control will suffice to make the charge over book debts fixed. It only decided that there was not enough control in the instant case.

7.3.2 *Re Beam Tube Products Ltd* [2006] EWHC 486; [2006] BCC 615 HC

Key Facts

The debenture provided for a fixed charge over book debts but a floating charge over the proceeds when they were paid into a collection account. The company was allowed to use the money until a crystallising event occurred. Four months later a blocked account was set up preventing the company from using the money collected. The lender claimed the charge was fixed.

Key Judgment

The charge over book debts was floating. It could not be converted into a fixed charge by creating a later blocked account because at the time of its creation it was a floating charge.

Key Comment

This case shows that it is crucial for a blocked account to be set up and active at the time the 'fixed' charge is created.

7.3.2 *Russell Cooke Trust Co Ltd v Elliott* [2007] EWHC 1443: [2007] 2 BCLC 637 HC

Key Facts

The company lent money to a variety of lenders so they could buy property. In return they gave a fixed charge over the purchased property as security. They also gave additional security in the form of a ‘floating deed’ over all other properties in which they held an interest.

Key Law

The floating deed was in fact a fixed charge because it contained very severe restrictions on the chargors’ right to deal with the property. They could not, for example, sell, convey, assign or transfer any interest in the additional security without the company’s written consent. Applying *Spectrum*, this was inconsistent with a floating charge.

7.3.2 *Re Harmony Care Homes Ltd* [2009] EWHC 1961; [2010] BCC 358 HC

Key Facts

The company issued a debenture to its landlord (‘NHP’). It was secured by what was expressed to be a fixed charge on uncollected book debts and, in the absence of any directions from NHP, a floating charge on the collected debts, which had to be paid into a designated bank account. The company’s receivers sought a declaration whether the charge was fixed or floating. If it was floating the preferential creditors would have priority over NHP to the collected debts.

Key Law

It was the intention of the parties that the debenture at its inception created a fixed charge over the collected book debts. From the opening of the bank account the company could not and did not make any use of the money in the account without the written consent of NHP.

Key Judgment

Susan Preveser QC

'In short, there was never a moment from the inception of the . . . debenture when the company was entitled to remove the charged assets from the security, and unlike the situation in *Spectrum*, the effect was of the debenture and the arrangements the parties put in place pursuant thereto, was to disentitle the company from using the proceeds of the book debts as a source of its cash flow or for any other purpose.'

7.3.3 *Re Woodroffes (Musical Instruments) Ltd* [1986] 1 Ch 366 CA

Key Facts

The company created a floating charge in favour of its bank and then created a second floating charge in favour of its director, W. The second charge was expressed to be convertible into a fixed charge by serving a written notice on the company, which W did three weeks later. Five days later the bank appointed receivers under its charge and the court had to decide who had priority. The bank argued that their charge had crystallised, giving them priority either when W served her notice or because the company ceased business after she served the notice.

Key Law

In the absence of an express term, when W's charge crystallised as a result of her serving the notice, this did not also crystallise the bank's floating charge. The bank's charge would have crystallised had there been a cessation of business, but on the facts this had not happened. W's charge had priority.

7.4.2 *Re CL Nye Ltd* [1971] Ch 442 CA

Key Facts

The company granted a bank a charge over its premises to secure a loan and overdraft facilities. The undated charge was sent to the company's solicitor and he stamped it on 18 March, which the court treated as the date of creation. He then mislaid it and did not find it again until 18 June. He inserted this date as the date of creation and it was registered on 3 July, following which the registrar issued a certificate of registration. The company went into liquidation and the liquidator argued it was registered outside the 21-day time period.

Key Law

Despite having been registered outside the 21-day time period, the registrar's certificate was conclusive evidence that the charge had been properly registered. The aim of the provision is to protect lenders against the possibility of going behind the certificate in order to challenge the validity of their charge.

7.4.2 *Wilson v Kelland* [1910] 2 Ch 306 CL

Key Facts

A brewery company issued debentures secured by a floating charge. This charge contained a 'negative pledge' prohibiting the creation of further charges from having priority over it. The company later granted a fixed charge to K, who made no searches and was therefore unaware of the existence of the earlier floating charge. He sought to enforce his fixed charge and the court had to determine priority.

Key Law

K had priority as the fixed charge holder. Although he had constructive notice of the existence of the floating charge by reason of its registration, he did not have notice of the 'negative pledge' as such clauses will only bind subsequent charge holders if they have actual, as opposed to constructive, notice. Actual notice was not possible as K made no searches.

7.4.3 *Re Castell & Brown Ltd* [1898] 1 Ch 315 CH

Key Facts

The company issued a series of debentures secured by a floating charge over its present and future property to secure various loans. Later it deposited with its bankers title deeds over its premises as security for its overdraft. The debenture holders commenced proceedings to enforce their security because of interest arrears and the court had to decide who had priority.

Key Law

A later fixed charge has priority over an earlier floating charge. The bank had priority since the deposit of title deeds created an equitable mortgage having priority over the floating charge.

7.4.3 *Re Automatic Bottlemakers Ltd* [1926] Ch 412

CA

Key Facts

In January 1925 the company issued a series of debentures secured by a floating charge over its entire undertaking and property. The charge expressly allowed the company to create further floating charges over specific items and having priority over the earlier charge. In August 1925 the company issued a further debenture to its bank secured by what was expressed to be a first floating charge over raw materials and finished or partly finished products. When a receiver was appointed the court had to decide who had priority.

Key Law

The August 1925 charge was validly created and had priority over the first charge. A later floating charge over a particular class of assets can have priority over an earlier floating charge over the company's entire undertaking. On its true construction the earlier charge allowed for this result.

7.4.3 *Power v Sharp Investments Ltd* [1993] BCC 609

CA

Key Facts

Between 3 April and 16 July 1990, Sharp advanced a total of £436,000 to the company, which was to be secured by a fixed and floating charge. The debenture was not actually executed until 24 July and not registered until 13 August 1990. In the winding up of the company the court had to decide whether the floating charge was granted to secure existing debt, in which case it could be set aside by the liquidator under s 245(1) Insolvency Act (IA) 1986. Sharp argued that the money was advanced 'at the same time as' the creation of the charge and therefore valid under s 245(2)(a) IA 1986.

Key Law

The charge could be set aside by the liquidator as it was granted to secure existing debt. The charge was executed, and therefore created, after the money had been advanced.

Key Judgment

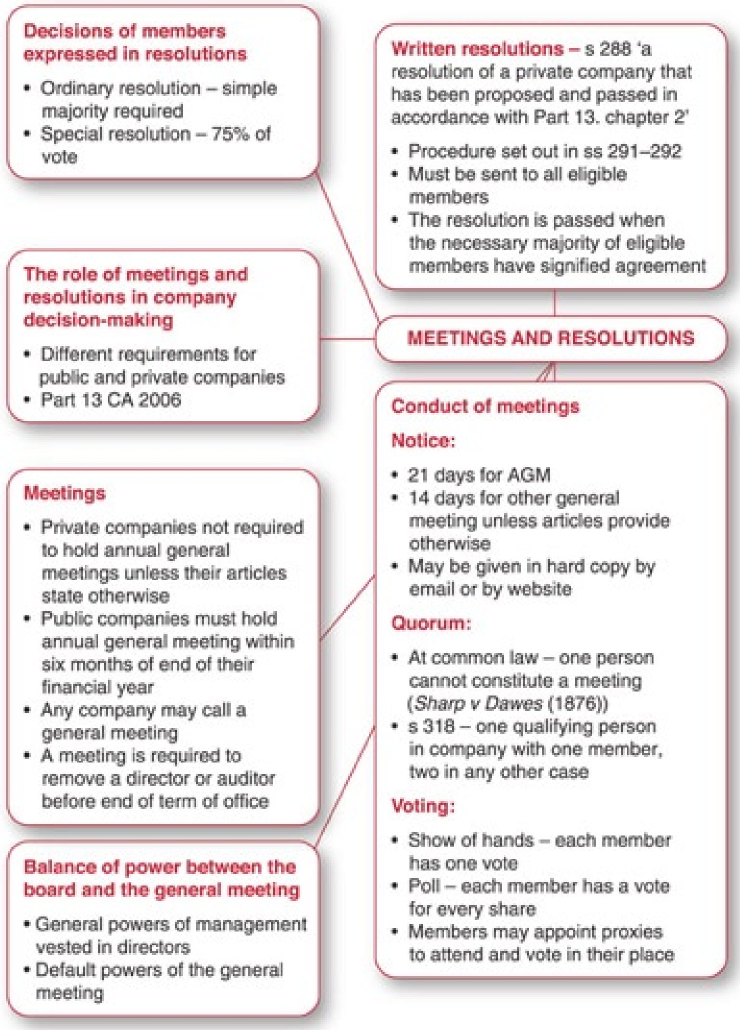
Sir Christopher Slade said money could not be said to be given ‘at the same time as’ the creation of the charge ‘if the making of the advance precedes the formal execution of the debenture by any time whatsoever, unless the interval is so short that it can be regarded as *de minimis* – for example a “coffee break” ’.

Key Comment

Lenders should not allow companies to draw on any monies until the charge is actually executed.

8

Meetings and resolutions



8.1 Introduction

1 A company is a separate legal person able to conduct business. However, a company can only act through agents and, apart from small owner-managed companies (quasi-partnerships), it is usual for shareholders to delegate management of the company to directors, who may or may not also be members of the company.

2 By appointing the board of directors the shareholders in general meeting appoint agents to act for the company. The articles of association generally state that the business of the company shall be conducted by the board of directors; see the model articles for both private companies

limited by shares and for public companies, Part 2, 'Directors' powers and responsibilities'. However, company legislation provides that certain decisions must be approved by shareholders, for example:

- alteration of the company's articles: s 21 CA 2006;
- change from private to public company (s 90CA 2006) or from public company to private (s 97 CA 2006);
- ratification of directors' breach of duty: s 239 CA 2006;
- a decision to wind up the company (see Chapter 12).

3 Note also:

- shareholders can give directions to the board by special resolution (Article 4 in both Model Articles for private companies limited by shares and public companies);
- sometimes the articles themselves provide that the authority of shareholders is required before action can be taken by the board;
- shareholders in general meeting may appoint the directors, in accordance with the company's articles, and under s 168 Companies Act 2006 they have power to remove directors by ordinary resolution.

4 Shareholders play an important role in the governance of companies, and general meetings, class meetings, written resolutions and unanimous shareholder agreements provide a framework for shareholder decision-making as described in this chapter.

5 However, the power of shareholders to influence the conduct of directors is often theoretical rather than real, particularly in large companies, where individual shareholders are widely dispersed and may have relatively small holdings. In such cases they are more likely to sell their shares if they are dissatisfied than to seek to remove directors or influence change.

6 The Companies Act (CA) 2006 reserves certain rights to shareholders, but it has become apparent in recent years that there is a need for separate regulation, developed through a series of self-regulatory codes, notably the UK Corporate Governance Code (revised in 2012), which contains five general principles, one of which is that the Board should ensure that there is a satisfactory dialogue with shareholders and should use the Annual General Meeting (AGM) to communicate and encourage shareholder participation: UK Corporate Governance Code, Section E, 'Dialogue with shareholders'.

7 The influence of institutional investors such as insurance companies and pension funds does have an impact, although not necessarily through voting in general meetings.

8 The UK Stewardship Code (2012) is directed mainly at institutional investors and is also based on a 'comply or explain' basis. The Code sets out a number of areas of good practice that institutional investors should aspire to and contains seven principles along with guidance on how the principles should be applied. The principles which those that ascribe to the Code should follow are:

- to publicly disclose their policy on how they will discharge their stewardship responsibilities;
- to have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed;
- to monitor their investee companies;
- to establish clear guidelines on when and how they will escalate their stewardship activities;
- to be willing to act collectively with other investors where appropriate;
- to have a clear policy on voting and disclosure of voting activity and;
- to report periodically on their stewardship and voting activities.

8.2 Meetings

8.2.1 Public and private companies

1 The AGM provides a formal mechanism for exchanging information, is the focus of corporate decision-making by the shareholders and provides an opportunity for shareholders to review the Board's performance. However, it has long been recognised as an unsatisfactory forum in modern companies, although the reasons for this differ between public companies on the one hand and private companies on the other.

2 Public companies often have a very large number of shareholders, some of whom are small private investors, while others are institutional shareholders.

- Annual general meetings tend to be poorly attended and private investors tend to have little influence on decisions taken.
- Institutional shareholders with large holdings of shares often exercise their influence outside the annual general meetings.

3 Shareholders in private companies tend to be fewer in number and less widely dispersed. In the case of small owner-managed private companies (quasi-partnerships) the shareholders may all themselves be directors and work closely together in running the company, so the need for a formal AGM has been questioned.

4 Part 13 of the CA 2006 contains the provisions relating to meetings and resolutions. The 2006 Act introduced a number of amendments designed to enhance the involvement of shareholders in public companies and to reduce the administrative burden on private companies.

5 Section 336(1) CA 2006 provides that a public company must hold an annual general meeting each year, linked to its accounting period, but there is no requirement for a private company to hold one, unless it includes a provision in its articles requiring such meetings. See further

below at 8.2.2.

6 Decisions in private companies, which under the CA 1985 were assumed to be taken by resolution in general meeting, can under the CA 2006 be taken by written resolution without the need for a meeting.

7 A private company is still required to hold a general meeting in order to remove a director or to dismiss an auditor before the end of his term of office. Also, a general meeting can be called by the directors at any time (s 302 CA 2006) or by members representing 10 per cent of the voting shares, or 5 per cent if it is more than 12 months since the last shareholder meeting (s 303 CA 2006).

8.2.2 Meetings under the CA 2006

1 Public companies are required under s 336(1) to hold an annual general meeting within six months of the end of their financial year. The main purpose of an AGM is to consider the accounts and reports of the auditors and directors; to declare any dividend; and to elect directors and auditors. Section 337 provides that the notice calling an AGM must state that it is an annual general meeting.

2 Private companies are not required by the Act to hold an AGM, but must do so if their articles so provide.

3 A general meeting can be called by all companies and is required in order to remove a director or dismiss an auditor before the end of his term of office.

4 Directors have the power to call a general meeting under s 302 CA 2006. The concept of the extraordinary general meeting has been abolished by the CA 2006.

5 Under s 303 directors must call a general meeting if requested:

(a) in the case of a public company, by members holding 10 per cent of the voting rights;

(b) in the case of a private company, by members holding 10 per cent of the voting rights, or 5 per cent if a general meeting has not been held for more than 12 months.

6 Class meetings must be held in certain circumstances. This is a meeting open to members of a particular class of shareholders or creditors (see Chapter 5, section 5.3 and Chapter 12).
7 Under s 355(2) CA 2006 records of meetings and resolutions must be kept for ten years from the date of the resolution, meeting or decision. Under previous legislation there was no statutory requirement.
8 A meeting can be held by telephone: *Re Associated Colour Laboratories Ltd* (1970).
9 A meeting can be held in different rooms with audio-visual links between them: *Byng v London Life Association Ltd* (1990).

8.2.3 The power of the court to order meetings

1 Section 306 CA 2006 gives the court power to order a meeting if for any reason it is impractical for a meeting to be called or conducted in the ordinary way: ***El Sombrero Ltd* (1958)**.
2 This may be done at the instigation of the court or on application of a director or a shareholder entitled to vote: ***Re British Union for the Abolition of Vivisection* (1995)**.
3 The power may not be used to override class rights (see further Chapter 5, section 5.3): ***Harman v BML Group Ltd* (1994)**.

8.2.4 Conduct of meetings

8.2.4.1 Notice

1 Members must be given 21 days' notice for an AGM of a public company unless all members entitled to attend and vote agree to a shorter period: ss 307(2) and 337(2).
2 Fourteen days' notice is required for any other general meeting, unless the

articles specify a longer period: s 307(1)–(3).

3 Special notice of 28 days is required for a resolution at an AGM to remove an auditor from office, or providing that a retiring auditor will not be re-appointed (ss 511, 514, 515), or to remove a director under s 168.

4 No business may be brought to a meeting unless notice has been given.

5 Notice may be given in hard copy, electronic form or by a website, or by a combination. The electronic form and the website may be used if a member has agreed that notice may be given in that way. If the website is used, members who have agreed to receive notice in that way must be notified that notice has been posted.

8.2.4.2 Content of notice

1 The notice must state the time, date and place of the meeting (s 311(1)) as well as certain details listed in s 311(3). There must also be a statement of a member's right to appoint a proxy to attend and vote.

2 Normally the notice of meeting will be accompanied by a circular briefly describing the business to be conducted. The notice and the circular together must give sufficient information to allow shareholders to decide whether to attend: *Tiessen v Henderson* (1899); ***Kaye v Croydon Tramways* (1898)**.

3 In the case of a special resolution the notice must state the full text of the resolution and the resolution may generally not be amended at the meeting: ***Re Moorgate Mercantile Holdings Ltd* (1980)**. However, see now the Model Articles for Public Companies, Art 40(2), which allow amendment in certain circumstances.

8.2.4.3 Quorum

1 At common law, one person cannot constitute a meeting: ***Sharp v Dawes* (1876)**; *Re London Flats Ltd* (1969). However, this has been varied by the Companies Act, for example:

- class meetings where there is only one member of the class;
- under s 306 CA 2006 the court may order a meeting to be held and fix the quorum at one: *Re El Sombrero Ltd* (1958); *Re Sticky Fingers Restaurant Ltd* (1992).

2 Section 318 CA 2006 provides that the quorum for a valid meeting is one ‘qualifying person’ in a company with only one member and two in any other case, unless the articles provide otherwise. A qualifying person is a member, the representative of a corporate member or a proxy.

3 No business can be done unless a quorum is present.

8.2.4.4 Voting

1 Generally voting at general meetings is by show of hands with each member having one vote.

2 A poll may be demanded in accordance with the statute and the articles, in which case a written record is kept and each member has a vote for every share held: s 284 CA 2006.

3 Section 321 CA 2006 lays down minimum requirements as to who may demand a poll at general meetings.

4 Section 322 CA 2006 provides that on a poll at a general meeting a member who is entitled to more than one vote need not cast all his votes in the same way.

5 If a poll is held at a general meeting of a quoted company the results must be published on the company’s website in accordance with s 341 CA 2006.

6 Members of a quoted company may also require directors to provide an independent report on any poll taken at an AGM.

7 The above measures are designed to enhance transparency.

8.2.4.5 Proxies

1 A member can appoint a proxy to attend, speak and vote at a meeting in their place. A proxy may vote on both a show of hands and a poll.
2 Section 323 CA 2006 allows a corporate member to appoint a human representative with the same powers as an individual member.

8.3 Resolutions

Decisions of the company made by members are expressed in resolutions. In the case of a public company resolutions must be passed at a meeting of the members: s 281(2). In a private company resolutions may be passed either at a meeting of the members or by the written resolution procedure: s 281(1). A resolution is validly passed at a general meeting if:

- notice of the meeting and resolution is given;
- the meeting is held in accordance with the CA2006 and the articles: s 301.

8.3.1 Ordinary resolutions

1 An ordinary resolution is defined by s 282(1) CA 2006 as one that is passed with a simple majority.

(a) In the case of a written resolution this requires a simple majority of the total voting rights of eligible members: s 282(2) CA 2006. The written resolution procedure is available only to private companies.
(b) A resolution passed at a meeting on a show of hands requires a simple majority of members who, being entitled to do so, vote in person on the resolution, and persons who vote as duly appointed proxies: s 282(3).
(c) On a poll a resolution is passed by a simple majority of the total

voting rights of members (based on one vote per share) who vote in person or by proxy: s 282(4).

2 Unless otherwise stipulated in the Companies Act or in the company's constitution, company decisions can be taken by ordinary resolution.
3 Note in particular that an ordinary resolution is required to remove directors: s 168 CA 2006.

8.3.2 Special resolutions

1 A special resolution is defined by s 283(1) CA 2006 as one that is passed by not less than 75 per cent:

- section 283(2) provides that in the case of a written resolution this means not less than 75% of the total voting rights of eligible members;
- under s 283(3) a resolution is not a special resolution unless it is stated that it is proposed as a special resolution and it is one that can only be passed as a special resolution;
- section 283(4) provides that a special resolution passed at a meeting on a show of hands requires 75 per cent of members who, being entitled to do so, vote in person on the resolution and those who vote as duly appointed proxies;
- section 283(5) provides that on a poll taken at a meeting a special resolution is passed by a majority of not less than 75 per cent of the total voting rights of members who, being entitled to do so, vote on the resolution.

2 Under the CA 2006 a special resolution is required for a large number of purposes, including:

- to alter the articles of association: s 21 CA 2006;
- to change a company's name, unless the company's articles provide for another method: s 77 CA 2006;
- to approve a reduction of capital: s 641(1) CA 2006.

3 The Insolvency Act 1986 requires a special resolution, for example:

- to resolve that the company should be wound up voluntarily: s 84(1)(b);
- in a members' voluntary liquidation, to approve the transfer of shares to another company: s 110(3);
- to resolve to petition for a compulsory winding up: s 122(1)(a).

8.3.3 Written resolutions

1 A written resolution is defined in s 288 CA 2006 as 'a resolution of a private company that has been proposed and passed in accordance with Chapter 2, Part 13'. A written resolution may be proposed by the directors or by members.
2 Under the CA 1985 a written resolution required the unanimous support of all members. This is no longer the case – see sections 8.3.1 and 8.3.2 above.
3 The procedure for written resolutions proposed by the directors is set out in some detail in s 291 CA 2006:

(a) The resolution must be sent to every eligible member by one or a combination of the following:

- in hard copy;
- by email;
- by the company website.

(b) A company using email or the website must have the consent of shareholders to use these forms of communication: s 1144(2) and Schedule 5 CA 2006.
(c) The resolution must be accompanied by a statement setting out how a shareholder must signify agreement and by notification of the date by which the resolution must be passed if it is not to lapse. Section 297 CA 2006 provides that the period in which agreement must be signified is as specified in the articles, or if no period is specified, 28 days beginning with the circulation date.
(d) A resolution is passed as soon as the necessary majority of eligible members have signified agreement. It will lapse if it is not passed before the end of the period specified in the articles or, if none is specified, 28 days.

4 Sections 292 to 295 CA 2006 deal with the procedure for written resolutions proposed by members.

(a) Shareholders who hold 5 per cent of the voting rights can require the directors to circulate a proposed resolution. Directors are not required to circulate a resolution if it would be ineffective even if passed, if it is defamatory or if it is frivolous or vexatious.
(b) Members may require a statement of not more than 1,000 words to be sent with the proposed resolution.
(c) The members requiring circulation are liable to pay the expenses.

8.4 Unanimous assent of all members

1 It is well established that the unanimous agreement of all members is

effective, even if a meeting is not held. This is a common law principle: ***Re Duomatic* (1969)**; ***Cane v Jones* (1981)**; ***Atlas Wright (Europe) Ltd v Wright* (1999)**; ***Schofield v Schofield* (2011)**. Such agreement must be notified to the registrar under s 30 CA 2006.

2 It should be noted, however, that unanimous assent will not be effective where a statutory provision requires more than just a resolution, for example where a particular procedure is required, as for the removal of a director or auditor.

8.5 Interference by the general meeting with company management

8.5.1 General power of management

1 Companies will usually delegate powers of management to the board of directors. The extent of such powers is determined by the relevant articles in the articles of association.

2 Where the general management of the company is vested in the directors (as in Art 3 of the model articles for both private companies limited by shares and public companies), the shareholders have no power by ordinary resolution to give directions to the Board or overrule their business decisions: ***Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* (1906)**; *John Shaw & Sons (Salford) Ltd v Shaw* (1935).

3 The right to litigate on behalf of the company is an aspect of management and as such is also vested in the board of directors: ***Breckland Group Holdings v London & Suffolk Properties Ltd* (1989)**; ***Mitchell & Hobbs (UK) Ltd v Mill* (1996)**. This can cause difficulty where the directors themselves have committed a wrong against the company. See also ***Marshall's Valve Gear Co Ltd v Manning, Wardle & Co Ltd* (1909)**.

4 Article 70 Table A CA 1985 states: 'Subject to the provisions of the Act, the

memorandum and the articles and to any directions given by special resolution, the business of the company shall be managed by the directors who may exercise all the powers of the Company'. Article 70 also provides that no such direction shall invalidate any prior action of the directors.

5 The Companies Act 2006 model articles for both private companies limited by shares and public companies contain provisions similar in effect but more clearly expressed:

- Article 3: subject to the articles, the directors are responsible for the management of the company's business, for which purposes they may exercise all the powers of the company.
- Article 4(1): the members may, by special resolution, direct the directors to take, or refrain from taking, specified action.
- Article 4(2): no such special resolution invalidates anything which the directors have already done.

6 The courts have taken a restrictive view of the power of members to direct the board and the members' reserve power contained in Art 4 of the model articles appears to be limited to specific instances rather than a general power to direct the board.

7 A company may restrict the powers of directors by provision in the articles. For example, in *Salmon v Quin Axtens* (1909) the articles gave a general power of management to the board of directors, but also gave a veto to one of two named directors on certain matters. It was held by the Court of Appeal (affirmed by the House of Lords) that the veto should be upheld and an ordinary resolution that sought to override it was ineffective.

8 A large number of powers are reserved to the general meeting by the Companies Act 2006 and the Insolvency Act 1986.

8.5.2 Default powers of the general meeting

1 The general meeting may ratify an act of the directors which is voidable as an irregular exercise of their powers. In *Bamford v Bamford* (1970) the members were allowed to ratify an issue of shares which it was alleged were improperly issued by the directors to prevent a takeover bid.

2 The company in general meeting may act if there is no board competent or able to exercise the powers conferred on it: ***Barron v Potter* (1914)**.

Key Cases Checklist

Meetings

El Sombrero Ltd (1958)
The court may order a company to hold a meeting if it is impractical for a meeting to be called in the ordinary way

Re British Union for the Abolition of Vivisection (1995)
The court may order a meeting on its own instigation or that of a director or shareholder entitled to vote

Harman v BML Group Ltd (1994)
The court's power to order a meeting will not be used if the result would override class rights

Kaye v Coydon Tramways (1898)
The notice of meeting must contain sufficient information to allow shareholders to decide whether to attend

Re Moorgate Mercantile Holdings Ltd (1980)
Notice of a special resolution must be accurate and may not generally be amended at the meeting

Sharp v Dawes (1876)
At common law one person does not constitute a meeting (but note now s 306 CA 2006)

Unanimous Agreement of All Members

Re Duomatic (1969)
The unanimous agreement of all members entitled to attend and vote at a general meeting is as binding as a resolution in general meeting would be
Cane v Jones (1981)
The *Duomatic* principle covers special resolutions
Atlas Wright (Europe) Ltd v Wright (1999)
The *Duomatic* principle was applied where informal assent was given to a statutory requirement designed to protect shareholders
Schofield v Schofield (2011)
The principle will apply only if unqualified agreement can be objectively established

Balance of Power Between Directors and Shareholders

The General Power of Management

Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame (1906)
Where the general management of the company is vested in the directors the general meeting has no power to give directions by ordinary resolution
Breckland Group Holdings v London & Suffolk Properties Ltd (1989)
The commencement of litigation on behalf of the company is an aspect of management entrusted to the board
Marshall's Valve Gear Co Ltd v Manning, Wardle & Co Ltd (1909)
Where the directors had failed to act to protect the company, commencement of legal action by a shareholder who was also a director was allowed. But note that this case was impliedly overruled by *Breckland*

Default Powers of the General Meeti

Default Powers of the General Meeting

Barron v Potter (1914)
Where the board of directors is deadlocked or unable to meet the company in general meeting may take action

8.2.3 *El Sombrero Ltd* [1958] Ch 900 HC

Key Facts

There were three members of the company and the articles required a quorum of two persons present in person or by proxy. Two of the members were unwilling to attend meetings and so the third applied under what is now s 306 CA 2006 for a court order convening a meeting and directing that one person present should constitute a quorum.

Key Law

It was impractical to call a meeting in these circumstances and so the court ordered a meeting to be held with a quorum of one. 'Impractical' is not the same thing as 'impossible' and whether or not calling a meeting is impractical depends upon an examination of all the facts of a particular case.

8.2.3 *Re British Union for the Abolition of Vivisection* [1995] 2 BCLC 1 HC

Key Facts

The articles of the Union provided that all votes at company meetings had to be cast in person and that no proxies were allowed. At its last extraordinary general meeting there was a serious disturbance between opposing factions. The police had to be called and no business was able to be conducted. Eight executive committee members of the Union applied to the court under what is now s 306(2) CA 2006 for a meeting to be held to consider a resolution to abolish the requirement of personal attendance at meetings and to allow proxy voting.

Key Law

It was impractical to hold a meeting due to the threat of further violent disorder by an extremist element. The court ordered a meeting to be held consisting only of the thirteen executive committee members. The remaining nine thousand members of the Union were allowed to vote by post and the police were to be notified of the meeting.

8.2.3 *Harman v BML Group Ltd* [1994] 1 WLR 893 CA

Key Facts

The company had two classes of shares, the ‘A’ and the ‘B’ shares. There was a shareholders’ agreement between them that a meeting would not be quorate unless Mr Blumenthal, the only ‘B’ shareholder, was present. The holders of the ‘A’ shares applied under what is now s 306 CA 2006 for an order that a meeting be held without the need for Mr Blumenthal to be present.

Key Law

The application was refused. A court will not order a meeting to be held if this will override a class right contained in a shareholders’ agreement which has been deliberately conferred for the protection of the minority. To do otherwise would amount to the court imposing a new shareholders’ agreement on the parties.

Key Judgment

Dillon LJ
‘Class rights have to be respected and I regard the right of Mr Blumenthal, as the holder of the B shares to be present in the quorum, as a class right for his protection which is not to be overridden by this machinery.’

8.2.4.2 *Kaye v Croydon Tramways Co* [1898] 1 Ch 358

CA

Key Facts

The notice of the meeting stated that it was to consider the sale of the company's business. It did not, however, mention the compensation which was to be paid under the contract of sale to the company's directors. The meeting was held and the resolution to sell the business was passed.

Key Law

The resolution was invalid. The notice was insufficient as it did not contain sufficient information to allow the shareholders to decide whether or not to attend.

Key Judgment

Lindley MR
'It is a tricky notice, and it is to my mind playing with words to tell shareholders that they are convened for the purpose of considering a contract of sale of their undertaking, and to conceal from them that a large portion of that purchase money is not to be paid to the vendors who are selling that undertaking.'

Key Link

The CA 2006, ss 1143–1148 allows companies to send documents and information electronically.

8.2.4.2 *Re Moorgate Mercantile Holdings Ltd* [1980] 1 WLR 227 HC

Key Facts

The notice of a meeting stated that it was to consider a special resolution that 'the share premium account of the company amounting to £1,356,900.84p be cancelled', as it had been lost. At the meeting, however, it was found that the account had £321.17p in it and so the resolution was amended to 'the share premium account of the company amounting to £1,356,900.84p be reduced to £321.17p'. The resolution was passed and the company then sought the confirmation of the court to reduce the account.

Key Law

The confirmation was rejected as the notice sent to the members was inaccurate. The resolution passed at the meeting was not the same in form or substance as that set out in the notice of the meeting; one provided for the entire cancellation of the share premium account; the other provided merely for its reduction.

8.2.4.3 *Sharp v Dawes* (1876) 2 QBD 26 CA

Key Facts

A meeting of a tin mining company was held for the purpose of making a call on shares. The meeting was only attended by one shareholder. Another shareholder, Dawes, refused to pay it and the court had to decide whether the meeting was valid.

Key Law

There was no valid meeting at which a call could be made. A meeting *prima facie* requires a coming together of more than one person.

Key Judgment

Mellish LJ
'According to the ordinary use of English language, a meeting could no more be constituted by one person than a meeting could have been constituted if no shareholder at all had attended.'

Key Link

Under s 306 CA 2006 a court can order a one-person meeting.

8.4 *Re Duomatic Ltd* [1969] 2 Ch 365 CH

Key Facts

The liquidator of the company sought the repayment of directors' salaries which had not been approved by an ordinary resolution passed by the members in a general meeting as required by the company's articles.

Key Law

The liquidator failed as the salaries had been approved by the unanimous informal assent of the shareholders.

Key Judgment

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

Key Comment

The difficulty with this principle is that its limitations are still being identified by the courts but it was extended to special resolutions in *Cane v Jones* (1980).

8.4 *Atlas Wright (Europe) Ltd v Wright* [1999] 2 BCLC 301 CA

Key Facts

A husband and wife entered into service agreements with the company in excess of five years but did not obtain the consent of the general meeting as required by s 319 CA 1985 [s 188 CA 2006]. However, despite the strict non-compliance with the section, all of the shareholders entitled to attend and vote at the meeting had given their informal consent in negotiations with them.

Key Law

The *Duomatic* principle applied and the service agreements were valid. The provisions in s 319 CA 1985 [s 188 CA 2006] only existed for the protection of the shareholders and they could therefore be waived by them.

Key Comment

Where the procedure in a statutory provision exists to protect a wider range of stakeholders, such as creditors, the *Duomatic* principle may not be available. Under s 188 CA 2006 the previous five-year period in s 319 CA 1985 was reduced to three years.

8.4 *Schofield v Schofield* [2011] EWCA Civ 154; [2011] 2 BCLC 319 CA

Key Facts

The appellant, Neil Schofield ('Neil') and his son, Lee Schofield ('Lee'), attended a meeting at the offices of Neil's solicitors. Neil argued that the meeting was an extraordinary general meeting of the company, at which Lee was removed as the sole director of the Company and Neil was appointed as his replacement. Although it was not called with the 14 days' notice required by ss 305(4) and 307(1) of the CA 2006, Neil argued that the corporate representative of 99.9 per cent of the shares in the company, and Lee, as the owner of the remaining share agreed, informally, to treat the meeting as valid and effective under the *Duomatic* principle.

Key Law

Neil's argument failed because, on an objective assessment, Lee had not agreed on the facts to treat the meeting as valid and effective.

Key Judgment

Etherton LJ

'What all the authorities show is that the Appellant must establish an agreement by Lee to treat the meeting as valid and effective, notwithstanding the lack of the required period of notice. Lee's agreement could be express or by implication, verbal or by conduct, given at the time or later, but nothing short of unqualified agreement, objectively established, will suffice.'

8.5.1 *Automatic Self-Cleansing Filter Syndicate Co v Cuninghame* [1906] 2 Ch 304 CA

Key Facts

The company's articles adopted a management article very similar to Art 70, Table A 1985 (now Art 3 Model Articles for Private Companies Limited by Shares). This gave the powers of management to the board of directors. The shareholders passed an ordinary resolution directing the directors to sell company property. The directors refused to do so.

Key Law

The general meeting has no power to interfere with the management of the company by the directors by simply passing an ordinary resolution.

Key Comment

This case represents the majority view of the relationship between the directors and the general meeting.

8.5.1 *Breckland Group Holdings Ltd v London & Suffolk Properties Ltd* [1989] BCLC 100 HC

Key Facts

The claimant was a 49 per cent shareholder in London & Suffolk. The other 51 per cent shareholder commenced litigation in the name of the company. The claimant alleged that this was in breach of a shareholders' agreement between them under which litigation required the consent of a director appointed by each of them. It was also argued that it was in breach of Art 80, Table A 1948 [Now Art 3, Model Articles for Private Companies Limited by Shares]. Under this article the appropriate organ to commence litigation in the name of the company is the board of directors.

Key Law

Based on Art 80 and the shareholders' agreement, the action was improperly commenced. Article 80 gave the powers of management to the board and the general meeting is not competent to interfere with matters which have been properly entrusted to the board.

8.5.1 *Mitchell & Hobbs (UK) Ltd v Mill* [1996] 2 BCLC 102 QBD

Key Facts

The company had articles in the form of Table A 1985 and Art 70 gave the powers of management to the board of directors. The managing director, who was also a 66 per cent shareholder, commenced litigation in the name of the company.

Key Law

The action was struck out as no board meeting had been held to authorise the proceedings. Simply being the managing director and majority shareholder was not enough.

Key Comment

If the managing director had been a 75 per cent shareholder he could under Art 70 have passed a special resolution to direct the directors to commence litigation. The same would now be true under Art 4(1) of the Model Articles for Public and Private Companies Limited by Shares.

Key Link

In *Smith v Butler* (2012), a managing director who held 31.2 per cent of the shares was held to have no implied actual authority to 'suspend' from office the chairman who held 68.8 per cent of the shares.

8.5.1 *Marshall's Valve Gear Co Ltd v Manning, Wardle & Co Ltd* [1909] 1 Ch 267 ChD

Key Facts

A majority shareholder, who was also the managing director, commenced an action in the name of the company when the board of directors refused to do so. He alleged that the defendant company, in which the other directors were interested, had breached the company's patent. The directors sought to have the action struck out on the basis that the decision to litigate was a management decision and not for the shareholders to decide.

Key Law

The directors' claim failed. Where the directors failed to take legal action to protect the company's interest the general meeting may do so.

Key Comment

This case represents a minority view and was impliedly, if not expressly, overruled by Harman J in *Breckland Group Holdings Ltd v London & Suffolk Properties Ltd* (1989) above.

8.5.2 *Barron v Potter* [1914] 1 Ch 895 HC

Key Facts

P and B were the only two directors of the company. B refused to attend board meetings to appoint additional directors. P tried to hold an informal directors' meeting, once on the platform on Paddington Station as B got off a train, and again the next day when he attended the company's offices. At these 'meetings' P proposed and voted on the appointment of additional directors and this was carried by P using his casting vote. The appointments were then ratified by the general meeting.

Key Law

There was no meeting of the directors as a casual meeting at the station and at the office could not be converted into a board meeting against the will of one of the parties. The appointment of the directors by the general meeting was valid, however, because when a board is deadlocked the powers of management revert back to the general meeting.

9

Directors

DIRECTORS

Types

- Executive and non-executive directors
- Managing Director (Chief Executive)
- The Chairman
- *De jure*, *de facto* and shadow directors
- Uncertainty over what duties are owed by a shadow director: *Ultraframe (UK) Ltd v Fielding* (2005); *Vivendi (SA) v Richards* (2013)

Appointment

- first directors appointed by subscribers to memorandum
- subsequent appointment in accordance with company's articles of association
- s 157 – a director must be at least 16 years of age

May be subject to disqualification

- Company Directors Disqualification Act 1986
- Undischarged bankrupts

Contracts of service

- Directors are not automatically employees
- Terms of contract must be available for inspection by members: s 228
- Terms of office longer than two years need approval from members: s 188

Termination of office

- Retirement – by rotation
- Resignation
- Removal from office: s 168
- Protection from removal by weighted votes: *Bushell v Faith* (1970)

9.1 Introduction

1 A company is an artificial person and as such can only act through agents.

2 Under s 154 of the Companies Act 2006 (CA 2006) every private company must have at least one director and a public company must have two. Every company must have at least one director that is a natural person; a corporate director cannot be the sole director.

3 There is no definition of a director, but s 250 CA 2006 provides that 'director' means any person carrying out the role of director, by whatever term described, and includes a 'shadow director'. See below 9.2.4 on shadow directors.

4 The Act does not require companies to be managed by the directors, but Art 3 of the model articles for both public companies and private companies limited by shares provide that 'subject to the articles, the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company'.
5 Every company must keep a register of directors and, where relevant, company secretary at its registered office and must notify the Registrar of Companies of any changes within 14 days.
6 The UK Corporate Governance Code (2012) requires that: 'Every company should be headed by an effective board [of directors] which is collectively responsible for the long-term success of the company.'

9.2 Types of director

9.2.1 Executive and non-executive directors

1 An executive director has a management or executive function within the company, for example as the Finance Director. They will normally be full-time employees with a contract of employment.
2 Non-executive directors (NEDs) are appointed to the boards of larger companies.
3 The NEDs are usually part time and will be paid a fee as an independent contractor rather than as an employee. They may typically hold other directorships and in the case of listed public companies may be public figures, such as former members of the government.
4 The role of an NED is, essentially, to provide an independent view to the board of directors on matters of strategy, performance and remuneration of executive directors.
5 The UK Corporate Governance Code (2012) provides that for FTSE 350 companies, the board should consist of at least half NEDs, excluding the chairman. It is rare to find NEDs in private companies.

9.2.2 Managing Director

1. The managing director (MD) is also known as the chief executive officer (CEO).
2. They are responsible for the day-to-day management of the company but their exact role will depend on the articles of association and their contract of employment.

9.2.3 Chairman

Larger companies will also formally appoint a chairman, who will chair directors' and shareholders' meetings. The UK Corporate Governance Code (2012) provides that:

- the roles of chairman and CEO should not be exercised by the same person;
- the chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of the role;
- the chairman is responsible for setting the board's agenda and ensuring that adequate time is available for discussing all agenda items.

9.2.4 *De jure, de facto* and shadow directors

1. A *de jure* director is one who has been properly appointed and satisfies all the legal requirements to be a director.
2. A *de facto* director is one who has not been properly appointed but who acts as a director: ***Revenue and Customs Commissioners v Holland* (2010)**.
3. *De jure* and *de facto* directors owe the full range of directors duties.
4. A shadow director is 'a person in accordance with whose directions or instructions the directors of a company are accustomed to act' (s 251(1)

CA 2006). They do not want to be considered as directors (they may have been disqualified, for example) and are usually said to ‘lurk in the shadows’: ***Re Hydrodam (Corby) Ltd* (1994)**; ***Secretary of State for Trade and Industry v Deverell* (2000)**.

5 The extent to which shadow directors owe duties to the company is unclear. In *Ultraframe (UK) Ltd v Fielding* (2005) the court felt that shadow directors do not normally owe duties to the company but in ***Vivendi SA v Richards* (2013)** it was said that they should owe duties, ‘at least to some degree’.

9.3 Appointment

1 Provisions relating to the appointment of directors, maximum and minimum numbers, quoracy, whether the chairman has a casting vote and similar matters will be included in the company’s articles of association.

2 The CA 2006 introduced a new minimum age provision. Under s 157 a director must be at least 16 years of age on taking office. Under s 159 any existing director under 16 ceased to be a director when s 157 came into force.

3 If a company has appointed a sole director, that person cannot also be the company secretary.

9.3.1 Who appoints directors?

1 Under s 9(4)(c) CA 2006 the first directors are appointed by a statement in the prescribed form signed by the subscribers to the memorandum. The statement must also be signed by the directors to show that they consent to act in that capacity: s 12(3).

2 Subsequent directors are appointed by members by ordinary resolution: *Woolf v East Nigel Gold Mining Co Ltd* (1905).

3 Section 160 provides that in the case of a public company every director

must be voted on individually unless it is agreed at the meeting, without anyone voting against the resolution, that the vote should be composite.

4 A company's articles of association may contain provisions for the appointment of directors. The model articles for private companies limited by shares (Art 17(1)) and public companies (Art 20) provide that directors may be appointed:

- by ordinary resolution; or
- by decision of the directors.

5 Section 161 provides that the acts of a director are valid even if there is a defect in his or her appointment or qualification. However, this section does not apply when there has been no appointment at all: *Morris v Kanssen* (1946) (see Chapter 4, key cases, section 4.5.2).

9.4 Termination of office

9.4.1 Retirement and resignation

1 Model articles for public companies, Art 21 provides:

- all directors must retire at the first AGM, but may seek reappointment;
- one third of directors must retire by rotation each year, but may seek reappointment.

2 A director may resign by giving notice to the company, which the company must accept. The articles may stipulate certain requirements, for example that notice must be in writing.

9.4.2 Removal from office

1 Directors (either individually or as a board) may be removed by the shareholders by ordinary resolution: s 168 CA 2006.

2 Conditions for removal are:

- special notice must be given of a resolution to remove directors (s 168(2));
- a copy must be supplied to the director who is the subject of the resolution;
- note that in any company a resolution to remove a director before his term ends must be taken at a meeting;
- the director is entitled to make representations in writing (which must be circulated to every member) and he is entitled to be heard at the meeting;
- removal under s 168 does not deprive the director of any claim for compensation or damages payable in respect of loss of office.

3 The shareholders' right to remove directors as set out in s 168 applies notwithstanding any agreement between the director and the company. However, the articles can validly contain a weighted-votes clause in favour of the shareholder/director whom it is proposed to remove and this can effectively prevent the removal of a director in a small private company: ***Bushell v Faith* (1969)**.

4 The practical consequences of removal of a director under s 168 are possible claims for:

- a claim for damages if there is a breach of an extrinsic service contract: *Southern Foundries (1926) Ltd v Shirlaw* (1940) (see Chapter 3, section 3.5.1);
- a claim for just and equitable winding up under s 122(1)(g) Insolvency Act 1986: *Ebrahimi v Westbourne Galleries Ltd* (1973) (see Chapter 11, section 11.5.2);

- A claim for unfairly prejudicial conduct under s 994 CA 2006: *Re A Company* (1986) (see Chapter 3, key cases, section 3.5.1; Chapter 11, key cases, sections 11.4.2 and 11.6.2).

9.4.3 Disqualification

1 A court may make a disqualification order against a person from acting as a director, receiver, insolvency practitioner or in any way, directly or indirectly, being concerned in the promotion, formation or management of a company.

2 Under the Company Directors Disqualification Act 1986 a person may be disqualified:

- for general misconduct in connection with companies (ss 2–5);
- for unfitness (ss 6–9);
- in other cases such as wrongful trading (ss 10–11).

3 The policy behind the Act is one of public protection: *Re Lo-Line Electric Motors Ltd* (1988).

4 The most common ground of disqualification is for unfitness under s 6 which requires the Secretary of State to show:

- the person has been a director of an insolvent company;
- the person's conduct as a director makes him unfit to be concerned with the management of a company: ***Re Sevenoaks Stationers (Retail) Ltd*** **(1990)**.

5 Under s 6, if the director is found to be unfit he must be disqualified for between two and fifteen years. There are guidelines on what the court can

take into account to determine unfitness in Schedule 1 of the Act.

6 Instead of a court order, the Secretary of State can, under s 1A, accept a disqualification undertaking by a person that he will not act as a director, thus saving the time and costs of a hearing.

7 Following a disqualification order or undertaking the court can grant leave to a director to act under s 17: ***Re Majestic Recording Studios Ltd* (1989)**.

8 It is a criminal offence to act in breach of an order (s 13) and also to act whilst an undischarged bankrupt without leave of the court (s 11). Liability under s 11 is strict: *R v Brockley* (1994).

9 Under s 15, acting whilst disqualified or an undischarged bankrupt makes the person jointly and severably liable with the company for the company's debts.

9.5 Remuneration

1 Directors are not entitled to remuneration unless this is provided for in the constitution: *Hutton v West Cork Railway Co* (1883).

2 Provision is usually made in the articles to pay directors: model articles for private companies limited by shares in Art 19, and for public companies in Art 23.

3 Where the articles provide for remuneration of directors to be fixed by the board, a *committee* of the board has no authority to award remuneration: ***Guinness v Saunders* (1990)**.

9.6 Directors as employees

1 Directors are not automatically employees of their companies. A director (especially an executive director) may have a separate contract of service with the company.

2 Whether a director is an employee or not is a question of fact: *Secretary of*

State for Trade and Industry v Bottrill (1999).

3 A copy of every director's service contract or a memorandum setting out the terms of the contract of service must be available for inspection by members (s 228).

4 A term in a director's contract which provides that the director shall be employed for more than two years which cannot be terminated by notice by the company must be approved by resolution of the members (s 188).

5 The UK Corporate Governance Code (2012) states that 'Notice or contract periods should be set at one year or less.'

Key Cases Checklist

Directors

Types of Director

Re Hydrodan (Corby) Ltd (1994)
De jure, de facto and shadow directors distinguished
Secretary of State for Trade and Industry v Deverell (2000)
Further guidance given by the court on shadow directors
Revenue and Custom Commissioners v Holland (2010)
A director of a corporate director of the company was not a *de facto* director of the company as all he had done was discharge his duties as the director of the corporate director
Vivendi SA v Richards (2013)
A shadow director owes duties in relation to the directions and instructions he gives to the board

Removal

Bushell v Faith (1970)
Weighted voting on a resolution to remove a director under s 168 CA 2006 is permitted and can effectively prevent removal

Disqualification

Re Sevenoaks Stationers (Retail) Ltd (1990)
The court divided the disqualification period for unfitness (2–15 years) into three brackets depending on the seriousness of the case
Re Majestic Recording Studios Ltd (1989)
Court gave leave to a disqualified director to act under s 17 CDDA 1986

Remuneration

Guinness plc v Saunders (1990)
A committee of the board had no authority to award remuneration to a director

9.2.4 *Revenue and Custom Commissioners v Hollandyy* [2010] UKSC 51; [2010] 1 WLR 2793 SC

Key Facts

Forty-two subsidiary companies were formed as part of a plan to reduce tax liability. Each company had a sole director, PS Ltd (as permitted at that time), whose own *de jure* director was Holland (H). Each subsidiary company, acting through PS Ltd, declared unlawful dividends and were all now in liquidation. The Commissioners argued that H was a *de facto* director of the companies and was therefore liable for the amount of the improperly paid dividends.

Key Law

By a three-to-two majority, the Supreme Court held that H was not a *de facto* director. H had not assumed the duties of a director in the subsidiary companies; all he had done was discharge his duties as the director of the corporate director (PS Ltd) of the subsidiary companies.

Key Comment

The minority thought it was 'artificial and wrong' to say that H was doing no more than discharging his duties as a *de jure* director of the corporate director.

9.2.4 *Re Hydrodan (Corby) Ltd* [1994] 2 BCLC 180 CH

Key Facts

H Ltd had two corporate directors whose own directors included T and H. In wrongful trading proceedings against T and H, the liquidator argued that they were either *de facto* or shadow directors of H Ltd.

Key Law

The liquidator did not establish any evidence that they were directors. Just because H Ltd had corporate directors it did not follow that their own directors (T and H) were shadow directors of H Ltd. *De facto* and shadow directors do not overlap; they are alternatives and are mutually exclusive.

Key Judgment

Millett J

'Directors may be of three kinds: de jure directors, that is to say, those whose have been validly appointed to the office; de facto directors, that is to say those who assume to act as directors without having been appointed validly or at all; and shadow directors who are persons falling within the definition [in s 251 IA 1986]'.

9.2.4 *Secretary of State for Trade and Industry v Deverell* [2000] 2 BCLC 133 CA

Key Facts

In disqualification proceedings, Deverell (D) and Hopkins (H) argued that they gave advice to the company as 'consultants'. The Secretary of State alleged they were shadow directors.

Key Law

They were shadow directors. On the facts D was concerned at the most senior level and with most aspects of the company's affairs. H's involvement went far beyond that of a consultant and he was a signatory to the company's bank account.

Key Judgment

Morritt LJ gave further guidance on a shadow director as follows:

'Such directions and instructions do not have to extend over all or most of the corporate activities of the company; nor is it necessary to demonstrate a degree of compulsion in excess of that implicit in the fact that the board are accustomed to act in accordance with them. Further, in my view, it is not necessary to the recognition of a shadow director that he should lurk in the shadows, though he frequently may.'

9.2.4 *Vivendi SA v Richards* [2013] EWHC 3006; [2013] BCC 771 CH

Key Facts

Nine payments totalling £10 million were made by a company that later went into liquidation. It was alleged that the payments were made in breach of duty by the *de jure* director, B, who acted on the instructions of R.

Key Law

There was a breach of duty by B and also by R in his capacity as a shadow director. R was liable to account for the money on the basis that he had dishonestly assisted B in his breach of duty.

Key Judgment

On shadow directors and duties **Newey J** said:

'A shadow director would typically owe such duties in relation to at least to the directions or instructions that he gave to the *de jure* directors. More particularly, a shadow director would normally owe a fiduciary duty of good faith (loyalty) and could reasonably be expected to act in the company's interests rather than his own separate interests when giving those directions and instructions.'

Key Problem

The exact scope of the duties owed by a shadow director remains unclear. One solution would be to add them to the definition of 'director' in s 250 CA 2006.

9.4.2 *Bushell v Faith* [1970] AC 1099 HL

Key Facts

F together with his two sisters, B and DB, were equal shareholders in a company. The two sisters called a general meeting of the company and removed F as a director under s 184 CA 1948 [s 168 CA 2006] by passing an ordinary resolution. The articles of the company gave a director, whom it was proposed to remove by ordinary resolution, three votes per share. F relied on this provision but the sisters argued that it was void as it defeated the object and purpose of s 184.

Key Law

The weighted vote provision did not infringe s 184 [s 168]. The section was intended to allow an ordinary resolution to be sufficient to remove a director but the company was free to allocate voting rights as it pleased. If it had been intended to prohibit such weighted voting then Parliament could have said so in the wording.

Key Comment

Lord Morris of Borth-y-Gest dissented, thinking that the weighted voting provisions ‘make a mockery of the law’.

9.4.3 *Re Sevenoaks Stationers (Retail) Ltd* [1990] 3 WLR 1165 CA

Key Facts

C was in his forties and a former merchant banker. In addition he had an MBA from Harvard and was a member of the Institute of Chartered Accountants. He was a director of five companies, all of which went into insolvent liquidation between 1983 and 1986. The debts totalled £559,000, of which £116,000 represented Crown debts. The judge disqualified him for seven years. He admitted he was unfit to be a director under s 1 CDDA 1986 but appealed against the length of the order.

Key Law

- Although he was not dishonest, C was incompetent to a very marked degree.
- The non-payment of Crown debts was not automatic evidence of unfitness; the effect of non-payment has to be considered in each case.
- The failure to produce accounts in relation to one of the companies was serious but there was no element of 'ripping off' members of the public and he had lost £200,000 to £250,000 of his own money.
- In these circumstances the length of the disqualification order was reduced to five years.

Key Judgment

The disqualification period under s 6 CDDA 1986 for unfitness is between two and fifteen years. Dillon LJ split this into three brackets:

> '(i) The top bracket of disqualification for periods of over 10 years should be reserved for particularly serious cases. These may include where a director who has already had one period of disqualification imposed on him falls to be disqualified yet again.
> (ii) The minimum period of two to five years' disqualification should be applied where . . . the case is, relatively, not very serious.
> (iii) The middle bracket of . . . six to 10 years should apply for serious cases which do not merit the top bracket.

9.4.3 *Re Majestic Recording Studios Ltd* [1989] BCLC 1 CH

Key Facts

A director was disqualified for five years after five companies which he managed went into liquidation owing £650,000. He applied for leave to act under s 17 CDDA 1986 in respect of one of the companies.

Key Law

Leave was granted. The court took into account that the director was the 'moving spirit' behind the company and that 55 jobs would be at risk if leave to act were denied. It was, however, conditional on the appointment to the board of an independent chartered accountant approved by the court and the auditing of the previous year's accounts.

9.5 *Guinness plc v Saunders* [1990] 2 AC 663 HL

Key Facts

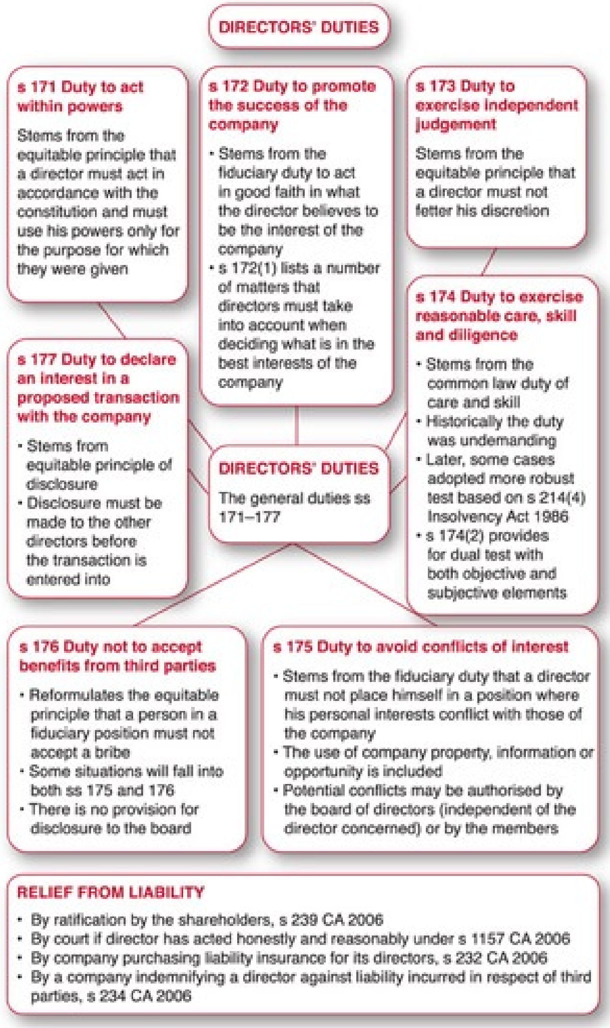
W was a director of Guinness when it launched a takeover bid for Distillers plc. W and two other directors formed a committee of the board to conduct the bid. Following the takeover, W received £5.2m for his services in connection with the bid. Guinness sought repayment. W denied breach of duty but in any event asked the court to excuse him on the ground he acted honestly and reasonably under s 727 CA 1985 [s 1157 CA 2006].

Key Law

W received the money in breach of duty and had to account for it. The company's articles, properly construed, did not entitle W to the money as it was not authorised by the board, only a committee. The claim under s 727 [s 1157] failed.

10

Directors' duties



10.1 Introduction

1 One of the most significant changes made by the Companies Act 2006 (CA 2006) is the codification of the duties owed to a company by its directors. Previously, the law on directors' duties was perceived as a complex web of common law, fiduciary and statutory rules and principles, some of which overlapped and which were sometimes not entirely consistent with one another.

2 The reform of the law was the subject of extensive review and consultation by the Law Commission and the Company Law Review

Steering Group.

3 The general duties of directors are set out in Part 10, Chapter 2 CA 2006. In *Modern Company Law for a Competitive Economy: Final Report*, a legislative statement of directors' duties was recommended in order to:

- achieve clarity and accessibility of the law;
- correct perceived defects in the law, particularly relating to conflicts of interest and;
- address the question of the 'scope' of directors' duties.

4 The Act sets out seven general duties in ss 171–177. These are based on the equitable principles arising from the fiduciary relationship between a director and his or her company and on the common law of negligence.

Section 171	Duty to act within powers
Section 172	Duty to promote the success of the company for the benefit of its members as a whole
Section 173	Duty to exercise independent judgement
Section 174	Duty to exercise reasonable care, skill and diligence
Section 175	Duty to avoid conflicts of interest
Section 176	Duty not to accept benefits from third parties
Section 177	Duty to declare any interest in proposed transactions

5 It is well established that directors owe duties to the company, not to individual shareholders or to shareholders collectively: ***Percival v Wright* (1902)**; ***Allen v Hyatt* (1914)**; ***Peskin v Anderson* (2001)**. The Act now provides, under s 170(1), that 'The general duties specified in sections 171 to 177 are owed by a director of a company to the company.' It follows that these duties can be enforced by the company only, but note the new statutory derivative claim in Part 11 CA 2006: see Chapter 11

below.

6 Because of their position, directors owe a duty of loyalty to their company and it is this duty that underpins the fiduciary duties set out in the Act. These duties are owed by directors and *de facto* directors. A *de facto* director is a person who assumes the role of director and is held out as a director, but has never actually been appointed. It is not clear whether shadow directors owe a duty of loyalty to the company: *Ultraframe (UK) v Fielding* (2005); *Vivendi SA v Richards* (2013); and it is likely that the courts will decide each case on its own facts. See Chapter 9, section 9.2.4.

7 Section 178 provides that the consequences of breach of the general duties set out in ss 171–177 are the same as would apply if the corresponding common law rule or equitable principle applied.

8 The statutory duties of disclosure previously contained in Part X CA 1985 have been re-enacted in Part 10 Chapter 4 CA 2006.

10.2 The general duties

1 Section 170(4) CA 2006 provides: 'The general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties.' Thus the case law developed prior to the CA 2006 continues to be relevant.

2 This is intended to strike a balance between predictability of statute and the ability of the courts to develop principles through the doctrine of judicial precedent.

10.2.1 Duty to act within powers

1 Directors must act in accordance with the company's constitution and must only exercise their powers for purposes for which they are conferred: s 171.

2 The articles of association may limit the powers of directors. If a company

has restricted objects its directors must not act outside those objects.

3 If powers are given to directors for a particular purpose they must not be used for some other purpose: ***Extrasure Travel Insurances Ltd v Scattergood* (2003)**; and directors must not use their powers to further their own personal interests: *Lee Panavision Ltd v Lee Lighting Ltd* (1992).

4 A misuse of power will be a breach of duty even if the directors are acting in what they believe to be the best interests of the company.

5 A number of cases involve the allotment of shares. It is a breach of duty to allot shares to avoid a takeover: ***Hogg v Cramphorn Ltd* (1967)**; or to alter the weight of shareholder votes to influence the outcome of a takeover bid: ***Howard Smith Ltd v Ampol Petroleum Ltd* (1974)**.

6 It will sometimes be arguable that the act in question was carried out to achieve more than one purpose, only one of which may be a misuse of power. For example, in ***Howard Smith Ltd v Ampol Petroleum Ltd*** shares were allotted not only to alter the balance of voting power to avoid a takeover, but also to raise capital (a valid reason for the allotment of shares). In this kind of situation the courts will decide whether the improper purpose was the main or dominant purpose. In this case it was held that it was and the directors were in breach of their duty.

7 Acts in breach of the proper purpose rule can be ratified by shareholders: ***Hogg v Cramphorn Ltd* (1967)**.

10.2.2 Duty to promote the success of the company

1 This stems from the equitable principle that directors must act *bona fide* in what they consider to be the best interests of the company as a whole: ***Re Smith & Fawcett Ltd* (1942)**; and see ***Item Software (UK) Ltd v Fassihi* (2004)**.

2 Section 172(1) provides: 'A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole . . .'

3 The duty is subjective. The question is whether the directors honestly believed that their act or omission was in the best interest of the company

at the time the decision was made. The court will not seek to make its own commercial judgment but will consider all the evidence to determine what the directors believed; see *Regentcrest v Cohen* (2001); ***Item Software (UK) Ltd v Fassihi* (2004)**.

4 Whether directors should consider wider constituencies (or stakeholders) than the company and its shareholders in managing the company has long been a question for discussion by commentators. Now s 172(1) lists a number of matters that the directors must consider in making decisions:

(a) the likely consequences of the decision in the long term;
(b) the interests of the company's employees;
(c) the need to foster the company's business relationships with suppliers, customers and others;
(d) the impact of the company's operations on the community and the environment;
(e) the desirability of the company maintaining a reputation for high standards of business conduct;
(f) the need to act fairly as between members of the company.

5 The section makes it clear that directors must act not only in the interests of the company as a separate entity, but must consider also the benefit of its members as a body. Furthermore, the list above is intended to ensure that the interests of other factors are taken into account as well in the board's decision-making.

6 Section 172(1)(b) replaces s 309 CA 1985, which provided that the directors must have regard to 'the interests of the Company's employees in general as well as the interests of members': ***Re Welfab Engineers Ltd* (1990)**.

7 Creditors are not specifically included above. However, s 172(3) provides that the duty imposed by s 172 is subject to any enactment or rule of law to consider the interests of creditors in certain circumstances. In general, directors do not owe duties to the company's creditors, but if a company is insolvent it has been held that directors must have regard to the interest of creditors: ***Liquidator of West Mercia Safetywear Ltd v Dodd***

(1988); *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd* (2002).

8 In *GHLM trading Ltd v Maroo* (2012), Newey J said: 'If a director acts to advance the interests of a particular creditor, without believing the action to be in the interests of creditors as a class, it seems to me that he will commit a breach of duty.'

9 Although the duties owed under s 172 are generally subjective, objective elements are sometimes relevant: ***HLC Environment Projects Ltd* (2013)**.

10.2.3 Duty to exercise independent judgement

1 Section 173 provides that directors have a duty to exercise independent judgement and not to fetter their discretion. This may be considered part of their general duty to act *bona fida* and to promote the success of the company. However, it is well established that directors must not bind themselves to act in a particular way regardless of whether it would be in the best interests of the company. However, it is not a breach of duty for directors to enter into a binding contract which may have the effect of fettering their discretion at a later date, if they believe the agreement to be in the best interests of the company at the time that the agreement is made: ***Fulham Football Club v Cabra Estates plc* (1994)**; *Dawsons International plc v Coats Patons plc* (1989).

2 Another situation where the duty to exercise independent judgement might arise is where a director is nominated by an 'outsider', for example by a holding company to sit on the board of a subsidiary. In such cases it has been held that the primary duty of the nominee is to the company of which he is a director, but that he may take account of the interests of the 'outsider' as long as this is not incompatible with his primary duty: *Re Neath Rugby Ltd* (2008).

10.2.4 Duty to exercise reasonable care, skill and diligence

1 Directors owe a duty of competence to the company, but historically the standard of care expected of them has been undemanding: *Re Brazilian Rubber Plantations and Estates Ltd (1911)*. Reasons for this approach included:

- directors were sometimes appointed more because of their social standing than because they had particular skills or qualifications;
- the courts did not wish to deter people from becoming company directors by imposing onerous duties of care and skill.

2 This duty was categorised into three propositions by Romer J in ***Re City Equitable Fire Insurance Co* (1925)**:

(a) A director was expected to show a degree of care and skill as may reasonably be expected from a person of his/her knowledge and experience. Note that the standard of care test was expressed in subjective terms, so a director was only expected to act with the degree of care and skill which he or she happened to possess and was not expected to have any particular qualifications or any experience of the company's area of business.

(b) A director is not bound to give continuous attention to the affairs of the company: *Re Cardiff Savings Bank* (1892).

(c) Subject to normal business practice, directors may leave routine conduct of business affairs in the hands of management.

3 In later cases the courts have adopted a more robust approach: *Dorchester Finance v Stebbing* (1989); *Norman v Theodore Goddard* (1991); ***Re d'Jan of London Ltd* (1994)**; *Re Simmon Box (Diamonds) Ltd* (2000) and *Base Metal Trading Ltd v Shamurin* (2004).

4 The test that was applied in these more recent cases had an objective element, based on s 214(4) Insolvency Act (IA) 1986:

- the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company; and
- the general knowledge, skill and experience that that director has.

5 In *Barings plc (No 5)* (2000) negligence on the part of company directors was considered in the context of an application for disqualification under the Company Directors Disqualification Act 1986. It was held that:

- directors have an obligation to acquire enough knowledge and understanding of the company's business to enable them to discharge their duties properly;
- they may, subject to any restriction in the articles, delegate certain functions to others, but this does not absolve them from a duty to exercise proper supervision (see also *Re Queens Moat Houses plc (No 2)* (2005));
- the extent of this duty will depend on the facts of the particular case.

6 Development of the law has been influenced by a number of factors including:

(a) There is an expectation of a more professional approach to company directorship than existed in the first half of the twentieth century, for example that directors should pay proper attention to the management of the company, and if as part of the role they have a duty to perform a particular action they will be in breach for failing to do so: ***Lexi Holdings Ltd plc v Luqman* (2009)**. However, a director who takes and acts upon appropriate legal advice will not be negligent: *Green v Walkling* (2007).

(b) It is usual now to appoint appropriately qualified people to designated executive directorships, for example finance director.

(c) Contracts of service for executive directors may contain clauses relating to care and skill, which may help to define the scope of the director's duty of care and skill.

7 However, it must be recognised that investing in a company carries some risk, managers may not be of the highest calibre and not every error of judgement will amount to negligence: *Re Elgindata Ltd* (1991).

8 Section 174 codifies the law by providing that a company director must exercise reasonable care, skill and diligence.

- Under s 174(2) the dual test, as set out in s 214 IA 1986, with both objective and subjective elements, must be applied in deciding whether a director is in breach of this duty.
- The standard of care, skill and diligence is defined as that which would be exercised by a reasonably diligent person with:

  (a) 'the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and

  (b) the general knowledge, skill and experience that the director has'.

10.2.5 Duty to avoid conflicts of interest

1 Directors owe a duty of loyalty to their company: see ***Item Software (UK) Ltd v Fassihi* (2004)**, where Arden LJ emphasised the 'fundamental nature of the duty of loyalty'.

2 Section 175(1) CA 2006 provides: 'A director of a company must avoid a

situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company.' The duty does not apply to a conflict arising from a transaction or arrangement with the company itself: s 175(3).

3 The section is a statutory statement of the well-established equitable principle stated in ***Aberdeen Railway Company v Blaikie Bros* (1854)**: 'it is a rule of universal application that no one, having such (fiduciary) duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect.'

4 Section 175(2) brings the exploitation of any property, information or opportunity within the section and makes it clear that it is immaterial whether or not the company could take advantage of the property, information or opportunity: ***Regal Hastings Ltd v Gulliver* (1942)**.

5 A number of cases deal with exploitation by a director of a corporate opportunity. A corporate opportunity is regarded as a corporate asset, which directors may not use for their own benefit. This applies even if it would be impossible for the company itself to make use of the opportunity: ***Industrial Development Consultants Ltd v Cooley* (1972)**.

6 Furthermore, a director may still be in breach of fiduciary duties in circumstances where he or she resigns to take up the opportunity: *CMS Dolphin Ltd v Simonet* (2001); ***Bhullar v Bhullar* (2003)**; *Foster Bryant Surveying Ltd v Bryant* (2007). In *Bhullar* Jonathan Parker LJ said that the no-profit and no-conflict rules are universal and inflexible, and s 170(2)(a) now provides that a person who ceases to be a director continues to be subject 'to the duty in s 175 (duty to avoid conflicts of interest) as regards the exploitation of any property, information or opportunity of which he became aware at the time when he was a director'.

7 However, much will depend on the nature of the corporate opportunity and the timing of taking it up; for example in ***Island Export Finance Ltd v Umunna* (1986)**, the court found in favour of the director. There are difficult judgements to be made between the duty not to exploit an opportunity on the one hand and the right of a director to take up

opportunities after he or she has left the company on the other, and each case will be decided on its own facts.

8 There are a number of other instances that would fall within s 175, for example a director must not compete with his or her company: *Hivac v Park Royal (1946)*. Problems may also arise when a person holds directorships in competing companies: ***Plus Group Ltd v Pyke* (2002)**; and see now also s 175(7).

9 It has long been recognised that a director may enter into a transaction in which he or she has a conflict of interest if he or she has the informed consent of shareholders in general meeting. In practice, articles of association often allow for disclosure to the board of directors instead. Under CA 2006, authorisation by the directors is now the default position in the case of a private company and in the case of a public company is sufficient if the constitution so provides: s 175(4) and (5).

10 Under s 175(4) this duty is not broken if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest. The court applied a strict approach in ***O'Donnell v Shanahan* (2009)** but ***Wilkinson v West Coast Capital* (2007)** is a rare finding of there being no possible conflict. Both cases pre-date the CA 2006.

11 Authority of the board is effective only if the decision of the board is made independently of the director or directors in question (s 175(6)). Furthermore, the function of receiving disclosures cannot be delegated to a committee of the board: *Guinness plc v Saunders (1990)*. See Chapter 9.

12 The consequences of breach of the duty to avoid conflict of interest are:

- a contract entered into in breach of the duty is voidable at the option of the company, subject to the rights of *bona fide* third parties, undue delays in rescinding the contract and affirmation of the contract by the company;
- the director must account for any gains.

10.2.6 Duty not to accept benefits from third parties

1 Section 176(1) provides that a director of a company must not accept a benefit from a third party conferred by reason of his being a director or his doing (or not doing) anything as director.

2 The general duty set out in s 176 is an aspect of the no-conflict principle. The section reformulates the principle of equity that a person in a fiduciary position must not accept a bribe: ***Boston Deep Sea Fishing & Ice Co Ltd v Ansell* (1888)**. A benefit may take any form, financial or non-financial. However, s 176(4) provides that the duty is not infringed if acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.

3 There is some overlap between ss 175 and 176, and some situations will fall within both. An important difference between the two sections is that s 176 does not provide for disclosure to and authorisation by the board of directors and it seems that the acceptance of benefits can only be authorised by the members.

10.2.7 Duty to declare an interest in a proposed transaction with the company

1 Under s 177 a director must declare to the other directors the nature and extent of any interest he may have in a proposed transaction or arrangement with the company, whether his interest is direct or indirect: ***Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald* (1996)**.

2 The section covers proposed transactions, and disclosure must be made before the transaction is entered into by the company: s 177(4). Declarations of interest in existing transactions or arrangements are covered by the provisions in ss 182–187.

3 The disclosure under s 177 may be made by written notice, general notice or statement at a meeting of directors: s 177(2).

10.3 Other statutory provisions regarding directors'

interests

Companies Act 2006 Part 10 Chapter 4	Transactions with directors requiring approval of members
Section 188	Directors' service contracts where the guaranteed term of employment is or may be longer than two years
Sections 190–196	Directors' contracts with the company where the director acquires a substantial non-cash asset from the company or where the company acquires a substantial non-cash asset from the director
Sections 197–214	Loans to directors
Sections 215–222	Payments for loss of office

10.3.1 Directors' service contracts

1. The consent of members is required if a director's service contract includes a guaranteed term of employment of more than two years: s 188 CA 2006.
2. Section 189 provides that if the requirements set out in s 188 are breached the service contract is deemed to contain a term allowing the company to terminate it at any time by reasonable notice.

10.3.2 Substantial property transactions

1. Contracts between directors and the company itself fall outside the scope of s 177 discussed above.
2. Under ss 190–196 contracts under which a director or a connected person acquires a substantial non-cash asset from a company or its holding company require the approval of members. The same applies if a company or holding company acquires a substantial non-cash asset from a director or connected person: ***Dukwari plc v Offerventure Ltd (No 2)***

(1999).

3 A substantial asset is defined as one which:

- exceeds 10 per cent of the company's asset value and is more than £5,000; or
- exceeds £100,000.

4 Exceptions are set out in ss 192–194.

5 Section 195 provides that a contract made in contravention of these requirements may be avoided by the company, and the director or connected person is liable to account to the company for any gain and to indemnify the company for any loss or damage resulting from the transaction.

6 Under s 196 it is provided that if within a reasonable period a transaction which was not approved is affirmed by members it will no longer be voidable.

10.3.3 Loans to directors: ss 197–214

1 Previously loans to directors were prohibited: s 330 CA 1985. Now, under s 197(1) and (2) CA 2006 a company may not make a loan, give a guarantee or provide security in connection with a loan to a director or a director of its holding company unless the transaction has been approved by a resolution of members: ***Neville v Krikorian*** **(2006)**.

2 A memorandum setting out the nature of the transaction, the amount of the loan and the purpose for which it is required and the extent of the company's liability under the transaction must be made available to all members.

3 For public companies there are more extensive provisions relating to quasi-loans (defined in s 199), loans and quasi-loans to persons connected with directors (ss 198–200) and credit transactions (s 201).

4 Any transaction which contravenes these provisions (to which there are

exceptions) is voidable at the instance of the company (s 213), unless:

- restitution is no longer possible;
- the company has been indemnified for any loss or damage resulting from the transaction;
- rights acquired by a third party in good faith, for value and without actual notice of the contravention would be affected by the avoidance.

5 Under s 214 such breach can be affirmed by members.

10.3.4 Ratifying a breach of duty

1 Under s 239 the members can ratify conduct by a director amounting to 'negligence, breach of duty or breach of trust in relation to the company': ***North-West Transportation Co v Beatty* (1877)**.

2 If the director is also a member, neither their votes nor any member connected with them can be included in the resolution.

10.3.5 Exemption from liability

1 Any attempt to exempt a director from liability for breach of duty by a provision in the articles or other document is void: s 232 CA 2006.

2 By virtue of s 234 a company can insure its directors against liability incurred to a person other than the company for breach of duty, but not for liability to pay a fine in criminal proceedings.

3 Section 235 provides for pension scheme indemnity whereby a director may be indemnified against liability incurred in connection with the company's activities as trustee of the scheme.

4 In an action involving breach of duty, a court may relieve a director of liability, in whole or in part, if the director has acted honestly and it

appears to the court that he or she should be excused in the light of all the circumstances: s 1157 CA 2006; see for example *Re Duomatic Ltd (1969)*.

Key Cases Checklist

To Whom are the Duties Owed?

Percival v Wright (1902) The general rule is that directors owe their duties to the company and not to individual shareholders *Peskin v Anderson* (2001) The directors of the Royal Automobile Club owed no duty to individual members to inform them of plans to demutualise the club *Allen v Hyatt* (1914) Exceptionally the directors owed an individual duty to the shareholders when they acted as their agents

Section 171 – Duty to Act within Powers

Hogg v Cramphorn (1967) It is a breach of duty to issue shares to defeat a takeover bid but this type of breach can be ratified by the members *Howard Smith Ltd v Ampol Petroleum Ltd* (1974) The primary motive for issuing shares was to defeat a takeover bid even though the company also needed to raise capital by issuing the shares *Extrasure Travel Insurances Ltd v Scattergood* (2003) The transfer of funds between a group of companies can amount to a breach of this duty

Section 172 – Duty to Promote the Success of the Company

Re Smith and Fawcett Ltd (1942) This is a subjective duty *Item Software (UK) Ltd v Fassihi* (2004) A director was in breach of this duty when he failed to disclose his own misconduct to the company *Re Welfab*

Engineers Ltd (1990) There was no breach of duty when the director took into account the interests of the company's employees when taking the decision to sell the company to a lower bidder *Liquidator of West Mercia Safetywear Ltd v Dodd* (1988) The director of an insolvent company was in breach of duty because he did not take into account the interests of the company's creditors *HLC Environment Projects Ltd* (2013) The duty in s 172 is subjective but an objective test applies when considering creditors' interests

Section 173 – Duty to Exercise Independent Judgement

Fulham Football Club Ltd v Cabra Estates plc (1994) The directors had not fettered their discretion when they agreed with outsiders how they would act in the future in return for the company receiving substantial benefits.

Section 174 – Duty to Exercise Reasonable Care, Skill and Diligence

Re City Equitable Fire Insurance Co Ltd (1925) The historical standards expected of a director *Re D'Jan (of London) Ltd* (1993) Director was negligent in signing a company insurance policy which he did not bother to read but was excused under what is now s 1157 CA 2006
Lexi Holdings plc v Luqman (2009) Two directors who performed no duties at all were negligent and liable for money misappropriated by another director, their brother

Section 175 – Duty to Avoid Conflicts of Interest

Aberdeen Railway Co Ltd v Blaikie Brothers (1843–60) There was conflict when a director of the company was a partner in the firm the company was contracting with *Regal Hastings Ltd v Gulliver* (1942)

The conflict rule is very strict. A director is accountable even if the company itself could not obtain the benefit of a particular contract.
IDC v Cooley (1972) Director ordered to account for the profits he made as a result of the breach of duty *Island Export Finance Ltd v Umunna* (1986) No breach of duty when the director had not taken a maturing business interest *Bhullar v Bhullar* (2003) It is a breach of duty if directors take a corporate opportunity in the same line of business of the company even if it is not a maturing business opportunity *Plus Group Ltd v Pyke* (2003) A director was not in breach of duty when he competed with the company because of the exceptional facts of the case *O'Donnell v Shanahan* (2009) Directors were in breach of duty when they took an opportunity to buy property which came to them while acting on company business *Wilkinson v West Coast Capital* (2005) An example of when there was no possibility of a conflict of interest

Section 176 – Duty not to Accept Benefits from Third Parties

Boston Deep Sea Fishing & Ice Co Ltd v Ansell (1888) Breach of duty to receive a secret commission and bonus

Section 177 – Duty to Declare an Interest in a Proposed Transaction with the Company

Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald (1996) In a sole director company, the director must disclose the interest to himself and record it in the board minutes

Other Statutory Provisions

Section 190 – Substantial Property Transactions

Dukwari plc v Offerventure Ltd (No 2) (1999) Substantial property transactions require the consent of the members otherwise the director has to indemnify the company for its losses

Section 197 – Company Loans to Directors

Neville v Krikorian (2006) Breach of duty for a director not to take steps to end the practice of improper company loans

Section 239 – Ratification of Breach by the Members

North-West Transportation Co v Beatty (1877) Director was able to use his votes as a member to ratify his breach of duty as a director This is no longer possible due to the wording of s 239

10.1 *Percival v Wright* [1902] 2 Ch 421 CH

Key Facts

The claimant shareholders asked the directors if they knew anyone who would buy their shares. The chairman and two directors replied that they would buy them. The sale took place but the directors did not inform the shareholders that negotiations were taking place for the sale of the company's entire share capital at a higher price per share. The claimants now sought to have the contract for the sale of their shares set aside on the ground that the directors should have disclosed the negotiations.

Key Law

During the negotiations the directors did not owe any fiduciary duties to individual shareholders. The duty is owed to the company itself.

Key Link

Under s 170(1) CA 2006 the duties are still owed to the company.

10.1 *Allen v Hyatt* (1914) 30 TLR 444 PC

Key Facts

The directors approached the shareholders to give them options to purchase their shares on the misleading pretence that this would help with the negotiation for the sale of the company. This was untrue and the directors intended to sell the shares themselves and keep the profit.

Key Law

The directors had to account for the profit. Under these special facts, they had become agents for the purchase and sale of the shareholders’ shares, and in that capacity owed them an individual fiduciary duty.

10.1 *Peskin v Anderson* [2001] 1 BCLC 312 CA

Key Facts

Four members of the Royal Automobile Club complained that the directors did not disclose to them their plans to demutualise the Club. Had they done so, they argued that they might have remained members, which would have resulted in them receiving a substantial cash benefit of £34,000 each.

Key Law

In the absence of special facts, a director owed no general fiduciary duty to the shareholders. Such a duty would place the directors in a frequent conflict situation between their undoubted fiduciary duty to the company and their alleged duty to the shareholders.

10.2.1 *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598 CH

Key Facts

Directors transferred funds to another company in the group so that the other company could pay a creditor.

Key Law

The directors had the power to deal with the company's assets in the course of its business and this power was given to promote its commercial interests. Instead of exercising it for this purpose, they used the power so that the other company could pay its debts and it was, therefore, improperly exercised.

10.2.1 *Hogg v Cramphorn* [1967] Ch 254 CH

Key Facts

C was the managing director of the company and he received an offer from B to buy the entire share capital of the company. He took the view that B lacked experience and that the takeover would not be in the company's best interests. To ensure it would not succeed, further shares were allotted to the company's employees, carrying ten votes per share. H challenged the new issue.

Key Law

The power to issue shares was a fiduciary power that had been exercised for an improper purpose. It was irrelevant that C acted *bona fide* in what he felt was in the best interests of the company. A breach of this duty, however, can be ratified. The proceedings were adjourned so that the matter could be referred back to the general meeting for approval by the members.

10.2.1 *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 PCL

Key Facts

The directors issued £10 million shares to HS Ltd for a twofold purpose. First, it provided the company with much needed capital to finish building two oil tankers and, second, the new shares gave HS Ltd the necessary majority to make a successful takeover bid for the entire share capital of the company. A majority shareholder in the company challenged the validity of the share issue.

Key Law

The directors had improperly exercised their power to issue shares. Their primary motive was to destroy one majority and to create a new majority shareholding in HS Ltd. Where shares are issued for more than one purpose it is necessary to determine the primary purpose of the issue. It is too narrow, however, to say that shares can only be issued for the purpose of raising additional finance.

Key Comment

Unlike *Hogg v Cramphorn* (1967), there was no point in referring the matter back to the members for ratification as the majority had already made it clear they were against the share issue and were the claimants in the case. Since these cases were decided, a decision by directors to issue shares now requires the consent of the members under s 551 CA 2006.

10.2.2 *Re Smith and Fawcett Ltd* [1942] Ch 304 CH

Key Judgment

Lord Greene MR
'They must exercise their discretion *bona fide* in what they – not what a court may consider – to be in the interests of the company, and not for any collateral purpose.'

10.2.2 *Item Software (UK) Ltd v Fassihi* [2004] EWCA Civ 1244; [2005] ICR 450 CA

Key Facts

F was the sales and marketing director of Item. The main business of Item was the distribution of software products for Isograph. During negotiations between the companies for new terms, F set up his own company and secretly approached Isograph for the work himself. At the same time he tried to sabotage Item's contract, which was later terminated by Isograph. When Item discovered what F had done he was summarily dismissed. They also sought damages for breach of duty.

Key Law

As part of the duty to act in good faith for the best interests of the company, F was under a duty to disclose his own breach of duty in trying to personally obtain a company contract.

Key Judgment

Arden LJ recognised this was a new application of this duty but on the facts felt 'there was no basis on which [F] could have reasonably come to the conclusion that it was not in the interests of Item to know of his breach of duty'.

10.2.2 *Re Welfab Engineers Ltd* [1990] BCLC 833 CH

Key Facts

A liquidator alleged that the directors had sold the business of the company to a lower bidder instead of the highest bidder and that this was a breach of their fiduciary duty.

Key Law

There was no breach of duty on the facts, and even if there was, they could have been excused as they acted honestly and reasonably under s 727 CA

1985 [s 1157 CA 2006]. In accepting the lower bid they took into account that this bid involved an undertaking to keep on the company's workforce.

10.2.2 *Liquidator of West Mercia Safetywear Ltd v Dodd* (1988) 4 BCC 30 CA

Key Facts

D was the director of West Mercia and also of its parent company. He ignored the direction of the liquidator and transferred £4,000 from the bank account of West Mercia to the account of the parent company, which he had personally guaranteed. The liquidator applied for a declaration that this amounted to a breach of his fiduciary duty.

Key Law

The declaration was granted. As the company was insolvent D was in breach of his fiduciary duty to the creditors of the company when he caused the money to be transferred.

Key Comment

The duty is not owed directly to creditors but to the insolvent company. Therefore, only the liquidator can enforce the breach acting on behalf of the company. No duty is owed where the company is solvent: *Multinational Gas Case* (1983).

10.2.2 *HLC Environment Projects Ltd* [2013] EWHC 2876 CH

Key Facts

At a time when the company was of doubtful solvency, its director made company payments to various parties including himself and to a company he was personally investing in. The liquidators alleged this was a breach of his duty under s 172 to promote the success of the company and the linked duty to consider the interests of the creditors in s 172(3). The director argued that he did not have the subjective knowledge of the company's doubtful solvency.

Key Law

The director was ordered to repay the money. Although the duties in s 172 are usually subjective an objective test applies:

- in considering whether creditors' interests were paramount;
- when there is no evidence of actual consideration the test is whether an intelligent and honest man in the position of the director could reasonably believe that the transaction was for the benefit of the company;
- where a large creditor is unreasonably overlooked.

10.2.3 *Fulham Football Club Ltd v Cabra Estates plc*

[1994] 1 BCLC 363 CA

Key Facts

The directors of Fulham agreed with its landlord, Cabra, that it would not oppose its planning application to develop the club's ground. The directors later changed their mind about the merits of the proposed development. They argued that they were not bound by the agreement as it fettered their discretion to exercise their fiduciary duty in the best interests of the company.

Key Law

The agreement was binding. It is not a fetter on directors' discretion if they act *bona fide* at the time they enter into the agreement as to how they will exercise their fiduciary duties in the future. Here, they had acted *bona fide* and the company was to receive substantial benefits in return amounting to £11 million.

Key Link

Section 173 CA 2006.

10.2.4 *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 CH

Key Facts

The liquidator brought proceedings against the directors alleging negligence, breach of trust and breach of duty.

Key Law

Some of the directors were negligent but escaped liability due to an exclusion clause in the company's articles. The skill and care of a director was assessed according to a subjective standard. In addition the director is not bound to give continuous attention to the affairs of the company and he may delegate to others and rely on them in the absence of grounds for suspicion.

Key Comment

The judiciary gradually recognised that this position no longer represented the law: *Re D'Jan (of London) Ltd* [1993] (below).

10.2.4 *Re D'Jan (of London) Ltd* [1993] BCC 646 CH

Key Facts

A director signed an insurance proposal form without reading it. Had he done so he would have discovered that there was a material non-disclosure which entitled the insurance company to refuse to indemnify the company following a fire at the factory. The company went into liquidation as a result. This action was brought by the liquidator alleging negligence against the director.

Key Law

The director was negligent in not reading the form but could be excused by the court as he had acted honestly and reasonably under s 1157 CA 2006. Hoffmann LJ held that the standard of care expected of a director was contained in the wrongful trading provisions in s 214(4) IA 1986. This recognises the idea of a reasonable director and applies the higher of either an objective or a subjective standard.

Key Link

Section 174 CA 2006 now contains a statutory statement of the standard of skill and care of a director. It is based on the twofold subjective/objective standard in s 214(4) Insolvency Act 1986.

10.2.4 *Lexi Holdings plc v Luqman* [2009] EWCA Civ 117; [2009] BCC 716 CA

Key Facts

S was the managing director of the company. The other directors included his sisters, Z and M. Nearly £60 million of company money was misappropriated by S using bogus bank accounts and he had previous convictions for dishonesty. Z and M were inactive and performed no duties as directors. The company sought to make Z and M liable for the £60m.

Key Law

They were negligent and liable for the money. They should have informed the auditors and the other directors about the bogus bank accounts (which they knew of) and their brother's previous convictions. Had they done so, S would have been unable to misappropriate the money.

10.2.5 *Aberdeen Railway Co Ltd v Blaikie Brothers* [1843–60] All ER Rep 249 HL

Key Facts

Aberdeen ordered some iron chairs from Blaikie Bros. John Blaikie was a partner in this business and also the chairman and a director of Aberdeen. When Aberdeen refused to take delivery of the chairs they were sued by Blaikie Bros for damages.

Key Law

John Blaikie was in breach of his fiduciary duty to avoid a conflict of interest between himself and his company. The contract was voidable at the company's option.

Key Judgment

On the no conflict rule **Lord Cranworth LC** said: 'So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into.'

10.2.5 *Regal Hastings Ltd v Gulliver* [1942] 1 All ER 378 HL

Key Facts

Regal owned and managed a cinema. The directors wished to acquire the leases of two other cinemas and then sell all three as a going concern. They formed a subsidiary to buy the two leases but the landlord insisted that the directors guaranteed the rent unless the paid-up capital of the subsidiary was £5,000. Regal could only afford to buy 2,000 shares and so the directors and their supporters purchased the remaining 3,000. The plan to sell the three cinemas as a going concern fell through; instead they sold the shares in both Regal and the subsidiary. The company's new owners brought this action to recover the profit the directors made as a result of selling the shares.

Key Law

The directors had made a profit out of their fiduciary relationship with the subsidiary company and had to account for the profit. It made no difference that the company itself was not in a position to buy the shares and make the profit.

Key Judgment

Lord Russell explained the strict nature of the fiduciary duty: 'The liability arises from the mere fact of a profit having, in the stated circumstances, been made. The profiteer, however honest and well intentioned, cannot escape the risk of being called upon to account.'

Key Comment

The directors would have been allowed to keep the profit if they had obtained the prior approval of the shareholders in the general meeting. Lord Porter pointed out that the result was an 'unexpected windfall' for the purchasers who in effect paid a reduced price for the shares.

10.2.5 *IDC v Cooley* [1972] 1 WLR 443, Birmingham Assizes CH

Key Facts

C was the managing director and architect of IDC. Whilst negotiating a contract on behalf of the company to design and construct a new depot for the Eastern Gas Board, he was offered the work in his private capacity. He faked illness and was released by IDC on the grounds of ill health, and then took the benefit of the contract personally. He was sued by IDC, who claimed an account of all the fees and remuneration he had received under the contract.

Key Law

C was in a fiduciary relationship with IDC and had allowed his own interests to conflict with those of the company. He was ordered to account for the benefits he had received under the contract for breach of this duty.

10.2.5 *Bhullar v Bhullar* [2003] EWCA Civ 424; [2003] 2 BCLC 241 CA

Key Facts

It was decided to divide the business of a property development company between two sides of a family who had fallen out with each other. Until this was done they agreed that they would not buy any more properties. Two directors noticed that a property was available next to an existing property the company owned. They purchased the property for themselves to support their pension fund without informing the other directors of the company.

Key Law

This was a breach of duty and they had to account to the company. Even though it was not a maturing business opportunity which the company was actively pursuing, by purchasing the land the directors had taken a corporate opportunity in the same line of business. They were therefore liable to account.

Key Comment

This is a very strict application of the no-conflict rule.

10.2.5 *Island Export Finance Ltd v Umunna* [1986] BCLC 460 HC

Key Facts

U was the managing director of Island Export. In 1976 he had negotiated a contract on the company's behalf to supply the Cameroon government with 6,000 post boxes. In 1977 he resigned for personal reasons relating to his career prospects within the company. At this time the company was not actively seeking new contracts with the Cameroon government. He subsequently acquired two contracts for the supply of post boxes with them through his own company formed after leaving Island Export, who alleged this was a breach of his fiduciary duty. They claimed an account of the profits on the two contracts.

Key Law

The fiduciary duties of a director do not automatically come to an end on resignation, but on the facts there was no breach of duty. U had not taken a 'maturing business opportunity' which Island Export was actively pursuing and he had not used confidential information in acquiring the contracts.

10.2.5 *Plus Group Ltd v Pyke* [2003] BCC 332 CA

Key Facts

The only directors and shareholders of the company were Pyke and Plank. Their business relationship broke down. Pyke set up a new company and did business with Constructive, which was an important customer of the company. Plus Group Ltd claimed an account of the profits from Pyke for competing with the company.

Key Law

Competing is not itself a breach; the court will wait to see if it results in a breach later. On the facts Pyke was not in breach of duty by competing with the company. He had been excluded from management, denied access to financial information, had his monthly payments stopped and his office moved out of the company's main premises. In addition, Pyke had not used confidential information belonging to the company.

Key Comment

Pyke's circumstances were regarded as being exceptional. Sedley LJ said that the law on competing directorships was in need of updating.

10.2.5 *O'Donnell v Shanahan* [2009] EWCA Civ 751; [2009] BCC 822 CA

Key Facts

O, S and L were the directors of a company that provided clients with financial advice and assistance. A property owner approached the company and asked if they could find a purchaser for it, which would have attracted a £30,000 commission for the company. S and L together with a company client purchased the property themselves for £1.35 million on an equal basis. O argued this was a breach of the no-conflict rule.

Key Law

This was a breach of duty. The opportunity to purchase the property came to them in their capacity as directors of the company while acting on the business of the company and using company information. It made no difference that the company itself would not have been able to buy the property as it had no available funds or that its business until now involved estate agency.

10.2.5 *Wilkinson v West Coast Capital* [2005] EWHC; [2007] BCC 717 CH

Key Facts

W owned 40 per cent of the shares in a company ('NGS'). A and B were directors and owned 50 per cent of the shares. A shareholders agreement (which included the company) provided that 65 per cent of the shareholders had to agree before the company could acquire another business. A and B, through a company they controlled, purchased another business. W claimed this was a corporate opportunity belong to NGS and the directors were in a conflict of interest.

Key Law

There was no conflict. A and B did not give their consent under the shareholders agreement and so the company could not acquire the other business. There was therefore no possibility of a conflict.

10.2.6 *Boston Deep Sea Fishing & Ice Co Ltd v Ansell* (1888) 39 Ch D 339 CA

Key Facts

A was a director of the company. Acting on the company's behalf he placed an order for some boats to be built and for the supply of ice. He was paid a secret commission by the boat builder. He was also a shareholder in the ice company, which paid him a bonus on his shares for placing the order.

Key Law

He was in breach of his duty and had to account to the company for the commission and the bonus.

Key Link

Section 176 CA 2006.

10.2.7 *Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald* [1996] Ch 274 CH

Key Facts

F was the sole director of the company. At a meeting attended only by F and the company secretary, F passed resolutions terminating his employment contract and authorising the payment of £100,000 as compensation. F then retired as a director and the company, under new management, sought a declaration that F ought to have disclosed his interest in the contract.

Key Law

Lightman J held that to comply with s 317 CA 1985 [s 177 CA 2006] the sole director ought to have declared the interest to himself and recorded this fact in the minutes.

10.3.2 *Dukwari plc v Offerventure Ltd (No 2)* [1999] Ch 253 CA

Key Facts

D plc agreed to buy a piece of land from O Ltd, which was connected with a director of D plc (the director was a shareholder in O Ltd). This attracted the substantial property transactions provisions in s 320 CA 1985 [s 190 CA 2006] and required the approval of D plc's shareholders, but this was not obtained.

Key Law

D plc was entitled to be indemnified by the connected director. The value of the property had since fallen dramatically following the collapse of the property market. The amount of the indemnity was the difference between the market value at the time of acquisition and the market value at the time it was resold by the company. The director bore the cost of the depreciation in the land value.

10.3.3 *Neville v Krikorian* [2006] EWCA Civ 943; [2007] 1 BCLC 1 CA

Key Facts

K and his sons were the two directors of U Ltd. The administrator sought to make them liable to repay company loans made to them amounting to over £2.5 million and contrary to s 330 CA 1985 [s 197 CA 2006]. They both agreed that they owed the money but K argued that their liability should not be joint and several as he was not aware of his son's loans.

Key Law

Although K did not know the exact amount of his son's loans there was no doubt he knew that loans were being made. It was a breach of his duty as a director not to take steps to end the practice and also to recover the loan amount. It was right to impose joint and several liability under s 341(2) CA 1985 [s 213(3) CA 2006].

Key Comment

The CA 2006 has relaxed the prohibition on company loans to directors: see ss 197–214.

10.3.4 *North-West Transportation Co v Beatty* (1877) 12 App Cas 589 PC

Key Facts

The company purchased a boat from B, one of its directors. The price was a fair one and was ratified by the shareholders. A minority shareholder sought to have the sale set aside.

Key Law

The sale was properly ratified. A share is a property right which the holder can exercise according to his own selfish interests. B was able to use his votes as a shareholder to ratify a contract which he was interested in as a director.

Key Comment

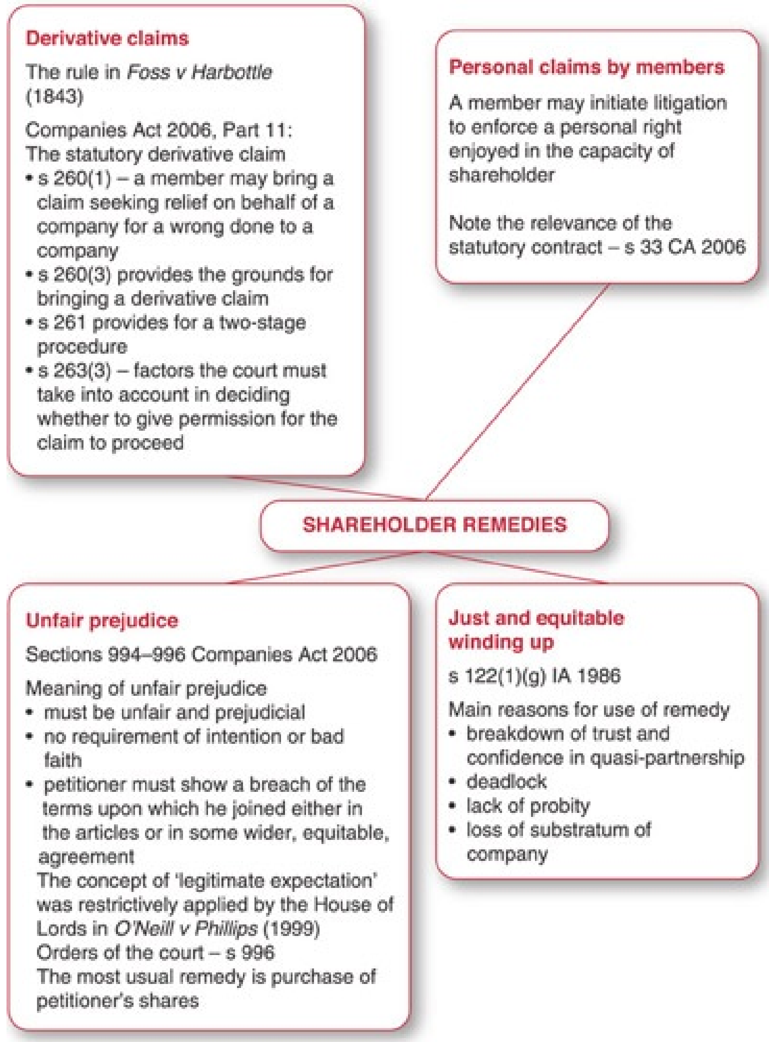
Under s 239 CA 2006 the votes of the director and those connected with him can no longer be counted.

Key Link

Sections 252–256 of the CA 2006 identify those who are ‘connected persons’ with a director.

11

Shareholder remedies



11.1 Derivative claims

11.1.1 The rule in *Foss v Harbottle*

1 If a wrong is done to the company, the proper person to sue the wrongdoer is the company itself: this is the rule in ***Foss v Harbottle*** **(1843)**.

2 In ***Edwards v Halliwell*** **(1950)** Jenkins LJ identified two limbs to the rule: 'First, the proper plaintiff in an action in respect of a wrong alleged to be done to a company or association of persons is *prima facie* the company or association of persons itself. Secondly, where the alleged wrong is a

transaction which might be made binding on the company or association and on all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action.'

3 Reasons for the rule are:

(a) it recognises the separate legal personality of the company;
(b) it prevents multiple shareholder actions to remedy the same wrong done to the company;
(c) it prevents futile litigation.

4 The disadvantage of the rule is that it could allow the majority to plunder the company, leaving the minority without a remedy. Exceptions to the rule have therefore been developed.

5 Responsibility for decision-making in a company lies with either the board of directors or the shareholders in general meeting, by consent of the majority.

6 Difficulties may arise if the directors themselves are the wrongdoers since the right to litigate on behalf of the company is generally reserved to the board of directors (Art 3 of both the model articles for public companies and those for private companies limited by shares: *Breckland Group Holdings Ltd v London & Suffolk Property Holdings Ltd* (1989) (see Chapter 8, section 8.5.1)).

- Before ss 260–264 CA 2006 became law (see 11.1.3 below), the courts exceptionally allowed an individual member to bring a derivative claim on behalf of the company in order to resolve this difficulty.
- A derivative claim is one where the right of action is derived from the company and is exercised on behalf of the company.
- A derivative claim is an exception to the proper claimant principle. It arises only when proceedings are not instigated by the company in circumstances where a member or members consider a claim should be made and the court is willing to ignore the proper

claimant principle.

7 In the course of the consultation process leading to the 2006 Act the Law Commission recorded a number of criticisms of the rule in ***Foss v Harbottle*** and the derivative claim: *Shareholder Remedies* (Law Com 246, 1997). It recommended partial abolition of the rule and a new derivative claim. This view was accepted by the Company Law Review. The *Final Report* recommended that derivative claims should be restricted to breaches of directors' duties and that they should be put on a statutory footing.

11.1.2 The derivative claim at common law

1 Prior to the Companies Act 2006 (CA 2006), the courts were prepared to allow a derivative claim to proceed where minority shareholders were able to establish 'fraud on the minority' and that the wrongdoers were in control of the company: ***Cook v Deeks* (1916)**.

2 The fraud on the minority exception was used sparingly as the courts were reluctant to hear cases brought against a director or other wrongdoer by an individual member on behalf of a company for a number of reasons:

- the derivative claim undermines the concept of majority rule;
- there is judicial reluctance to become involved in disputes over management and business policy;
- the floodgates argument, that is, the fear that allowing these claims would result in a flood of actions by minority shareholders;
- difficulties of proof, leading to protracted litigation;
- the cost of proceedings and the question of who should pay. The company will benefit if the action succeeds, but does not want to undertake litigation: ***Wallersteiner v Moir (No 2)* (1975)**. In appropriate circumstances the courts will make a *Wallersteiner* order, ordering the company to fund the litigation. In ***Smith v***

***Croft* (1986)** Walton J held that an action will be commenced reasonably if an independent board of directors, exercising the standard of care which prudent businessmen would exercise in their own affairs, would have commenced the action. Legal aid is not available for derivative actions.

3 A restrictive view of the scope of the derivative claim was taken, for example in ***Prudential Assurance Ltd v Newman Industries* (1981)**, where it was held that there should be a preliminary action to establish that a *prima facie* case could be made, thereby extending the proceedings.

4 Other instances where claims have not been successful include:

- where the court took the view that a majority within the minority of shareholders who were independent of the wrongdoers did not want to proceed with the claim: ***Smith v Croft (No 2)* (1988)**;
- where a more appropriate way of dealing with the matter was available: for example, *Cooke v Cooke* (1997), where the claimant had also petitioned under what is now s 994 CA 2006; *Mumbray v Lapper (2005)*, where either of the parties could have sought relief either by winding up on the just and equitable ground or under s 994 (see sections 11.4 and 11.5 below);
- where the claim was made for personal reasons rather than for the benefit of the company: ***Barrett v Duckett* (1995)**;
- where the claim was based on negligence on the part of the directors: *Pavlides v Jensen* (1956); which can be contrasted with ***Daniels v Daniels* (1978)**, where the claim succeeded because the negligence had resulted in the wrongdoers making a profit and was therefore deemed to be self-serving.
- where the claimant did not come to court with 'clean hands' ***Nurcombe v Nurcombe* (1985)**.

5 The Companies Act 2006 Part 11, Chapter 1, ss 260–264 now makes provision for a statutory derivative claim.

6 Common law derivative actions can no longer be commenced unless it is a double derivative action, as these have survived the CA 2006. This arises when the action is commenced not by a member of the company that suffers the wrong, but by a member of a member of that company. An example is a minority member of a holding company that owns all the shares in a wronged subsidiary. If the subsidiary does not commence an action the member of the holding company can: *Universal Project Management Services Ltd v Fort Gilkicker Ltd* (2013).

11.1.3 The statutory derivative claim

1 Part 11, Chapter 1 CA 2006 puts the derivative claim on a statutory footing and provides for a more flexible framework to allow a shareholder to pursue an action.

2 Under s 260 a shareholder may bring a claim seeking relief on behalf of the company for a wrong done to the company.

- The claim may only be brought in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director, shadow director or former director of the company.
- The claimant is not required to show wrongdoer control or a fraud on the minority: ***Bamford v Harvey* (2012)**.
- A claim may also be brought by an order of the court in proceedings under ss 994–996 (unfair prejudice).

3 Section 261 provides for a two-stage procedure:

- the member must make a *prima facie* case to continue the derivative claim;

- the court considers only the evidence presented by the claimant and if a *prima facie* case is not made the court will dismiss the case;
- if the evidence supports a *prima facie* case the court may then give permission for the derivative claim to be heard.

4 Permission will be refused (s 263(2)) if the court is satisfied:

- that a person acting in accordance with s 172 (duty to promote the success of the company) would not wish the claim to proceed: **Iesini *v Westrip Holdings Ltd* (2009)**;
- in the case of an act or omission that is yet to occur, that the act or omission has been approved by the company;
- in the case of an act or omission that has occurred, that the act or omission had been approved by the company beforehand or ratified afterwards: ***Franbar Holdings v Patel* (2008)**.

5 Section 263(3) sets out the factors that the court must take into account in considering whether to grant permission to continue the claim. These include:

(a) whether the member is acting in good faith;
(b) the importance that a person acting in accordance with s 172 would attach to the claim: ***Phillips v Fryer* (2013)**;
(c) where the act or omission is yet to occur, whether it is likely to be authorised or ratified by the company;
(d) where the act or omission has occurred, whether it could be and is likely to be ratified by the company;
(e) whether the company has decided not to pursue the action;
(f) whether the act or omission in question gives rise to a claim that the member could pursue in his or her own right: see ***Franbar Holdings Ltd v Patel* (2008)**.

6 Before the CA 2006, negligence alone, from which the director derived no personal benefit, was not sufficient to allow a derivative claim: *Pavlides v Jensen* (1956). This restriction is not stated in s 260 and some commentators have expressed concern that this may result in large numbers of claims for negligence.

11.2 Personal claims

1 An individual shareholder may initiate litigation to enforce personal rights in relation to the internal management of the company. Such claims may arise in a number of situations.

2 Where a decision is taken that the company should enter into a contract that is outside the company's objects, a shareholder may bring an action to prevent the contract being concluded: *Simpson v Westminster Palace Hotel Co* (1860); ***Parke v Daily News* (1962)**.

3 An action may be brought where the transaction requires a special majority but agreement has, for example, been achieved by an ordinary resolution: ***Edwards v Halliwell* (1950)**.

4 Personal rights of a shareholder have been enforced where, for example:

(a) dividends were paid in the form of bonds when the articles required payment in cash: *Wood v Odessa Waterworks Co* (1889);
(b) a member's vote was improperly rejected by the chairman of a general meeting: ***Pender v Lushington* (1877)**;
(c) directors failed to allow a veto of a decision as provided in the articles: *Quin & Axtens Ltd v Salmon* (1909);
(d) but not where the matter complained of was a mere internal irregularity which could be ratified by the members: *MacDougall v Gardiner* (1875).

In the context of the above examples, note the relevance of the statutory contract (s 33 CA 2006, discussed in Chapter 3 above).

11.3 The 'no reflective loss' principle

1 In some circumstances, the loss suffered by the company may affect the shareholders or others, for example the share price may fall or the company may not be able to pay a dividend. The no reflective loss principle means that a member may not bring a personal action against the wrongdoer to recover a loss that just reflects the company's loss.

2 The principle ensures that a person can only be sued once for the damage caused and where the damage is caused to the company, the company is the proper claimant.

3 The principle applies even where:

- the member has a personal cause of action against the defendant: *Day v Cook* (2001);
- the company decides not to take action against the wrongdoer: ***Johnson v Gore Wood & Co* (2003)**.

4 However, an exception to the rule exists where the failure to recover the loss is the fault of the wrongdoer. For example, in *Giles v Rhind (2002)* Rhind's wrongdoing had caused the company to go into liquidation. The company had started an action against Rhind but the administrator had been obliged to discontinue the claim for lack of funds. Giles, a shareholder, was able to claim.

11.4 Unfair prejudice

11.4.1 Introduction

1 Section 994(1) CA 2006 provides that a member may petition the court 'on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally, or to some part of its members (including at least himself)'. This section (first enacted as s 75 CA 1980) replaced s 210 CA 1948, which provided a remedy for 'oppressive' conduct and had been very restrictively interpreted by the courts.

2 Only two reported cases were successful under the old s 210 test: ***Re Harmer*** **(1959)** and ***Scottish Co-operative Wholesale Society Ltd v Meyer*** **(1959)**.

3 Unfairly prejudicial conduct is wider than oppression and so these two cases are still good examples of what today would be unacceptable behaviour under s 994 CA 2006.

4 The company and its members can agree to have unfairly prejudicial complaints decided by arbitration instead of court proceedings under s 994 CA 2006. Where they have done so, s 994 proceedings commenced in court can be stayed: ***Fulham Football Club (1987) v Richards*** **(2011)**.

5 If the dispute is decided by arbitration the case will be heard in private, but s 994 court proceedings must be transparent because of the principle of open justice. This means that the hearing must be in public and the parties identified by name: *Global Torch Ltd v Apex Global Management* (2013).

11.4.2 Who can petition?

1 A claim may be made by:

- members of the company;
- those to whom shares have been transferred by operation of law, for example personal representatives, trustees in bankruptcy.

2 A person may only petition as a member, but it is recognised that the interests of a member are not necessarily limited to constitutional rights. See for example ***Re a company (No 00477 of 1986)* (1986)**. Furthermore, the 'interests of members' is not restricted to interests held in their capacity as members, as long as there is a sufficient connection with membership: ***Re JE Cade & Sons Ltd* (1992)**. In *Gamlestaden Fastigheter AB v Baltic Partners Ltd* (2007) a member was allowed to rely on the unfair prejudice remedy to protect his interest as a creditor. It should also be noted that 'interests' are wider than 'rights'.

3 There is no requirement of 'clean hands' (in contrast to the remedy under s 122(1)(g) Insolvency Act 1986: see section 11.5.1 below) but the conduct of the petitioner may affect the remedy: ***Re London School of Electronics* (1986)**; or the decision as to whether s 994 applies: *Woolwich v Milne* (2003).

4 A petitioner cannot complain of conduct consented to by all of the shareholders before he became a member: ***Re Batesons Hotels (1958) Ltd* (2013)**.

11.4.3 Meaning of 'unfairly prejudicial conduct'

1 Conduct must be both unfair and prejudicial: ***Re RA Noble (Clothing) Ltd* (1983)**; *Re BSB Holdings Ltd (No 2)* (1996).

2 However, in contrast to the way the courts interpreted s 210 of the 1948 Act, the terms 'unfair' and 'prejudicial' have been given a very wide interpretation.

3 The courts have employed the concept of the reasonable bystander in determining unfair prejudice.

4 There is no need, in proving unfairness, to show either intention or bad faith: ***Re RA Noble & Sons (Clothing) Ltd* (1983)**. The test is whether it could be reasonably considered that the conduct unfairly prejudiced the petitioner's interests.

5 Prejudice does not necessarily require a reduction in the value of the petitioner's shareholding and may be shown in a number of ways:

(a) Exclusion from management, if this breaks a mutual understanding about the management of the company: ***Re a Company (No 00477 of 1986)* (1986)**. However, this will not be unfairly prejudicial if the directorship is unlawful, as in *Hawkes v Cuddy (2007)*, where it was in breach of s 216 Insolvency Act 1986.

(b) Failure to pay dividends duly declared: ***Re Sam Weller & Sons Ltd* (1990)**; failure by directors to even consider payment of a dividend to shareholders when they themselves were well remunerated: *Re McCarthy Surfacing Ltd* (2008).

(c) Payment of excessive remuneration to directors: ***Re Cumana* (1986)**.

(d) Diversion of corporate assets, financial benefit or corporate opportunity: ***Re London School of Electronics Ltd* (1986)**; ***Little Olympian Each-Ways Ltd (No 3)* (1995)**.

(e) Packing the board with directors having interests adverse to the company: *Whyte, Petitioner* (1984).

6 In general, mismanagement will not amount to unfair prejudice: *Re Elgindata Ltd* (1991); but serious or gross mismanagement has been considered prejudicial: ***Re Macro (Ipswich) Ltd* (1994)**.

7 The section has been interpreted to include not only a breach of the company's constitution, but also a failure to meet the 'legitimate expectations' of a member or members. In the case of small private companies, the legitimate expectations may be outside of the constitution: *Re Saul D Harrison & Sons plc* (1994); *Richards v Lundy* (2000). However, the courts have not been willing to recognise legitimate expectations beyond the constitution, as it appears in its public documents, in the case of public companies: *Re Blue Arrow plc* (1987); ***Re Tottenham Hotspur plc* (1994)**.

8 In ***O'Neill v Phillips* (1999)**, the House of Lords had the first opportunity to consider the unfair prejudice provisions, including the application of the concept of 'legitimate expectations' and held:

- the phrase ‘legitimate expectation’ should be interpreted restrictively;
- ‘equitable considerations’, which may be wider than the shareholder’s strict constitutional rights, could be taken into account in appropriate circumstances.

9 In this case, although the petitioner might have had an expectation that his shareholding would be increased and the profit shared equally, the majority shareholder (Phillips) had made no unconditional promise to do this and it was therefore not unfairly prejudicial to the petitioner that it was not done.

11.4.4 The orders of the court

1 It is important to note the scope and flexibility of the orders available to the court. The court has freedom to make whatever order is deemed appropriate in the circumstances, but some specific orders are set out in s 996 CA 2006. These are:

- to regulate the company’s affairs in future: ***Re Harmer Ltd* (1958)**, a case heard under the ‘oppressive conduct’ provision, s 210 CA 1948);
- to order the company to do or refrain from doing something;
- to authorise civil proceedings to be brought in the name and on behalf of the company;
- to require the company not to make alterations to its articles without the leave of the court;
- to order the purchase of the petitioner’s shares, at a price that reflects the value of the company.

2 The most common remedy is an order of the court for the purchase of the

petitioner's shares. See ***Grace v Biagiola* (2006)** for a discussion of the remedy.

3 Exceptionally, the court can order that the respondent sell their shares to the petitioner: ***Re Brenfield Squash Racquets Club Ltd* (1996)**.

4 The following principles are applied:

- the shares are normally purchased at their full value and are not discounted to reflect the fact that they represent a minority holding: ***Re Bird Precision Bellows Ltd* (1986)**;
- the conduct of the petitioner (for example if he or she was in any way to blame for the breakdown) may be relevant and the shares may be discounted to reflect this;
- usually the valuation will be calculated as at the time of the order, but the court has discretion in fixing the date and may fix it at the time of the petition: ***Profinance Trust SA v Gladstone* (2001)**;
- if the parties cannot agree, the price should be set by an independent valuer.

5 Either before or during the petition, the respondent may have offered what he regarded as a fair price for the petitioner's shares in order to settle the dispute. Guidance on what amounts to a fair offer was given by Lord Hoffmann in ***O'Neill v Phillips* (1999)**:

- The offer must be to purchase the shares at a fair value normally without a discount for it being a minority holding.
- If the value is not agreed it should be determined by a competent expert.
- The offer should be to have the value determined by the expert as an expert. The aim is economy and expedition and therefore an arbitration to decide the value is not needed, nor does the expert have to give reasons.
- Both parties should have access to the same information and have the right to make submission to the expert.

- If there is a breakdown in relations between the parties, the majority shareholder must be given a reasonable opportunity to make an offer before he becomes obliged to pay costs.

11.4.5 The future of the remedy?

1 The introduction of the 'unfair prejudice' provisions now contained in s 994 CA 2006 has given minority shareholders an important remedy.

2 However, it has been criticised for the length and complexity of cases and the cost involved in bringing a case: *Re Unisoft Group Ltd (No 3) (1994)*; and for the fact that it may allow minority shareholders to enforce their will over that of the majority: ***Re a Company (No 004377 of 1986)*** **(1986)**.

3 In ***O'Neill v Phillips*** **(1999)** the House of Lords reviewed the development of the law relating to unfair prejudice and clarified many important aspects. The influence of the decision can be seen in recent cases, for example *Re GN Marshall Ltd* (2001); ***Re Phoenix Office Supplies Ltd*** **(2003)**.

11.5 Winding up on the just and equitable ground

1 The Insolvency Act 1986 (IA 1986) provides a rather drastic remedy for a dissatisfied shareholder, used mainly in situations involving small closely held companies (quasi-partnerships) where the relationship of trust and confidence has broken down.

2 Section 122(1)(g) provides that the company may be wound up if the court is of the opinion that it is just and equitable that the company should be wound up.

3 Section 124 IA 1986 provides that an application can be made by anyone who is a contributory. A contributory is a person who is liable to

contribute to the assets of a company in the event of its being wound up. A fully paid-up member who is not liable to contribute has to show that he or she has a tangible interest in the winding up.

11.5.1 Restrictions on the remedy

1 It is an equitable procedure, and there is therefore the requirement for 'clean hands' on the part of the petitioner. This means that misconduct by the petitioner himself will result in the remedy being refused.

2 Section 125(2) IA 1986 provides that the court may not order a winding up if there is an alternative remedy available to the petitioners, for example an offer to purchase the petitioner's shares at a reasonable price, and they have been unreasonable in not accepting it: *Re a Company (No 002567 of 1982) (1983)*. However, there have been circumstances where the alternative remedy has not been appropriate and the application for winding up has succeeded: ***Virdi v Abbey Leisure* (1990)**.

11.5.2 Reasons for applications for just and equitable winding up

1 Successful petitions have been made on the following grounds:

- loss of substratum (main object) of company: ***Re German Date Coffee Co* (1882)**;
- fraudulent formation of a company: ***Re Brinsmead (Thomas Edward) & Son* (1897)**;
- Justifiable loss of confidence in company management: ***Loch v John Blackwood Ltd* (1924)**;
- deadlock in the company's management: ***Re Yenidje Tobacco Co Ltd* (1916)**;
- exclusion from management in a quasi-partnership type company: ***Ebrahimi v Westbourne Galleries* (1973)**.

2 In *Ebrahimi*, Lord Wilberforce laid down general guidelines in cases involving quasi-partnerships There must have been:

- a breakdown of trust and confidence;
- reasonable expectation on the part of the petitioner of taking part in the management of the company;
- a restriction on the sale of shares so that the petitioner is 'locked into' the company.

11.5.3 Scope of the remedy

1 In some cases where unfair prejudice cannot be shown, the court has ordered a winding up: ***Re RA Noble (Clothing) Ltd* (1983)**.
2 A winding-up order may be more appropriate if in a successful unfairly prejudicial petition the respondent does not have the funds to buy the shares: ***Re Phoneer Ltd* (2002)**.
3 But a petition was refused in *Re Guidezone Ltd (2000)* on the ground that the proposition that winding up on the just and equitable ground is wider than s 994 CA 2006 is inconsistent with ***O'Neill v Phillips* (1999)**.

Key Cases Checklist

Derivative Claims

The General Rule

Foss v Harbottle (1843) If a wrong is done to the company, it is the company itself that is the proper claimant and not individual shareholders *Johnson v Gore Wood & Co Ltd (2002)* Where a company suffers a loss caused by a third party, it is the company that must sue to recover that loss and not a shareholder as his loss merely reflects the company's loss

Exception to *Foss v Harbottle, Pender v Lushington* – Personal Claims

Parke v Daily News (1962) A member may bring a personal action to restrain a proposed *ultra vires* act *Pender v Lushington* (1877) A member may bring a personal action to have his votes counted at a general meeting *Edwards v Halliwell* (1950) Two members of a trade union were allowed to bring an action when a company took a decision by ordinary resolution when the articles required a special resolution *MacDougall v Gardiner* (1875) A member has no right to bring a personal action to correct a mere internal irregularity which can be ratified by the members

Derivative Action – Pre-2006 CA Cases

Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) (1982) The right to bring a derivative action had to be determined at a preliminary hearing and wrongdoer control had to be established – no longer required under the Act *Cook v Deeks* (1916) A claimant had to establish fraud on the minority – an act incapable of being ratified by the members – no longer required under the Act *Smith v Croft (No 2) (1988)* A derivative action should not be continued if a majority of the independent minority do not wish the action to proceed – see now s 263(4) of the Act *Barrett v Duckett* (1995) A claimant must bring the action in good faith and not for personal interests – see now s 263(3)(a) of the Act *Daniels v Daniels* (1978) A derivative action could be based on self-serving negligence but not mere negligence – both types are now covered in s 260(3) of the Act *Nurcombe v Nurcombe* (1985) Derivative actions require the claimant to come to court with 'clean hands' – see now s 263(3)(a) of the Act *Wallersteiner v Moir (No 2)* (1975) Claimant can seek court order that company indemnify him for costs of action – still possible after 2006 Act

Derivative Action – Post-2006 CA Cases

Franbar Holdings Ltd v Patel (2008) Permission to continue with derivative action was refused as the claim was better suited to s 994 proceedings and action based on breach of shareholders' agreement *Iesini v Westrip Holdings Ltd* (2009) Court will only invoke its jurisdiction in s 263(2)(a) if *no* director promoting the success of the company would continue with the claim *Bamford v Harvey* (2012) Permission to continue with derivative action refused as the company itself was in a position to bring the action. No longer necessary to show wrongdoer control *Phillips v Fryer* (2013) Permission to continue derivative action was granted as it was the most effective means of getting the case to court quickly and economically

Unfair Prejudice

Early Example of the Old Oppression Test

Re Harmer Ltd (1959) Behaviour of autocratic father who was majority shareholder and director in a family company and was found to have acted in an oppressive manner *Scottish Co-operative Wholesale Society Ltd v Meyer* (1959) Directors of holding company carried on business of its subsidiary in an oppressive manner

Who can Petition under S 994?

Fulham Football Club (1987) v Richards (2011) Court stayed court proceedings as articles provided for the dispute to be decided by arbitration *Re JE Cade & Sons Ltd* (1992) Petition dismissed as claimant not bringing the action in capacity as a member *Re Batesons Hotels* (1958) *Ltd* (2013) Petitioner cannot complain of conduct that was consented to by all the shareholders before he joined the company

Examples of Successful S 994 Cases

Re a Company (No 00477 of 1986) (1986) Exclusion from management in quasi-partnership type company *Re London School of Electronics* (1986) Diverting business to another company *Re Sam Weller & Sons Ltd* (1990) Non-payment of dividends *Re Cumana Ltd* (1986) Excessive director remuneration *Re Little Olympian Each-Ways Ltd (No 3)* (1995) Transfer of company assets to another company at an undervalue *Re Macro (Ipswich) Ltd* (1994) Serious mismanagement over a period of 50 years *Grace v Biagioli* (2005) Improperly withholding the petitioner's dividend

Court Orders Following Successful Petition

Re Brenfield Squash Racquets Club Ltd (1996) Majority ordered to sell shares to petitioner *Re Bird Precision Bellows Ltd* (1986) No discount to be applied when making share purchase order *Profinance Trust SA v Gladstone* (2001) Shares generally valued at date of share purchase order but court can choose another date

Examples of Unsuccessful S 994 Cases

Re RA Noble (Clothing) Ltd (1983) Exclusion from management caused by petitioner's own lack of interest *Re Tottenham Hotspur plc* (1994) Exclusion from management in a public limited company *Phoenix Office Supplies Ltd v Larvin* (2003) Claim by petitioner to be able to force majority to buy his shares without establishing fault on their part *O'Neill v Phillips* (1999) Leading case on s 994. Lord Hoffmann explains what petitioners have to establish – breach of terms upon which petitioner joined either under the articles or under some wider, equitable agreement.

Just and Equitable Winding Up

Re German Date Coffee Co (1882) Winding up ordered when main object failed *Re Brinsmead (Thomas Edward) & Son* (1897) Winding up ordered when company formed for fraudulent purpose *Loch v John Blackwood Ltd* (1924) Winding up ordered due to justifiable lack of confidence in company management *Re Yenidje Tobacco Co Ltd* (1916) Winding up ordered as the only two shareholder/directors were in deadlock *Virdi v Abbey Leisure Ltd* (1990) Winding up ordered as it would give the petitioner a fairer valuation of his shares *Re Phoneer Ltd* (2002) Winding up was more appropriate than unfair prejudice action *Ebrahimi v Westbourne Galleries Ltd* (1973) Leading case on just and equitable winding up. Petition successful following exclusion from management in quasi-partnership

11.1.1 *Foss v Harbottle* (1843) 2 Hare 461 CH

Key Facts

Two shareholders commenced an action against the promoters and directors of the company, alleging that they had sold their own property to the company at an exorbitant price and then improperly mortgaged it.

Key Law

They were not competent to commence the action. If a wrong is done to the company the company is the proper claimant and not individual shareholders.

Key Judgment

Wigram V-C
'The only question can be whether the facts alleged in this case justify a departure from the rule which, *prima facie*, would require that the corporation should sue in its own name.' No such justification was found.

11.1.2 *Cook v Deeks* [1916] 1 AC 554 PC

Key Facts

Three directors, who were also the majority shareholders, diverted a company contract to another company which they owned and controlled. A general meeting then ratified what they had done. The fourth director and minority shareholder commenced an action against them to make them account for the profits they had made on the contract.

Key Law

Diverting the contract was a breach of duty and could not be cured by ratification as it amounted to a fraud on the minority. The contract belonged in equity to the company and they had to account for the profits.

Key Comment

Section 260(3) CA 2006 now sets out the circumstances when a derivative action can be brought and no longer requires fraud to be proved.

11.1.2 *Wallersteiner v Moir (No 2)* [1975] QB 373 CA

Key Facts

A minority shareholder engaged in litigation against a director, who was found to have misapplied company property, which lasted ten years. By this time he had exhausted his own funds and those of other shareholders in bringing the action. His action eventually succeeded.

Key Law

As long as actions are commenced reasonably, the company can be ordered to indemnify the claimant for the costs of the action.

Key Comment

Under s 205 CA 2006 the company can pay a director's defence costs, which must be repaid if the director loses.

11.1.2 *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 CA

Key Facts

Prudential owned 3.2 per cent of the shares in Newman. They alleged that two directors of Newman caused the company to purchase assets at an overvalue. The general meeting gave their consent to the purchase but Prudential further alleged that the meeting had been given misleading information. Prudential commenced a derivative action against the directors and sought damages. They argued that the two directors were in control of Newman and were able to prevent it from commencing an action itself.

Key Law

Prudential succeeded.

1. The right to bring a derivative action should be determined at a preliminary hearing.
2. There is no ‘interest of justice’ exception to *Foss v Harbottle* as this is too vague.
3. ‘Control’ of a company by the wrongdoers can embrace both numerical control and control by influence or by the apathy of shareholders.
4. Prudential as a shareholder had not suffered any personal loss distinct from that of the company. Their loss was merely a reflection of the loss suffered by the company.

Key Comment

- Under the new statutory derivative action there is no longer any need to show wrongdoer control. This makes it easier for shareholders to bring a claim.
- Under the old law, preliminary hearings could last as long as the trial with the resulting costs. Now, under ss 261–264 CA 2006, a member must obtain the court's permission to continue with a derivative action.

11.1.2 *Smith v Croft (No 2)* [1988] Ch 114 CH

Key Facts

The claimants were minority shareholders and sought to recover company money which they alleged had been used by the directors to give financial assistance so that another company could buy its shares. This financial assistance was illegal and *ultra vires*. A majority of the shareholders, who were independent of the directors, did not wish the action to proceed.

Key Law

The action was struck out. The views of the independent shareholders should be taken into account. If a majority of the independent minority do not want an action to proceed, then proceedings should not be commenced.

Key Comment

This is now reflected in s 263(4) CA 2006 of the new statutory derivative action. In deciding whether to grant leave to bring or continue the action, the court is specifically required to consider the views of 'members of the company who have no personal interest, direct or indirect, in the matter'.

11.1.2 *Barrett v Duckett* [1995] BCC 362 CA

Key Facts

B was a 50 per cent shareholder in the company. She complained that D, the other 50 per cent shareholder, together with his wife, had diverted assets away from the company, paid themselves excessive remuneration and had taken cash from the company. D presented a winding-up petition as the company was insolvent and in deadlock. B then commenced a derivative action. D applied to have the action struck out.

Key Law

The action was struck out. B had no funds to bring the action. The company did have some money and a liquidator was best placed to decide whether to commence an action and this provided a better alternative remedy. Also, B was not pursuing the action *bona fide* on behalf of the company. If she had been she would have sued her daughter, who was also a director at the relevant time. She was motivated by personal, rather than financial, reasons following her daughter's divorce from D.

Key Comment

Under the new statutory derivative action, when deciding whether or not to grant leave, the court can take into account whether 'the member is acting in good faith in seeking to continue with the claim'. See s 263(3)(a) CA 2006.

11.1.2 *Daniels v Daniels* [1978] Ch 406 CH

Key Facts

Mr and Mrs Daniels were the majority shareholders and directors of the company. They caused the company to sell some of its land to Mrs Daniels for £4,250, which was well below its true value. She later sold it for £120,000. Three minority shareholders commenced a derivative action and she applied to have it struck out.

Key Law

The application was dismissed. Although there was no allegation of fraud the directors benefited personally and their use of their powers in this way was a fraud on the minority.

Key Judgment

Templeman J distinguished the earlier case of *Pavlides v Jensen* (1956) as in that case the directors sold property to outsiders, so that there was no personal benefit to them. It was ‘mere negligence’ rather than ‘self-serving negligence’, as in *Daniels*.

Key Comment

The circumstances when a statutory derivative action can be brought in s 260(3) CA 2006 now specifically includes a claim of negligence. The distinction in *Daniels* and *Pavlides* is, therefore, no longer relevant; ‘mere negligence’ is now covered.

11.1.2 *Nurcombe v Nurcombe* [1985] 1 WLR 570 CA

Key Facts

A husband, who was the majority shareholder in a company, misapplied company money. His wife, the minority shareholder, was awarded a lump sum in matrimonial proceedings, which included the money misapplied by the husband. On discovering this she commenced a derivative action against him and the company.

Key Law

Derivative actions require the claimant to come to court ‘with clean hands’. The wife did not have clean hands, as having received the money in matrimonial proceedings she was attempting to receive it again through her derivative claim. This would amount to a form of double recovery and was unfair.

Key Comment

Under the new statutory derivative action, when deciding whether or not to grant leave, the court can take into account whether 'the member is acting in good faith in seeking to continue with the claim'. See s 263(3)(a) CA 2006.

11.1.3 *Bamford v Harvey* [2012] EWHC 2858; [2013] BCC 311 CH

Key Facts

B and H were the sole directors and equal shareholders in the company. B alleged that H had borrowed £3.5 million from the company and that he had not repaid it. B therefore commenced a derivative claim against H and sought permission from the court under the second stage of the derivative procedure in s 263 CA 2006 to be allowed to continue it. H argued that the company should have commenced the action, which it was permitted to do under a shareholders agreement between them and that, as a matter of principle, the derivative action should not be allowed to continue.

Key Law

Permission to continue the derivative action was refused. B could, under the shareholders agreement, have arranged for the company to commence proceedings in its own right. In refusing permission, Roth J stated that it is no longer necessary for a derivative claimant to show that the wrongdoers are in control of the company preventing it from bringing the action itself. Wrongdoer control remains, however, a factor for the court to take into account.

11.1.3 *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526; [2010] BCC 420 CH

Key Facts

The applicants sought permission to continue a derivative action under s 261 CA 2006. They claimed that the directors of the company (W) were in breach of duty by improperly accepting rescission of a contract to buy shares. They also claimed restitution for expenses incurred by W as a result of the breach together with a claim that another company held a licence to extract minerals on behalf of W.

Key Law

- The application was refused.
- Under s 263(2)(a) CA 2006 the court must refuse permission to continue a derivative action if a person acting in accordance with s 172 (duty of a director to promote the success of the company) would not seek to continue with the claim. This means that permission can only be refused if *no* director within s 172 would continue with the claim.
- On the facts the evidence against the directors was so weak that no director acting within s 172 would seek to continue with the claim.
- The claim for restitution failed because the pleadings in respect of restitution did not allege a breach of duty by a director and therefore did not fall within a derivative claim.
- The trust claim was considered to be a strong one but it was referred back to the directors for re-consideration under s 261(4)(c) CA 2006.

11.1.3 *Franbar Holdings Ltd v Patel* (2008) CH

Key Facts

Franbar sought permission to continue a derivative action under s 261 CA 2006. Numerous complaints were made against two of its directors but essentially it was claimed that they had diverted business opportunities away from the company in order to drive its share price down and that they withheld financial information. In addition to the derivative action there was also a claim for breach of a shareholders agreement and an unfairly prejudicial conduct petition under s 994 CA 2006.

Key Law

Permission was refused. A hypothetical director acting under s 172 would not attach great importance to the derivative claim because the complaints were 'more naturally . . . formulated' as breaches of the shareholders agreement and the s 994 proceedings.

11.1.3 *Phillips v Fryer* [2013] BCC 176 CH

Key Facts

P sought permission to continue a derivative action under s 261 CA 2006 to recover money allegedly taken by the defendant directors from the company in which he held 50 per cent of the shares. P had already commenced s 994 unfairly prejudicial proceedings against them seeking an order that they sell their shares to him and that they restore to the company the money wrongly taken by them. The defendants argued the derivative proceeding would duplicate the s 994 proceedings and increase the costs of the dispute.

Key Law

Permission was granted. When considering the s 263 factors, the claimant was clearly acting in good faith. His aim was to recover the money taken as quickly as possible and this was precisely what any director, seeking to promote the success of the company would do under s 172 of the Act. As a matter of case management there were grounds for making a summary judgment application in the derivative action proceedings which were unlikely to take six days to hear, which was the estimated time that the s 994 hearing would take. The derivative claim was therefore the most effective means of getting the case to court quickly and economically.

11.2 *Parke v Daily News* [1962] Ch 927 ChD

Key Facts

The company's newspaper business had been sold and the company proposed to use the sales proceeds as *ex gratia* redundancy payments to its employees. This was challenged as being *ultra vires* by a shareholder.

Key Law

The court declared that the payments would be of no benefit to the company and were therefore *ultra vires*. The shareholder had the right to bring an action.

Key Comment

This decision has since been reversed by s 247 CA 2006, but the basic right of a member to challenge an illegal act remains.

11.2 *Edwards v Halliwell* [1950] 2 All ER 1064 CA

Key Facts

Two members of a trade union commenced an action preventing the union from increasing members' subscriptions. The rules of the union (equivalent to the articles) required a ballot of the members and a two-thirds majority to approve of the increase but this had not been done.

Key Law

The increase in subscriptions was not allowed. The failure to follow the special procedure in the rules of the union was not merely a matter of internal irregularity but a matter of substance.

11.2 *Pender v Lushington* (1877) 6 Ch D 70 CH

Key Facts

The company's articles provided that every member was entitled to ten votes per share, subject to a maximum of 100 votes overall. To avoid this provision P transferred some of his shares to his nominees. At a general meeting the chairman refused to count the votes of the nominees on a resolution proposed by P, which was accordingly lost. P commenced a representative action on behalf of himself and the other shareholders who had tried to vote with him.

Key Law

He was successful, as a member of a company has a personal right to have his votes counted.

Key Problem

It is difficult to identify precisely just what the personal rights of a member are. The CA 2006 does not address this issue and future problems cannot therefore be ruled out.

11.2 *MacDougall v Gardiner* (1875) 1 Ch D 13 CA

Key Facts

The chairman of the company, G, adjourned a general meeting after there was a resolution to do so on a show of hands. He refused a demand for a poll on the decision to adjourn by shareholders, including M, who sought to exercise their right to a poll under the articles.

Key Law

The court refused to interfere with this decision. The shareholders had no personal right to insist on a poll. The chairman's refusal was merely an internal irregularity which could be cured by the majority of the members agreeing to it. Litigation would therefore be pointless.

Key Link

Similarly, in *Mozley v Alston* (1847), two shareholders were held not to have a personal right to have the directors retire by rotation in accordance with the articles.

11.3 *Johnson v Gore Wood & Co Ltd* [2002] 2 AC 1 HL

Key Facts

J owned and controlled W Ltd. He instructed the defendant firm of solicitors to purchase property for development purposes but alleged negligence. By the time the land was conveyed the company had suffered losses. The company's action against the firm was settled but J brought this claim for personal losses, which he said were distinct from those of his company.

Key Law

J was unable to claim for pension contributions which the company was unable to make using the money which would have been produced by developing the property. This loss merely reflected the company's loss. A claim for loss of the enhanced value of his pension had the payments been made was, however, allowed, as were other losses such as personal borrowings, interests and charges.

Key Judgment

Lord Bingham of Cornhill said the cases established the following points. Where a company suffers a loss:

- caused by a breach of duty owed to it, only the company can sue to recover it – the shareholder cannot sue for a diminution of loss in the value of the shares because this merely reflects the company's loss and is not distinct: *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* (1982);
- but has no cause of action to recover the loss, a shareholder may sue even if the loss is a diminution in the value of the shares: *George Fischer (Great Britain) Ltd v Multi-Construction Ltd* (1995); and
- caused by a breach of duty owed to it, a shareholder can sue if he can show an independent duty was owed to him and he has suffered a separate and distinct loss: *Stein v Blake* (1998).

11.4.1 & 11.4.4 *Re Harmer Ltd* [1959] 1 WLR 62 CA

Key Facts

Mr Harmer ignored the wishes of the other members and directors including his two sons. They alleged he had opened an unprofitable branch in Australia, paid himself unauthorised expenses, packed the board with his supporters, employed private detectives to spy on the staff and was negotiating to sell the American side of the business contrary to the company's best interests. They petitioned under s 210 CA 1948 [s 994 CA 2006], which required them to show his behaviour was 'oppressive'.

Key Law

The petition was successful. Mr Harmer was ordered not to interfere with the affairs of the company unless directed to do so by the board. He was given a service contract and also appointed as 'President' of the company but on the understanding that this position carried no rights, duties or responsibilities.

11.4.1 *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324 HL

Key Facts

The Society formed a subsidiary to manufacture a man-made material called Rayon, which required a licence. The Society appointed a majority of the directors and was also the majority shareholder in the subsidiary. Dr Meyer was a minority shareholder in the subsidiary who had the necessary experience to obtain the licence. When the licence requirement was dropped the Society transferred Rayon production to itself and starved the subsidiary of the raw materials needed to manufacture Rayon. Its shares became worthless as a result.

Key Law

Dr Meyer's petition under s 994 CA 2006 [s 210 CA 1948] was successful. The Society, through its board of directors, had carried on the business of the subsidiary in an 'oppressive' manner. It was ordered to buy his shares at a price of £3.75 per share, which was their value before the oppressive conduct started.

11.4.1 *Fulham Football Club Ltd (1987) v Richards* [2011] EWCA Civ 855; [2012] Ch 333 CA

Key Facts

The petitioner, Fulham Football Club Ltd ('the club') was a member holding one share in the Football Association Premier League Ltd ('FAPL'). The club complained that Richards, who was the Chairman of FAPL, had acted as an unauthorised agent in the transfer of the footballer, Peter Crouch, to Tottenham Hotspur. The club wanted to sign the player for themselves, and alleged that the behaviour of Richards was unfairly prejudicial to their interests in FAPL. The judge stayed the court proceedings as the articles of the FAPL and the rules of the Football Association required such disputes to be decided by arbitration. The club appealed.

Key Law

The appeal was dismissed. The judge was right to stay the proceedings as a member does not have an inalienable right to have a s 994 petition heard in court if they have an arbitration agreement. This was because there is no express or implied rule in the CA 2006 preserving the members' right to a court hearing, and also there is no public policy rule to the same effect.

11.4.2, 11.4.3 & 11.4.5 *Re a Company (No 00477 of 1986)* [1986] BCLC 376 CD

Key Facts

The petitioners sold their shares in A Ltd to O plc in return for shares in O plc. They alleged that O plc had no funds to invest and simply stripped the assets of A Ltd as well as removing one of the petitioners as a director. At a preliminary hearing, it was argued that this conduct did not affect the petitioners as members, but as directors or defrauded vendors of their shares in A Ltd.

Key Law

Removal as a director can affect a petitioner in his capacity as a member. This is unlikely in the case of a large plc but Hoffmann J gave the example of a member who has invested his capital in a quasi-partnership type company. His interests as a member may include a legitimate expectation that he will remain a director. If he is removed his interests as a member are affected.

Key Comment

This decision greatly extended the scope of the section and removal as a director is a very common complaint in s 994 CA 2006 petitions.

11.4.2 *Re JE Cade & Sons Ltd* [1992] BCLC 213 ChD

Key Facts

The minority shareholder owned a farm which the company occupied as a tenant. He commenced a petition under s 459 CA 1985 [s 994 CA 2006].

Key Law

The petition was dismissed, as he did not commence the proceedings to protect his interests in his capacity as a member, but in his capacity as the freeholder of the farm.

11.4.2 *Re London School of Electronics Ltd* [1986] 1 Ch 211 CH

Key Facts

The petitioner was a minority shareholder and director in the company, whose business was a private tutorial college. He alleged that the majority shareholders had diverted students to a rival college that they had set up and removed him as a director. As a result the petitioner himself diverted some 12 students to another college which he had set up.

Key Law

The conduct by the majority was unfairly prejudicial and the court made a share purchase order of the petitioner's shares. There is no 'clean hands' requirement, so the petitioner's own conduct was not fatal to a claim, but it may affect the order which the court decides to grant.

11.4.2 *Re Batesons Hotels* (1958) Ltd [2013] EWHC 2530 CH

Key Facts

The court was asked to decide the following point of law: 'Can a petitioner complain of unfairly prejudicial conduct which occurred before the petitioner became a shareholder, and to which all the shareholders at the material time expressly consented?'

Key Law

The court answered in the negative. The consent can be informal using the *Duomatic* procedure and the restriction on bringing an action in this situation applies to s 994 proceedings and derivative actions.

Key Link

See Chapter 8, section 8.4 for the *Duomatic* principle.

11.4.3 *Re RA Noble (Clothing) Ltd* [1983] BCLC 273 CH

Key Facts

The petitioner alleged unfairly prejudicial conduct by being excluded from the management of the company.

Key Law

His exclusion from management was prejudicial but was not unfair as the petitioner had shown no interest in the company's management and left it to the other shareholder. His exclusion was therefore the result of his own disinterest and the petition failed. Instead, the court granted a winding up order on the just and equitable ground.

11.4.3 *Re Sam Weller & Sons Ltd* [1990] Ch 682 CH

Key Facts

Despite a large amount of accumulated profits and cash in the bank, the company paid the same dividend for 37 years.

Key Law

The judge refused to strike out the petition, as this was capable of amounting to unfairly prejudicial conduct.

11.4.3 *Re Cumana Ltd* [1986] BCLC 430 CH

Key Facts

The petitioner alleged that the majority shareholder had paid himself excessive remuneration (£365,000 over a 14-month period) and was proposing a rights issue that would dilute his holding from 33 per cent to 0.33 per cent at a time when he knew the petitioner could not afford to buy any more shares.

Key Law

Excessive remuneration and proposed share issues can amount to unfairly prejudicial conduct. The court ordered the petitioner's shares to be purchased.

11.4.3 *Re Little Olympian Each-Ways Ltd (No 3)* [1995] BCLC 636 ChD

Key Facts

The petitioner alleged that the majority had transferred the business of the company to another company, which they controlled, at a substantial undervalue.

Key Law

This was unfairly prejudicial conduct.

11.4.3 *Re Macro (Ipswich) Ltd* [1994] BCC 781 CH

Key Facts

The minority shareholders alleged that the majority shareholder and sole director had mismanaged the company, which operated as a residential landlord.

Key Law

Serious mismanagement can amount to unfairly prejudicial conduct. On the facts there was mismanagement over a 50-year period and this included: failure to have a planned maintenance programme for the properties; failure to inspect the properties; failure to carry out repairs; taking commission from builders doing repairs; and excessive management charges.

Key Link

Simply poor management including commercial misjudgement will not suffice: *Re Elgindata Ltd* [1991] BCLC 959.

11.4.3 *Re Tottenham Hotspur plc* [1994] 1 BCLC 655 CH

Key Facts

V, the chief executive, and C, the chairman, fell out with each other. V's service contract was terminated and he ceased to be the chief executive. He commenced s 459 CA 2005 [s 994 CA 2006] proceedings claiming that he had a legitimate expectation to continue to take part in the management of the company.

Key Law

The petition failed. V's rights were governed solely by the company's constitution and the board had the normal right to hire and fire. There was no other agreement or understanding which V could point to.

Key Comment

Petitioners in plcs have not fared well under the section. The courts are reluctant to recognise agreements beyond the constitution. The reason was explained by Jonathan Parker J in *Re Astec (BSR) plc* [1998] 2 BCLC 556: 'If the market in a company's shares is to have any credibility, members of the public dealing in that market must . . . be entitled to proceed on the footing that constitution is as it appears in the company's public documents, unaffected by any extraneous equitable considerations and constraints.'

11.4.3, 11.4.5 & 11.5.3 *O'Neill v Phillips* [1999] 1 WLR 1092

HL

Key Facts

O joined a construction company, which was owned and controlled by P. He began as a manual worker but he impressed P and worked his way up the company. He became a 25 per cent shareholder, managing director and received 50 per cent of the profits. P had discussed with O the possibility of O becoming a 50 per cent shareholder but there was no concluded agreement between them. After a recession in the construction industry they fell out. P removed O as the managing director (though he remained an ordinary director) and told him he would no longer receive half of the profits, just his salary and dividends. O commenced s 459 [s 994 CA 2006] proceedings. He claimed the termination of the profit-sharing agreement and the repudiation of the alleged agreement to become a 50 per cent shareholder was unfairly prejudicial.

Key Law

The petition was unsuccessful. O was unable to show he had a legal or equitable agreement to receive half of the profits or shares.

Key Judgment

Lord Hoffman gave guidance on the scope of the unfairly prejudicial remedy:

- There must normally be a breach of the terms upon which the member joined the company.
- If the articles are being observed, the petitioner must be able to point to some wider equitable agreement or understanding.
- It was probably a mistake, in previous case law, to use the term 'legitimate expectation' to describe the right of a petitioner to rely on equitable principles when bringing a claim.
- The section does not allow a petitioner to exit a company at will; there must be an element of fault on the part of the respondent.
- The unfair prejudice must be suffered by the petitioner in his capacity as a shareholder and not in some other capacity such as an employee.

11.4.4 *Grace v Biagioli* [2005] EWCA Civ 1222; [2006] 2 BCLC 70 CA

Key Facts

G was one of four shareholders. A company which he managed as part of a group of companies which they operated performed poorly. In response, the others withheld G's dividend. G, in turn, began to explore the possibility of buying a competing company in the Far East. When the others discovered this they removed him as a director. G alleged this was unfairly prejudicial behaviour.

Key Law

G's conduct in trying to buy a competing company justified his dismissal. However, the steps the others had taken to deny him his dividend amounted to unfairly prejudicial conduct. A share purchase order was granted.

11.4.4 *Re Brenfield Squash Racquets Club Ltd* [1996] 2 BCLC 184 CA

Key Facts

The majority 86 per cent shareholder used the company for its own purposes. This included charging the company exorbitant management fees and using it as a source of petty cash. The company's premises were also used to secure their debts, amounting to more than £800,000.

Key Law

This amounted to unfairly prejudicial conduct and was so serious that the majority were ordered to sell their shares to the minority petitioner.

11.4.4 *Re Bird Precision Bellows Ltd* [1986] Ch 658 CH

Key Facts

The petitioner had been excluded from a quasi-partnership type company. The court found that this was unfairly prejudicial and made a share purchase order of the petitioner's shares. The court had to decide how the shares were to be valued.

Key Law

The order was that the shares were to be valued *pro rata* without any discount. The court has a complete discretion on how to value the shares but gave the following guidelines:

- Where shares are purchased from a petitioner in a quasi-partnership company, the sale is effectively forced upon him as he is really an unwilling seller due to the unfairly prejudicial behaviour. Here the value should be assessed *pro rata* and not discounted to reflect the minority holding.
- Equally, if the delinquent majority shareholder is ordered to sell to the minority, he should not receive a premium to reflect his majority holding.
- In the rare situation that the minority shareholder was the cause of his own exclusion, a discount is appropriate.
- If the petitioner purchased the shares as an investment, his original purchase price would reflect the fact that he was buying a minority holding. Therefore, a discounted value may be appropriate.

11.4.4 *Profinance Trust SA v Gladstone* [2001] EWCA Civ 1031; [2002] 1 WLR 1024 CA

Key Law

Robert Walker LJ said the general trend of authorities was that the starting point is that shares are to be valued at the date of the share purchase order. However, fairness may require the court to take another date:

- where the conduct complained of deprived the company of its business an earlier valuation may be required;
- where the company's business had changed significantly; and
- where there is a s 459 petition pending and a general fall in the market an early valuation may be required, especially if the court disapproved of the unfairly prejudicial conduct.

But an earlier valuation will not be made simply to give the petitioner the most advantageous exit from the company, especially if the unfairly prejudicial conduct is not severe. The parties' conduct in making, accepting and rejecting offers may also influence the date.

11.4.5 *Phoenix Office Supplies Ltd v Larvin* [2003] 1 BCLC 76 CA

Key Facts

L was a minority shareholder and director of the company. Without warning he decided for personal reasons that he wanted to leave the company, based in Sheffield, and start a new life in Manchester. He wanted the other two directors to buy his shares and they offered him £33,000 for them, which included a substantial discount to reflect his minority holding. He commenced s 459 [s 994 CA 2006] proceedings. He claimed the company was a quasi-partnership and that they had broken an understanding that each would receive one-third of the company's net assets value if they left the company.

Key Law

In the absence of a contractual right to do so s 459 does not provide a member, who wishes to voluntarily leave the company for personal reasons, with the right to force the others to buy his shares at their full discounted value.

Key Judgment

Auld LJ said that 'not every quasi-partnership company relationship gives rise to an entitlement to a "no fault" divorce; there must be something more'.

11.5.1 *Virdi v Abbey Leisure* [1990] BCLC 342 CA

Key Facts

The company was formed with the object of buying and running a nightclub. The club was sold and the majority shareholders wanted to buy another club with the proceeds. A minority shareholder petitioned to have the company wound up but the articles provided that a member who wanted to transfer his shares had to offer them to the existing members and that they would be valued by an accountant.

Key Law

The winding-up petition succeeded. The company's assets consisted almost entirely of cash and it was not unreasonable for the petitioner to object to an accountant's valuation as he might apply a discount to reflect the petitioner's minority holding. A liquidator was better placed to value the shares and protect the petitioner's interests.

11.5.2 *Re German Date Coffee Co* (1882) 20 Ch D 169 CA

Key Facts

The company had narrow main objects: to acquire a German patent to manufacture substitute coffee made from dates. The Germans refused to grant the patent and minority shareholders petitioned for a just and equitable winding up as the company was now unable to pursue its principal object.

Key Law

Despite the company's establishing a factory in Hamburg to manufacture the coffee and doing prosperous trade, and despite its also acquiring a similar Swedish patent, the court granted the winding-up order. The company's substratum had gone. The company's objects clause only permitted the company to manufacture the coffee substitute by working a particular German patent, which could not be obtained.

Key Comment

Modern drafting techniques now allow companies to engage in a very wide range of objects. Under s 31(1) CA 2006, a company's objects are unrestrictive unless specifically restricted by the articles.

11.5.2 *Re Brinsmead (Thomas Edward) & Son* [1897] 1 Ch 406 CA

Key Facts

The company was formed by three former employees of John Brinsmead & Sons, who were well-known piano manufacturers. The company was formed for the fraudulent purpose of manufacturing pianos and then passing them off as being made by John Brinsmead & Sons.

Key Law

The court had no doubt that in these circumstances a shareholder was entitled to petition for a winding-up order on the just and equitable ground.

11.5.2 *Loch v John Blackwood Ltd* [1924] AC 783 PC

Key Facts

The managing director of the company failed to hold general meetings, submit accounts or recommend a dividend. He ran the company in a profitable but oppressive manner towards the shareholders with the exception of his wife.

Key Law

Running the company in this way led to a justifiable lack of confidence in the management of the company's affairs. A winding-up order was granted on the just and equitable ground.

Key Judgment

Lord Shaw of Dunfermline 'But this lack of confidence must be grounded on conduct of the directors, not in regard to their private life or affairs, but in regard to the company's business. Furthermore the lack of confidence must spring not from dissatisfaction at being outvoted on the business affairs or on what is called the domestic business policy of the company.'

11.5.2 *Re Yenidje Tobacco Co Ltd* [1916] 2 Ch 426 CA

Key Facts

Two cigarette manufacturers, Rothman and Weinberg, combined their businesses to form the company. They were the only shareholders and directors but could not work together. Rothman sued Weinberg for fraud and they would only communicate with each other through the company secretary. Weinberg petitioned for a winding-up order.

Key Law

It was just and equitable to wind up the company in these circumstances. The company was in effect a partnership and the circumstances would justify the dissolution of a partnership. It was therefore proper to grant the winding-up order.

11.5.2 *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360

HL

Key Facts

From 1945 E and N carried on a carpet business as partners. In 1958 they formed WG Ltd to operate the business. E and N held 400 shares each and were directors. N's son later joined the company, taking 200 shares, and also became a director. N and his son fell out with E. They dismissed him under s 184 CA 1948 (s 168 CA 2006), as they were legally entitled to do, by ordinary resolution. The company's policy was not to pay dividends but to pay the directors a salary. E petitioned for a winding-up order on the just and equitable ground.

Key Law

The winding-up order was granted. The company was a quasi-partnership and therefore the legal right to remove E was subject to equitable considerations. The company was formed on the basis that they would each continue to participate in the management of the company. Removing E meant that he was excluded from the company's profits and the articles required the consent of the others before he could sell his shares. He was therefore at the mercy of N and his son and in these circumstances it was just and equitable to wind up the company.

Key Judgment

Lord Wilberforce identified the characteristics of a quasi-partnership as follows: 'Certainly the fact that a company is a small one, or a private company, is not enough . . . the superimposition of equitable considerations requires something more, which typically may include one, or probably more, of the following elements: (i) an association formed or continued on the basis of a personal relationship, involving mutual confidence – this element will often be found where a pre-existing partnership has been converted into a limited company; (ii) an agreement, or understanding, that all, or some (for there may be "sleeping" members), of the shareholders shall participate in the conduct of the business; (iii) restrictions upon the transfer of the members' interests in the company so that if confidence is lost, or one member is removed from management, he cannot take out his stake and go elsewhere.'

11.5.3 *Re Phoneer Ltd* [2002] 2 BCLC 241 CH

Key Facts

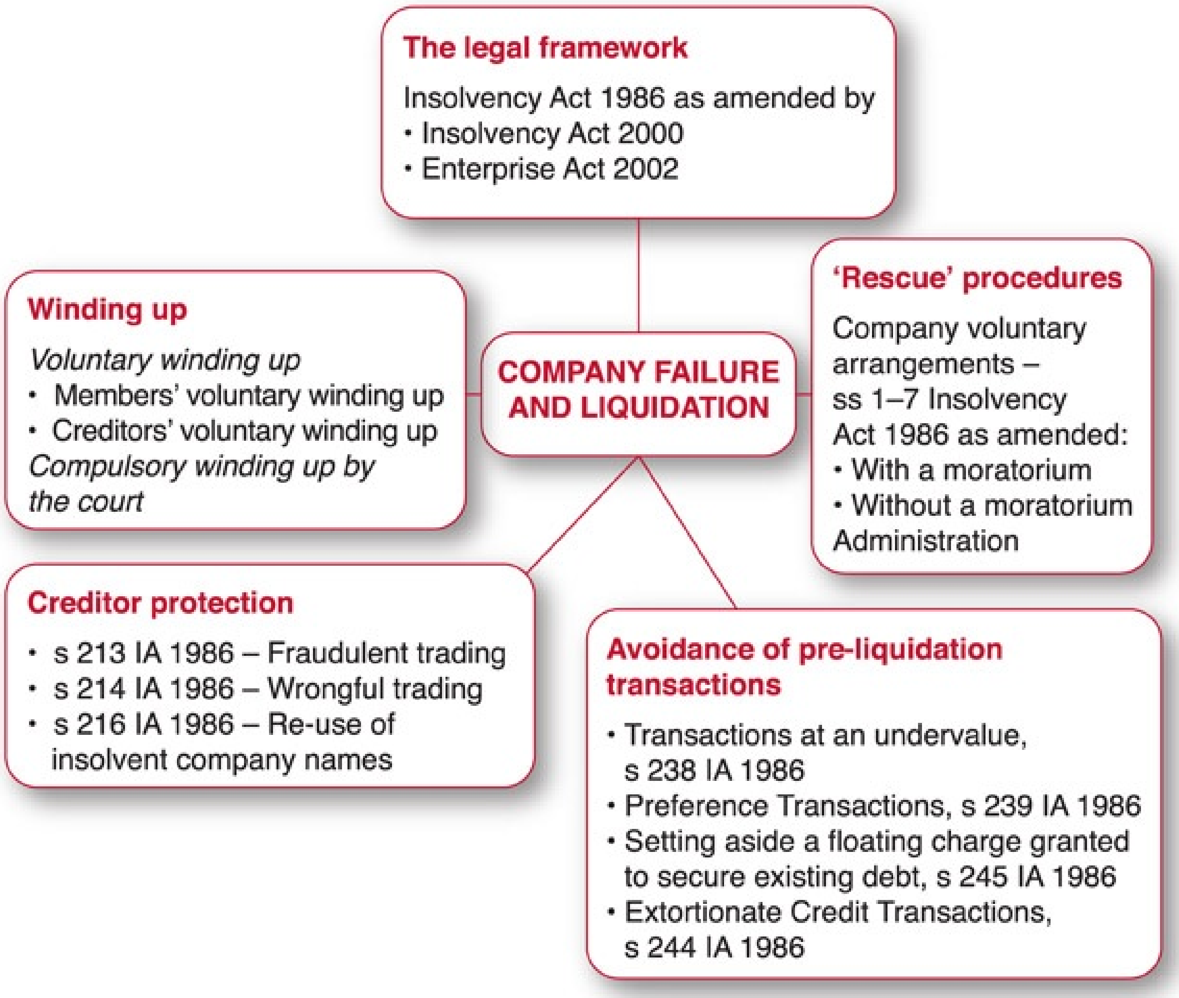
The petitioner successfully established unfairly prejudicial conduct and sought a share purchase order.

Key Law

A winding-up order was more appropriate as the company did not have the necessary funds to buy the shares. The realised assets were ordered to be split on a 50/50 basis to reflect a shareholders’ agreement rather than on the basis on which they originally contributed the capital, which was 70/30.

12

Company failure and liquidation



12.1 The legal framework

1 The law governing insolvency and liquidation was changed and updated by the Insolvency Act 1985, following recommendations of the Cork Report, and is now contained in the Insolvency Act 1986 (IA 1986). Further changes were introduced by the Insolvency Act 2000 and the Enterprise Act 2002.

2 The changes were intended to introduce procedures to facilitate the survival of a company in financial difficulty.

3 It is necessary to distinguish between insolvency procedures and liquidation procedures. Not all insolvency procedures result in the

liquidation of the company and in some circumstances (notably the members' voluntary winding up and winding up on the just and equitable ground) a company that is not insolvent will be put into liquidation.

4 The law relating to insolvency and liquidation is complex and extensive and this chapter covers some general principles only.

12.1.1 Objectives of corporate insolvency law

The following objectives have been suggested:

1 To facilitate the recovery of companies in financial difficulty.
2 To suspend the pursuit of rights and remedies of individual creditors.
3 To prevent transfers and transactions which unfairly prejudice the general creditors.
4 To divest directors of their powers of management in certain circumstances.
5 To ensure an orderly distribution of the assets and a fair system for the ranking of claims.
6 To impose responsibility for culpable management by directors and officers.

12.1.2 Insolvency practitioners

All liquidation and insolvency procedures require the appointment of an insolvency practitioner to a particular office as shown in the chart below.

Procedure	Office
Administrative receivership	Administrative receiver
Administration order	Administrator
Voluntary arrangement	Supervisor
Liquidation (voluntary or compulsory)	Liquidator

12.1.3 Qualification

1 Only an individual can act as an insolvency practitioner, and he or she must not be:

- an undischarged bankrupt;
- subject to a director's disqualification order;
- a patient within the meaning of the mental health legislation.

2 He or she must be qualified to act generally; recognised professional bodies can authorise persons to act as insolvency practitioners.

3 A person who acts without being qualified to do so commits a criminal offence.

12.2 Company voluntary arrangements

These are governed by ss 1–7 IA 1986 as amended by the Insolvency Act 2000. In its original form, a company voluntary arrangement (CVA) did not provide for a moratorium on payment of the company's debts, which meant that it was possible that a creditor would petition for a winding up before the CVA could be agreed. The amended legislation provides for two kinds of CVA: without a moratorium and with a moratorium, which allows the company time to come to a binding agreement with its creditors.

12.2.1 Company voluntary arrangements without a moratorium

1 A proposal is made for a composition in satisfaction of the company's debts or a scheme of arrangement.

2 The proposal may be made by:

- the directors of the company, where the company is not in

administration or in liquidation;
- the administrator if the company is in administration;
- the liquidator where the company is being wound up.

3 The role of the nominee:

- a person who will supervise the implementation of the proposal, called the nominee, must be nominated;
- a liquidator or administrator may act as nominee or may nominate another insolvency practitioner;
- the nominee must submit a report to the court indicating whether he or she thinks the proposal should be put to meetings of creditors and members;
- if the nominee thinks the proposal should be put to meetings he or she must call separate meetings of all creditors whose addresses are known and members.

4 The meetings may approve or modify the proposal, but cannot approve an arrangement which deprives a secured creditor of his right to enforce the security without the consent of the creditor. Nor can they approve a proposal which alters the priority of preferential debts.

5 Under s 4A IA 1986 (introduced by the Insolvency Act 2000) if the meetings come to different decisions the decision of the creditors must prevail. However, the members may apply to the court within 28 days and the court may order the decision of the members meeting to have effect or make any order that it thinks fit.

6 Once the proposal is approved, it binds all creditors who had notice and were entitled to vote at that meeting. However, there is a 28-day period within which application may be made to the court to have the proposal set aside.

7 Once approved, the arrangement is implemented by the nominee, who

becomes the supervisor of the arrangement. When complete all creditors must be notified and must receive an account of receipts and payments.

12.2.2 Company voluntary arrangements with a moratorium

1 Company voluntary arrangements with a moratorium are governed by the Insolvency Act 1986 Schedule A1, introduced by the Enterprise Act 2002. The procedure may be used only by small companies as defined by s 382(3) of the Companies Act 2006 (CA 2006) and there are other restrictions on eligibility set out in Schedule A1.

2 The procedure is similar to that for a CVA without a moratorium except that:

- the directors must apply for the moratorium;
- they must give evidence that the company is likely to have sufficient funds to enable it to carry on business during the moratorium;
- they must submit to the nominee any information he requires to enable him to form an opinion;
- if the nominee forms a favourable opinion, the directors must file certain prescribed information with the court.

3 The effect of the moratorium is similar to an administration order, with the major difference that the directors retain their management role.

12.3 Administration

1 Unlike liquidation, which results in the company ceasing to do business, administration is designed to rescue the company, either as a whole or in part.

2 The law relating to administration orders has been overhauled by the Enterprise Act 2002 and is now contained in Schedule B1 of the Insolvency Act 1986 as amended. Previously only the court could appoint an administrator. An administrator may now be appointed by:

- the court – application may be made by the company or its directors or by a creditor;
- out of court appointment by the company or its directors;
- out of court appointment by the holder of a qualifying floating charge.

3 The legislation provides for a hierarchical list of purposes. The administrator must perform his or her role with the objective of:

- rescuing the company as a going concern, or
- achieving a better result for the company's creditors as a whole than would be achieved if the company were wound up before going into administration, or
- realising the property in order to make a distribution to one or more secured or preferential creditors.

4 The appointment of an administrator displaces the board of directors.

12.4 Receivers and administrative receivers

12.4.1 Appointment

1 A receiver is an individual appointed to take control of property which is security for a debt.

2 Receivers may be appointed by the court or in accordance with the terms of a debenture. Normally there is a clause in the charge which entitles the chargee to appoint a receiver.

3 An administrative receiver may be appointed by a creditor whose debt is secured by a floating charge on the whole, or substantially the whole, of the company's undertaking. He or she takes control of the whole, or substantially the whole, of the company's property. This right was abolished with respect to any floating charge created after 15 September 2003 by the Enterprise Act 2002. Holders of floating charges created before that date may still appoint an administrative receiver.

12.4.2 Effect of appointment of administrative receiver

1 The administrative receiver has sole authority to deal with charged property.

2 The directors continue in office but have no authority to deal with the charged property, so their role is extremely limited.

3 An administrative receiver is an agent of the company until the company goes into liquidation (IA 1986 s 44(1)(a)).

4 The administrative receiver must, within three months of appointment, prepare a report to be sent to the company's creditors and must call a meeting of unsecured creditors.

5 Apart from any contract for which specific performance may be ordered, the administrative receiver may cause the company to repudiate any existing contract.

12.5 Winding up

Winding up (liquidation) is the process whereby the company's assets are collected and realised, its debts paid and the net surplus distributed in accordance with the company's articles of association. Winding up is followed by dissolution of the company.

12.5.1 Voluntary winding up

The members adopt a resolution to wind up the company (special or ordinary). This may result in a members' voluntary winding up or a creditors' voluntary winding up.

12.5.1.1 Members' voluntary winding up

1. The members of a company adopt a resolution to put the company into liquidation, following a statutory declaration by the directors that the company is able to pay its debts.
2. The members appoint a liquidator, usually at the meeting where the resolution to wind up the company is adopted.
3. On appointment of the liquidator, all powers of the directors cease.

12.5.1.2 Creditors' voluntary winding up

1. The members adopt a resolution to put the company into liquidation without a statutory declaration of solvency by the directors.
2. Members can nominate a liquidator, but the liquidator must hold a creditors' meeting at which they may nominate a liquidator, who will become the liquidator of the company unless the court directs otherwise.
3. The creditors may appoint a liquidation committee of up to five persons to act with the liquidator. Members may appoint five members to this committee.

12.5.2 Compulsory winding up

1. The court orders that the company be wound up on application to the court by a person entitled to petition. Section 124 provides that petitions may be made by:

- any creditor who establishes a *prima facie* case;
- contributories (shareholders who may contribute to the company's assets on liquidation);
- the company itself;
- the directors of the company;
- a supervisor of a voluntary arrangement;
- the clerk of the magistrates court if the company has failed to pay a fine;
- any or all of the parties listed above together or separately;
- the secretary of state;
- an official receiver – if the company is already in voluntary liquidation;
- an administrator of the company;
- an administrative receiver of the company.

2 The vast majority of petitions are by creditors.

3 The grounds on which a petition may be made are contained in s 122 Insolvency Act 1986. The most important are:

- the company is unable to pay its debts (s 122(1)(f));
- it is just and equitable to wind the company up (s 122(1)(g)) (see Chapter 11).

12.5.3 Consequences of a winding-up order

1 A compulsory winding up is deemed to have commenced on the date the petition was presented to the court.

2 A voluntary winding up is deemed to commence on the date the resolution was passed to wind up the company.

3 In a compulsory winding up, after the petition has been presented to the

court, any disposition of the company's property is void without leave of the court (s 127 IA 1986): *Re Gray's Inn Construction Co Ltd* (1980); *Hollicourt (Contracts) Ltd v Bank of Ireland* (2001).

4 Legal proceedings cannot be commenced or continued against the company without leave of the court (s130(2) IA 1886).

12.5.4 Appointment and role of the liquidator

1 The official liquidator attached to the court where the order is made will be appointed.

2 If there are substantial assets, an insolvency practitioner may be appointed to replace the official liquidator.

3 Once the liquidator is appointed the directors cease to have any right to manage the company.

4 The role of the liquidator is to realise the assets and distribute them to those entitled to payment: s 143 IA 1986.

5 In an insolvent liquidation, priority of payment is important:

(a) Where a debt is secured by a fixed charge, the asset charged may be taken in settlement of the debt. Charges secured by a floating charge are subject to the ring-fencing provisions of the Enterprise Act 2002 (see Chapter 7, section 7.3.1).

(b) The principle of set-off will allow a creditor who is owed money by the company to deduct the difference before paying the company, thus in effect receiving full payment of his debt to the company.

6 Subject to these two principles, the order of payment is:

- expenses of the winding up, including the liquidator's remuneration;
- preferential debts: up to four months' salary of employees, up to a

prescribed amount, holiday pay and contributions to state and occupational pension schemes;

- debts secured by floating charges; note that the liquidator must deduct from the realised assets of the floating charge (called the 'prescribed part' under s 176A IA 1986) for the benefit of the unsecured creditors the following amounts:
  - 50 per cent of the first £10,000
  - – 20 per cent of the realised assets above £10,000
  - – subject to an overall maximum of £60,000;
- unsecured creditors;
- deferred debts, for example debts due to a shareholder in his capacity as such, like dividends declared but not paid;
- where the company is not insolvent, any surplus will be distributed among members in accordance with class rights.

7 Fixed and floating charge holders who suffer a shortfall after their charged assets have been realised are not allowed to participate in the 'prescribed part' explained above: *Re Airbase UK Ltd* (2008).

8 Property which the company holds on trust for another cannot be claimed and distributed by a liquidator: ***Re Kayford Ltd*** **(1975)**.

9 Property in the company's possession which is subject to an effective reservation of title clause is also beyond the reach of the liquidator: ***Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd*** **(1976)**.

12.6 Personal liability in winding up

12.6.1 Fraudulent trading

1 **W**here a person (often, but not always, a director of a company) was involved in running a company which is in the course of being wound up and which was operated with the intention of defrauding creditors, the liquidator can apply to the court for an order that the person must contribute towards the assets of the company (s 213 Insolvency Act 1986).

2 In addition to civil liability, the director may be disqualified under s 4 Company Directors Disqualification Act 1986 or prosecuted under s 993 CA 2006.

3 To establish fraud, intention or recklessness must be proved: *R v Grantham* (1984).

4 Fraudulent trading can consist of defrauding one creditor in a single transaction: ***Re Gerald Cooper (Chemicals) Ltd* (1978)**. However, this does not mean that every time a creditor is defrauded the company's business is being carried on with intent to defraud: ***Morphitis v Bernasconi* (2003)**.

5 To come within the section, the person must have 'carried on' the business of the company. Those who carry out administrative rather than management functions within the company, such as the company secretary, do not fall within the section: ***Re Maidstone Building Provisions Ltd* (1971)**.

12.6.2 Wrongful trading

1 A liquidator may apply for an order that a director, former director or shadow director of the company is liable to contribute to the company's assets if it can be shown that:

- the company has gone into insolvent liquidation;
- at some time before the start of the winding up, the director knew or ought to have known that there was no prospect of the company not going into insolvent liquidation; and
- the director was a director at the time of the relevant transaction (s 214 Insolvency Act 1986).

2 The director's conduct should be judged against the standard of a reasonably diligent person having both:

- the knowledge, skill and experience that would reasonably be expected of someone carrying out the same function; and
- the knowledge, skill and experience of the director himself.

3 The main reason for these provisions is to compensate creditors in situations where directors have acted improperly in the ways described above. If the company is in insolvent liquidation cases are more likely to be brought under s 214, rather than s 213, where it is not necessary to prove fraud or dishonesty: ***Re Produce Marketing Consortium Ltd* (1989)**; ***Re Purpoint Ltd* (1991)**.

12.7 Avoidance of pre-liquidation transactions

Liquidators (and administrators) can examine certain transactions prior to winding up or administration and set them aside, thus swelling the assets available for distribution to the creditors.

12.7.1 Transactions at an undervalue

1 These are dealt with in s 238 IA 1986
2 A transaction at an undervalue is one where the company either gifts its property or enters into a transaction with a person for a consideration significantly less than the consideration provided by the company: ***Phillips v Brewin Dolphin Bell Lawrie Ltd* (2001)**.
3 An example would be the sale of company property worth £20,000 for £10,000.

4 The transaction must have been made at a time when the company was unable to pay its debts or became unable to pay them as a result of the transaction. This is assumed if the transaction is with a connected person, such as a director.

5 The liquidator can apply to the court for an order 'restoring the position to what it would have been if the company had not entered into that transaction' at an undervalue.

6 The liquidator can look back for up to two years from the date the winding-up petition was presented.

7 It will not be a transaction at an undervalue if the company entered into it:

- in good faith;
- for the purpose of carrying on its business; and
- there were reasonable grounds for believing it would benefit the company.

12.7.2 Preferences

1 These are dealt with in s 239 IA 1986.

2 A preference is when the company does something which puts a creditor in a better position in the insolvent liquidation of the company than they would otherwise have been.

3 It will only be a preference if the company was 'influenced . . . by a desire' to produce this result (s 238 (5) IA 1986): ***Re MC Bacon Ltd* (1990)**.

4 An example is paying off a company overdraft which has been guaranteed by a company director. Here the company is preferring the director over other creditors.

5 The company must be unable to pay its debts or became unable to pay them as a result of the preference. This is assumed if the transaction is with a connected person.

6 The liquidator can ask the court for an order restoring the company to its pre-preference position.

7 The liquidator can look back for up to two years in the case of a connected person (a director) and six months if the person is unconnected (a bank) from the date the winding-up petition was presented.

12.7.3 Other avoidance transactions

1 Under s 245 IA 1986 a liquidator can set aside a floating charge if given to secure an existing debt (see Chapter 7, section 7.4.3).
2 Under s 244 IA 1986 extortionate credit transactions that the company has entered into can be challenged by a liquidator for up to three years from the date the winding-up petition is presented.
3 An example of extortionate credit is where the company borrows money for 'grossly exorbitant' repayments or the transaction grossly contravenes 'ordinary principles of fair dealing'.

12.8 Dissolution

1 Dissolution of a company takes place when its name is removed from the register kept at Companies House. On liquidation, three months after the liquidator has sent his final accounts to the Registrar, dissolution automatically follows unless an application is made to the court seeking deferral of the date of dissolution. There are slightly different procedures for voluntary and compulsory liquidations.
2 There are a number of other ways in which dissolution may take place, including:

- in an administration, three months after notification by the administrator that there is nothing to distribute to creditors the company is deemed to be dissolved.
- by order of the court as part of a compromise, arrangement or reconstruction.
- s 1000 CA 2006 sets out a procedure by which the Registrar is

empowered to strike a company off the register. This accounts for a large number of dissolutions, where after sending letters to the company and advertising the Registrar is satisfied that the company has ceased to do business.

- under s 1003 CA 2006, on application of the company itself three months after publication of a notice in the Gazette.

12.9 Re-use of an insolvent company's name

1. Section 216 IA 1986 deals with the re-use of company names and the so-called 'phoenix syndrome'.
2. A director or shadow director of a company that has gone into insolvent liquidation is prohibited, without leave of the court, from using the same or a similar name of the company for a period of five years.
3. A breach of the section is a criminal offence and can result in personal liability for the new company's debts: ***Ad Valorem Factors Ltd v Ricketts* (2003)**.

Key Cases Checklist

Liquidation

Consequences of a Winding Up Order

Re Gray's Inn Construction Co Ltd (1980)
Payments out of a bank account were dispositions of property under s

127 IA 1986 and were void. The bank had to make good the payments

Hollicourt (Contracts) Ltd v Bank of Ireland (2001)

Liquidator could recover payments from payees on cheques but not from the bank under s 127 IA 1986

Pre-Liquidation Transactions

Re MC Bacon Ltd (1990)

A company transaction was not a voidable preference under s 239 IA 1986 as the company did not have the relevant desire to improve the creditor's position on insolvency

Phillips v Brewin Dolphin Bell Lawrie Ltd (2001)

When assessing an alleged transaction at an undervalue under s 238 IA 1986 all linked transactions have to be taken into account

Personal Liability in a Company Liquidation

Fraudulent Trading

Re Maidstone Building Provisions Ltd (1971)

A company secretary was not liable for fraudulent trading under s 213 IA 1986

Re Gerald Cooper (Chemicals) Ltd (1978)

A single transaction can amount to fraudulent trading

Morphitis v Bernasconi (2003)

It is not necessarily fraudulent trading every time a creditor is defrauded

Wrongful Trading

Re Produce Marketing Consortium Ltd (1989)

Two directors had to contribute a total of £75,000 for wrongful trading under s 214 IA 1986

Re Purpoint Ltd (1991)

Director liable for wrongful trading after ignoring auditor's warning

Reuse of Insolvent Company's Name

Ad Valorem Factors Ltd v Ricketts (2003)

Director liable under s 216 IA 1986 for reusing the name of an insolvent company in which he was a director

Property not available to the Liquidator

Re Kayford Ltd (1975)

Property held on trust by the company for its customers was not available for distribution by the liquidator

Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd (1976)

The liquidator could not claim property in the company's possession which was subject to a reservation of title clause

12.5.3 *Re Gray's Inn Construction Co Ltd* [1980] 1 WLR 711 CA

Key Facts

A winding-up petition was presented on 3 August 1972 but the bank did not become aware of this until 17 August 1972. The winding-up order was granted on 9 October 1972. Between 3 August and 9 October the company continued to operate its bank account. The liquidator sought an order under what is now s 127 IA 1986 that the payments in and out of the account were void dispositions.

Key Law

Under s 127 any disposition of company property or the transfer of shares after the commencement of winding up is void unless validated by the court. The payments into and out of the bank account amounted to a disposition of company property and were void. The bank had to make good the payments.

12.5.3 *Hollicourt (Contracts) Ltd v Bank of Ireland* [2001] 1 BCLC 233 CA

Key Facts

The company continued to write out cheques to third parties for three months before the bank became aware that a winding-up petition against the company had been presented. The liquidator claimed these were void dispositions of company property under s 127 IA 1986.

Key Law

Section 127 did not apply. The bank was not liable to repay the amount of the cheques into the company's account. The company (through the liquidator) could recover the amounts from the payees of the cheques but not from the bank which honoured the cheques. The bank is only acting as the company's agent when it pays out against a cheque and this is the same whether the account is in credit or debit.

Key Comment

It is more difficult for a liquidator to identify and sue individual payees rather than a bank.

12.5.4 *Re Kayford Ltd* [1975] 1 WLR 279 ChD

Key Facts

The company operated a mail order business for goods. Customers paid for the goods in advance and these sums were paid into a separate bank account of the company. The company went into liquidation without supplying the goods and the liquidator claimed the sum in the bank account.

Key Law

The amounts could not be claimed by the liquidator as the money was held on trust for the benefit of the customers.

12.5.4 *Aluminium Industrie Vaassen BV v Romalpa*

Aluminium Ltd [1976] 2 All ER 552 CA

Key Facts

The claimants sold some aluminium foil to the defendants. The contract provided that ownership in the foil was to be retained by the claimants and not to pass to the defendants until the full price had been paid. In addition, products made from the foil were to be stored separately and held by the defendants as bailees. Sales of such products were permitted in the ordinary course of its business as agents for the claimants.

Key Law

The clause was effective to preserve the claimants' title to the foil. They were held entitled to any unused foil and also to trace into the proceeds of sale of the finished goods. The retention clause did not constitute a charge over the claimants' property and so did not require registration under s 396 CA 1985 [s 860(7) CA 2006].

Key Comment

It was significant that counsel conceded that the defendants held the foil as bailees. Where the *Romalpa* clause does anything other than reserve title to the original goods, they have generally been treated as floating charges and void for non-registration.

12.6.1 *Re Gerald Cooper (Chemicals) Ltd* [1978] 2 Ch 262 CH

Key Facts

C, a director of the company, accepted advance payment from a customer in return for the supply of some indigo. The company had no supplies of indigo and had no intention of supplying any. Instead it used the customer's money to repay a loan owed to a loan company, which was fully aware of the facts, and then went into liquidation.

Key Law

C and the directors of the loan company were both liable for fraudulent trading. It made no difference that it amounted to defrauding only one creditor in one transaction.

12.6.1 *Morphitis v Bernasconi* [2003] EWCA Civ 289; [2003] Ch 552 CA

Key Facts

Following advice from its solicitors a company was restructured and this involved a promise to pay rent to its landlords, although to the knowledge of the solicitors and the company there was never any intention to do so. The liquidator commenced proceedings for fraudulent trading and the solicitors settled by paying £75,000. The directors defended the action.

Key Law

There was no fraudulent trading.

- Section 213 does not apply every time an individual creditor is defrauded. What must be shown is that the business of the company has been carried on with intent to defraud.
- The restructuring scheme included transferring the company's assets to a new company with a similar name which would make the directors liable for the company's debts if it went into liquidation within 12 months under s 216 IA 1986. On the facts the business of the company was not carried on to defraud the landlord creditor but to protect the two directors from liability under s 216.
- When calculating the amount of contribution that a person should make under s 214 there is no right to include a punitive element. This can be done under the criminal provisions dealing with fraudulent trading in s 993 CA 2006.

12.6.1 *Re Maidstone Building Provisions Ltd* [1971] 1 WLR 1085 CH

Key Facts

The company secretary, who was also the company's financial adviser, omitted to inform the directors that the company was insolvent and should cease trading. The court had to decide whether the secretary was a party to the carrying on of the company's business with intent to defraud creditors.

Key Law

Failing to inform the directors amounted to doing nothing and the secretary could not therefore be said to be a party to carrying on the business.

12.6.2 *Re Produce Marketing Consortium Ltd* [1989] BCLC 513 HC

Key Facts

The company went into liquidation in October 1987. Prior to this the company continually exceeded its overdraft, liabilities exceeded assets, cheques were returned unpaid, accounts were prepared and delivered late, trade creditors remained unpaid and the directors were warned by the auditors of possible fraudulent trading. The directors admitted that they knew in February 1987 that the company was insolvent but claimed that they only carried on trading until October 1987 in order to realise the perishable stock in the company's cold store.

Key Law

The two directors had traded wrongfully and were jointly and severally liable to make a contribution of £75,000 towards the assets of the company. They could not rely on the 'every step' defence in s 214(3) as the evidence was they had not limited their trading activities to realising the perishable food. At the very latest they ought to have realised that there was no realistic prospect of avoiding insolvent liquidation at the end of July 1986.

Key Comment

Only the liquidator can commence wrongful trading proceedings and only then with the consent of the liquidation committee.

12.6.2 *Re Purpoint Ltd* [1991] BCC 121 HC

Key Facts

M was the director of a printing company which had no capital base and whose only assets were purchased by bank borrowing or on hire purchase. Its business was inherited from another company which had gone into liquidation. By the end of 1986 the company could not meet its debts as they fell due, it owed very large crown debts and there was no prospect of turning its trading into profit. The company went into liquidation in May 1988.

Key Law

M was ordered to pay a contribution of £53,572 towards the assets of the company for trading wrongfully. He ought to have known at the latest that there was no reasonable prospect of avoiding liquidation when he was warned by the auditors in May 1987 about trading whilst insolvent.

12.7.1 *Phillips v Brewin Dolphin Bell Lawrie Ltd* [2001] BCC 864 CA

Key Facts

BD agreed to buy the stockbroking business of A Ltd for £1.25 million. The sale was structured through two agreements. The first agreement involved A Ltd transferring the business to a subsidiary and BD buying the subsidiary's share capital for £1 and also agreeing to pay £325,000 in redundancy payments to the employees of A Ltd. The second agreement involved BD's parent company subleasing computer equipment from A Ltd for four years at £312,500 per year. This would equal the £1.25 million purchase price and was tax efficient for BD. When A Ltd went into liquidation the liquidator claimed that the first agreement was a transaction at an undervalue and commenced proceedings against BD and its parent company.

Key Law

- In calculating the consideration paid by BD both agreements had to be taken into account. They were linked and the sale was dependent on both agreements being implemented.
- The consideration paid under the first agreement was the value of the shares sold (valued by the court at £1,050,000) less the amount of the redundancy payments paid by BD (£325,000).
- This resulted in a transaction at an undervalue amounting to

£725,000.

- Although the second agreement had to be taken into account the court found it had no value because the computer equipment was repossessed, as subletting it was in breach of the head lease agreement between A Ltd and the owners of the equipment.

12.7.2 *Re MC Bacon Ltd* [1990] BCC 78 CA

Key Facts

The company lost its major customer and could only survive with the support of its bank, who demanded a floating charge to secure the overdraft facility. The company went into liquidation within two years and the liquidator sought to have the floating charge set aside on the basis that it amounted to a preference. It was argued that the company (through the directors) was influenced by a desire to improve the bank's position as a creditor in the company's liquidation.

Key Law

There was no preference. The directors were influenced by a desire to stay in business, not by a desire to improve the bank's position as required by s 239. A claim that the charge was also a transaction at an undervalue under s 238 also failed.

Key Judgment

Millett J said of the s 239 claim:

> ‘A man is not to be taken as desiring all necessary consequences of his actions . . . a transaction will not be set aside as a voidable preference unless the company positively wished to improve the creditor’s position in the event of its own insolvent liquidation.’

Key Problem

The difficulty with this approach is that the more pressure a creditor puts on the company the less likely it is to be a preference.

12.9 *Ad Valorem Factors Ltd v Ricketts* [2003] EWCA Civ 1706; [2004] 1 All ER 894 CA

Key Facts

R was a director in Air Component Co Ltd, which went into liquidation. He later became a director in Air Equipment Co Ltd, which also went into liquidation. Both companies traded in air compressors and covered the same geographical area. AVF Ltd was owed a debt by Air Equipment and when it went into liquidation AVF Ltd claimed R was liable under s 216 IA 1986.

Key Law

Air Equipment Co Ltd was a prohibited name under s 216 and R was liable. Taking into account the types of product dealt in, the location of the business and the types of customers dealing with the companies, the names of the two companies were sufficiently similar to suggest that Air Equipment was associated with Air Component. It made no difference that this was not a 'phoenix syndrome' case; there was no evidence that creditors of Air Equipment or anyone else had been misled by the similarity of the new names or a transfer of assets between the companies at an undervalue. The name was prohibited and personal liability of R followed. He could have protected himself by either not taking part in the management of Air Equipment or by seeking leave of the court but he did neither.

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