British Commercial and Company Law
Eóin Mac Domhnaill BCL (NUI), LLM (Dubl).
macdomhe@tcd.ie

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Company Law

Lecture Notes

These are my lecture notes from our lectures on Company Law. They are based on the relevant chapters in Sealy and Worthington, Arora, Courtney, Dignam and Lowry and Slorach and Ellis as well as other sources.

These notes are an aid to your studies and should be used alongside the text books in your library notes your own notes.

Core Texts

- Cases and Materials in Company Law, (Eighth Edition) L. Sealy and Sarah Worthington, Oxford University Press, 2007
- Company Law, Brenda Hannigan, Butterworths, London, 2003
- Business Law 2009-2010, Slorlach and Ellis, Oxford University Press, 2009
- Company Law 2009, A Dignam and J Lowry, University of London, 2009
- The Law of Business Organisations, A Arora, University of London, 2008
- The Law of Private Companies (Second Edition) Thomas Courtney, Butterworths, 2002.

Further information as well as detailed guideance on various topics discussed in class is available for free on www.companieshouse.gov.uk. I have handed out some of these detailed guidance notes in class.

Company law is an extensive subject, we will not cover much of it in the time we have. We will look at company in its commercial context; the theory behind with particular emphasis on the

separate legal personality of companies and exceptions to that principle in both statute and the common law; the process of **formation of a company**; we will consider **corporate governance** and the **duties of a Director** to a company and the protections the law offers to **minority shareholders** and finally look at end of the life of a company (**winding up etc.)** as well as considering the end of **partnerships**.

Company Law

INTRODUCTION

A Company is very easily legally defined. According to Sealy and Worthington "[i]t is the kind of legal entity or corporate body which is brought into being by the registration procedures laid down by the Companies Act 2006 and its predecessors. Its creation is evidenced by the issue of a certificate of incorporation by the registrar of companies."

This is a good definition but there are exceptions, a tiny number of companies are formed outside of the Companies Acts. A company may also be created in the UK by Royal Charter or by a special act of Parliament. Very few of these companies still exist and they often fall outside of general company law.

Everyday usage of the word company may also cause confusion. In the UK and Ireland the word "company" has other meanings in everyday speech. In particular, the abbreviation "Co." and "&Co." are commonly used as part of the name of an unincorporated partnership that is not a "company" in the strict legal sense and is occasionally used by sole traders.

In the UK, except in the rare case of a company with unlimited liability, the last word of the name of a company will be "Limited" often abbreviated to "Ltd." or in the case of a public company the abbreviation PLC.

Company Law has a very wide scope. Company law is about the formation of companies, their continuing regulation during their life and the procedures for dealing with their assets when they are terminated on liquidation. The state consequently plays a major role in company law. However, self-regulation, as we have seen in all our Commercial law topics, also plays a significant part in the regulation of larger companies and is widely discussed in the theoretical literature. Like much of our course of British Commercial and Company law it is not easily compartmentalised, tort, contract, and equity all combine.

Companies have a crucial role to play in British Commercial law. Companies are the most important Business structure. Their popularity is relatively recent; they came to prominence in the Victorian era.

The registered company has been the main vehicle for business activity since 1844, when the Joint Stock Companies Act 1844 was passed and provided for incorporation of companies by registration. The current companies' legislation is the Companies Act 2006, with specific legislation dealing with the insolvency of companies and financial services.

Like other organisations, registered companies have a constitution – documents or statements that govern their relations internally and with third parties, internal structure and operating procedures. The Companies Act not only provides the facilities and procedure for registration but also authorises subsidiary legislation (e.g. the Companies (Model Articles) Regulations 2007, which prescribe a default constitution for registered companies).

Two important topics that we have come across before and that are essential to understanding how companies operate are *separate legal personality* and *limited liability.*

Sources of Company Law

- UK Companies Acts
- Case law
- Commercial Life
- EU Law.

Types of Company

The Companies Acts recognises a number of types and classifications of companies.

Limited and Unlimited Companies.

Section 3 defines a limited and an unlimited company.

Limited and unlimited companies

(1)A company is a “limited company” if the liability of its members is limited by its constitution.

It may be limited by shares or limited by guarantee.

(2)If their liability is limited to the amount, if any, unpaid on the shares held by them, the company is “limited by shares”.

(3)If their liability is limited to such amount as the members undertake to contribute to the assets of the company in the event of its being wound up, the company is “limited by guarantee”.

(4)If there is no limit on the liability of its members, the company is an “unlimited company”.

Companies with unlimited liability are very rare. The concept of limited liability applies to the liability of the shareholders. Therefore, the liability to contribute in liquidation in respect of the company’s debts in the case of a limited liability company is limited to the nominal value of the shares held by each individual shareholder. A shareholder who, for example, holds 100 £1 shares must under the terms of issue pay the £100 to the company for his allotment, but that is the full extent of his liability for the debts of the company, even if the company becomes insolvent. The creditors of the company are unable to look to the shareholders for repayment of the company debts. The company is therefore limited by shares, although a creditor of the company, for example a bank, may insist on company directors giving a personal guarantee for the company’s debt. In that case directors will not only be liable for any unpaid balance on their shares but also separately for the value of the guarantee.

It may be, however, that the company promoters (those who register the company and bring it into existence) wish to show confidence and security to those with whom the company will deal and so they may wish to establish an unlimited company (i.e. one whose shareholders are liable to contribute for the full extent of their estate in the liquidation of the company, and therefore for the full debts of the company).

Finally, within the distinction of limited or unlimited companies may be limited by guarantee. The purpose of such companies usually is not to trade for profit, but rather the undertaking of business for scientific, cultural or other similar purpose. A profit in such circumstances, while desirable where it occurs, is not distributed among the members but put back into the company or used to further the company's public purposes. With the company limited by guarantee, there are members but not shareholders of the company and the company's constitution will set out the procedure by which people become members. As there are no shares by reference to which the liability of the members for the company's debts is limited, the limitation is instead achieved by guarantee. This guarantee is invoked to the extent necessary if the company is wound up and is unable to pay its debts in full, but regardless of the shortfall, the liability of the members is limited to the amount of the guarantee. Since 1980 a company can no longer be formed (or re-register) as a company limited by guarantee and with a share capital. Section 5 of the 2006 Act continues the prohibition (first contained in the Companies Act 1980) that a company cannot be formed as or become a company limited by guarantee with a share capital.

The fact that a company has limited liability - and so outsiders trade with or allow credit to the company at their own risk - must be communicated to the public under mandatory publicity requirements required by successive Companies Acts.

Private and Public Companies

Section 4 of the Act of 2006 deals with an important division between companies, Private and Public Companies.

4 Private and public companies

(1)A "private company" is any company that is not a public company.

(2)A "public company" is a company limited by shares or limited by guarantee and having a share capital—

(a)whose certificate of incorporation states that it is a public company, and

(b)in relation to which the requirements of this Act, or the former Companies Acts, as to registration or re-registration as a public company have been complied with on or after the relevant date.

(3)For the purposes of subsection (2)(b) the relevant date is—

(a)in relation to registration or re-registration in Great Britain, 22nd December 1980;

(b)in relation to registration or re-registration in Northern Ireland, 1st July 1983.

We see that companies under the Companies Act can be divided into two main categories:

- public limited companies
- private limited companies

Section 4(2) of the Act defines a public company as a company limited by shares, or limited by guarantee and having a share capital.

Public limited company

- A public company must satisfy a number of formalities (s.4 Companies Act 2006):

The company's certificate of incorporation must state that it is a public company.

It must include the words 'public limited company' (or the abbreviation 'plc') at the end of its name.

It must satisfy the minimum capital requirements, that is, have an issued nominal capital of £50,000, of which at least 25 per cent has been paid up.

The certificate of incorporation must state that the company is limited by shares.

Any company that does not meet these requirements will be a private company under s.4 Companies Act 2006, including:

- a private company limited by shares
- a private company limited by guarantee
- an unlimited company.

In general, the key features of the public company are largely similar to those of a private company but there are some distinguishing features:

- The shares in a public company are available to the public whereas there are often many restrictions on the transfer of shares in a private company.

The divide between ownership (through shareholders) and management (through directors) tends to be more marked in a public company, with shareholders often being major financial institutions that invest in the company and leave its running to the directors.

For the sake of completeness, Companies Legislation provides for certain other forms of company.

Section 6 allows for Community Interest Companies. This is a new form of Business organisation introduced in the Act of 2006 which is designed for use by social enterprises. Community Interest Companies are registered under the same legislation as other registered companies, but have to complete certain additional formalities and are subject to certain additional elements of regulation.

6 Community interest companies

(1)In accordance with Part 2 of the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c. 27)—

(a)a company limited by shares or a company limited by guarantee and not having a share capital may be formed as or become a community interest company, and

(b)a company limited by guarantee and having a share capital may become a community interest company.

(2)The other provisions of the Companies Acts have effect subject to that Part.

We will return to this topic after we revise our understanding of the concept of Separate Legal Personality and how it applies to Company Law.

Separate Legal Personality.

The fact that a company has a separate legal personality and is a legal person in its own right is fundamental to the whole structure of Company law. Separate legal personality ensures that it, the company, owns property, it contracts with third parties, it is owned by its members and directed by its directors, and much more.

Company Law

We will;

- Examine the separate entity rule and the application of the rule
- discuss the common law and statutory exceptions to the rule, including the issue of how parent/subsidiary companies are treated in law
- discuss whether or not the courts have been consistent in lifting the veil of incorporation.

Companies registered under the Companies Act have legal personality; they are treated as 'legal persons' with full contractual capacity and accountable for their conduct and obligations. A key feature of the registered company is that it is a legal person with a separate existence from its members (shareholders) and its directors. As such, the principle of separate legal personality forms the cornerstone of company law. However, the law is prepared to look behind or disregard the corporate principle and have regard to the human and commercial reality of the situation. The 'veil of incorporation' may be lifted by the judiciary or by statute. However, it is difficult to be precise about the circumstances in which a judge will lift it; indeed, it may be said that the power to do so is a tactic used by the judiciary in a flexible way to counter fraud, sharp practice, oppression and/or illegality.

Salomon and Salomon

The Joint Stock Companies Act 1844 (sometimes called the Deed of Settlement Act 1844) which laid the basic foundation for modern company law by a system of (rather complicated) registration, but in which the company was based on a deed of settlement and the members had unlimited liability to creditors for the company's debts. The advantages of limited liability were first conferred eleven years later by the Limited Liability Act 1855 on shareholders if certain conditions regarding the number of shareholders and the value/size of their shareholding were satisfied. A year later in 1856, however, the law in this area was consolidated with the Joint Stock Companies Act 1856, the first modern Companies Act with a single registration system, the use of statutory forms and the replacement of the deed of settlement (contained in the 1844 Act) by a memorandum and articles of association for every company.

With this change in companies' legislation, most of those safeguards were swept aside so that the benefits of limited liability were conferred simply on the registration of a company with at least seven members, with no lower limit as to the amount of the nominal value of the shares or the extent to which it had been paid up. The only requirement which remained was that the name of the company should conclude with the word 'limited'. The public would always be aware that they were dealing with a limited liability company and so dealt at their own risk.

The question of how far the benefits of limited liability should be extended and how statute conferring the benefits of separate corporate status should be interpreted was considered by the courts in *Broderip v Salomon* [1895] Ch 323, which eventually reached the House of Lords as *Salomon v Salomon & Company Ltd* [1897] AC 22. The facts of the case were that Salomon had for many years carried on business as a leather merchant and shoe manufacturer. He decided to form a limited liability company, to which he sold his shoe manufacture business, but he retained the majority shareholding in the newly formed company (he was allotted 20,001 fully paid-up shares and six other members of his family were each allotted one fully paid-up share). Salomon and the six other members of his family subscribed to the company's memorandum and the balance of the purchase price was secured by a debenture to himself over the assets of the company.

The business did not prosper and on its liquidation the company's liquidator claimed that the business was still Salomon's, with the company being a mere sham designed to limit Salomon's liability for business debts and therefore:

• Salomon should be held personally liable for the full debts of the company.

• The debenture should not have priority in repayment over the company's other creditors.

At first instance the trial judge, Vaughan Williams J, held that the company was an agent for Salomon and the sole purpose of forming the company was to limit the risks of running a business. Through the registered company Salomon took the profits of the business without running the risk of personal liability. The company was no more than an agent of Salomon and therefore a mere sham.

The Court of Appeal reached the same conclusion, but for different reasons. It took the view that the Companies Acts were intended to confer the privileges of limited liability only on genuine, independent shareholders who combined their capital to enable an enterprise to be started, and not on 'one substantial person and six mere dummies', with the substantial shareholder effectively being the sole owner of a business. Although the court could not hold the incorporation of the company void, since the issue of a certificate of incorporation was conclusive evidence of incorporation, it could order Salomon to give relief to the company's creditors by indemnifying the company against its liabilities, thereby looking beyond the veil of incorporation.

The House of Lords unanimously reversed the Court of Appeal decision.

Lord Halsbury LC held that Salomon was under no liability to the company or its creditors, and his debentures were validly issued. Lord Halsbury took the approach that the statute, having enacted the formal and procedural requirements which must be complied with to register a company, did not enact requirements regarding the extent or degree of interest which may be held by each of the seven subscribers or as to the proportion of influence possessed by one or the majority shareholder over the others. Neither did it require an investigation of the motive for becoming a shareholder (there are obviously exceptions to this general rule but they were not required to be investigated in Salomon), and so provided the statutory requirements for registering a company were complied with, the law would hold that the subscribers formed a body corporate.

Although the Salomon case established one of the fundamental principles of company law – that a company is a legal person independent and distinct from its management and its shareholders – the principle has been the subject of considerable debate. We will return to this debate later. Despite this debate and occasional judicial inconsistency in application, the decision in Salomon has been affirmed and applied many times.

In the New Zealand case of Lee v Lee's Air Farming Ltd [1961] AC 12 the plaintiff's husband, who was the controlling shareholder and governing director of a company formed by him, was killed in the course of his employment with the company. The widow was held entitled to compensation from the company for his estate as the company which employed him had separate legal personality, and the widow's action against the company for compensation succeeded, although her husband was the majority shareholder and owner of the company. On similar facts in *Malyon v Plummer* [1964] 1 QB 330, Sellers LJ in the Court of Appeal, said:

In my opinion, the inter-position of FP Maylon Ltd, if that is how it should be regarded, does not prevent the court assessing truly the loss which the wife has suffered. The husband's business, FP Maylon, has been destroyed by the loss of the husband, and it is clear that the revenue was, in substance, derived from him. The decision in Salomon v Salomon Co need not blind one to the essential facts of dependency and require a finding of fact that is contrary to the true financial position as distinct from an artificial or fictitious one.

In *Lee v Lee* the court was able to grant compensation to the widow under the New Zealand Workman's Compensation Act by asserting the separate entity principle, whereas in Maylon the widow was able to assert that when the husband died the company ceased to exist as a business entity and they were one and the same and so the widow was able to recover compensation for loss of livelihood.

Further cases which may be contrasted are *Buchan v Secretary of State for Employment, Ivey v Secretary of State for Employment* [1997] IRLR 80 and *Secretary of State for Trade and Industry v Bottrill* [1999] ICR 59. In *Buchan* the employment appeal tribunal distinguished the Privy Council case in Lee in two joined appeals. The directors in the two companies held, respectively, a half and a controlling interest in their companies. It was held in each case that they were not employees for the purpose of making a claim against the National Insurance Fund. The tribunal held that such directors could block decisions at board level, including decisions relating to their dismissal, and that this was inconsistent with being an employee. The tribunal held that it was not the purpose of the legislation to fund compensation for those whose businesses have failed. By contrast, in *Bottrill* the question of fact was whether Bottrill was an employee or not.

There was one other director and Bottrill, while he was the managing director, had a contract of employment which set out all his duties, his hours, sick pay and so on. He paid tax and National Insurance. When the company became insolvent he applied for a redundancy payment. The court held that it was a question of whether Bottrill was an employee or not and the fact that he was a controlling shareholder was not decisive. The court concluded that there was a genuine contract of employment and so the veil of incorporation was not lifted.

Solomon was followed in *Macaura v Northern Assurance Co* [1925] AC 619 Mr Macaura owned an estate and some timber in Tyrone in the North of Ireland. He agreed to sell all the timber on the estate in return for the entire issued share capital of Irish Canadian Saw Mills Ltd. The timber, which amounted to almost the entire assets of the company, was then stored on the estate. On 6 February 1922 Mr Macaura insured the timber in his own name. Two weeks later a fire destroyed all the timber on the estate. Mr Macaura tried to claim under the insurance policy. The insurance company refused to pay out arguing that he had no insurable interest in the timber as the timber belonged to the company. Allegations of fraud were also made against Mr Macaura but never proven. (There was an investigation into this suspicious fire but this does not affect our understanding of Company Law.) Eventually in 1925 the issue arrived before the House of Lords who found that:

- the timber belonged to the company and not Mr Macaura

Mr Macaura, even though he owned all the shares in the company, had no insurable interest in the property of the company

just as corporate personality facilitates limited liability by having the debts belong to the corporation and not the members, it also means that the company's assets belong to it and not to the shareholders.

Lord Sumner said:

[H]e had no lien or security over it and, though it lay on his land by his persuasion, he had no responsibility to its owner for to hold it for his debt. He owned almost all the shares in the company and the company owed him a good deal of money, but, neither as creditor, nor as shareholder, could he hold it for

his debt.

The Macuara case should be contrasted with the decision of the Supreme Court of Canada in *Constitution Insurance Co of Canada v Kosmopoulos* (1987) 34 DLR 208, where Kosmopoulos was the sole shareholder and director of a company, Kosmopoulos Ltd, which carried on a retail business. Kosmopoulos took out insurance in his own name and when business assets were destroyed by fire, the Supreme Court of Canada held that his action to recover under the insurance would succeed. The Supreme Court held that it was not necessary that the insured should have a legally enforceable claim in the property. It was sufficient that he had a relation to, or concern in, the subject matter of the insurance whereby he would suffer a loss on the occurrence of the insured risks. Wilson J in the Supreme Court expressed the view that:

Mr Kosmopoulos, as a sole shareholder of the company, was so placed with respect to the assets of the business as to have the benefit from their existence and prejudice from the destruction. He had a moral certainty of advantage or benefit from those assets but for the fire. He had, therefore, an insurable interest in them, capable of supporting the insurance policy and is entitled to recover under it.

Limited liability has huge advantages for shareholders but it also means that the company is a separate legal entity with its own property, rights and obligations. Separate legal personality and limited liability are not the same thing.

Limited liability is the logical consequence of the existence of a separate personality. The legal existence of a company (corporation) means it can be responsible for its own debts.

The shareholders will lose their initial investment in the company but they will not be responsible for the debts of the company. Just as humans can have restrictions imposed on their legal personality (as with children, for example), a company can have legal personality without limited liability if that is how it is conferred by the statute. A company may still be formed today without limited liability as a registered unlimited company (s.3(4) Companies Act 2006).

Although there appears to be no material difference in the law in the UK and Canada, the courts have reached different conclusions on practically the same facts. The difference in approach in largely due to the courts' resolve to apply the Salomon principal while at the same time being realistic about the limitations that it can impose on the courts. Ensuring that the corporate entity is not used as a vehicle for fraud or deception means that the courts are willing to look behind the corporate entity, even if this has led to inconsistencies.

The courts have recognised a number of exceptions to the separate entity rule, but they have also recently strenuously reinforced its application. Therefore, in *Adams v Cape Industries Plc* [1990] Ch 433 the Court of Appeal held that an English parent company whose business was mining asbestos in South Africa through subsidiaries was not present in the US through another member in a group and so could not have damages awarded against it through its US subsidiary. Slade LJ said:

…save in cases which turn on the wording of particular statutes or contracts, the court is not free to disregard the principle of Salomon v Salomon & Co Ltd merely because it considers that justice so requires.

In Polly Peck International Plc (No. 3) [1996] 1 BCLC 428 Walker J held that the Adams case and the statement requiring Salomon to be applied is a principle of law which is binding on first-instance judges.

However, the Adams case has not always been applied. In *Creasey v Breachwood Motors Ltd* [1993] BCLC 480 the court allowed the substitution of one company for another as defendant, holding the latter company liable, and in *Re BCCI* [1993] BCLC 1490 the court approved a compromise under which the assets/liabilities of several companies in liquidation were pooled. In *Creasey* the court seems to attempt to reassert that the underlying justification for lifting the corporate veil could, if necessary, be couched in terms of equitable considerations (i.e. rules of equity which allow the courts flexibility to achieve justice rather than being Southwell QC said:

The power of the court to lift the corporate veil exists. The problem for a judge of first instance is to decide whether the particular case before the court is one in which that power should be exercised, recognising that this is a very strong power which can be exercised to achieve justice where its exercise is necessary for that purpose, but which, misused, would be likely to cause not considerable injustice.

This approach, however, was disapproved *in Ord & Another v Belhaven Pubs Ltd* [1998] 2 BCLC 447, where the Court of Appeal held that in the absence of any impropriety, sham or concealment in the restructuring of the group, it would be wrong to lift the corporate veil in order to make the shareholders of the defendant company liable instead of the company itself.

Companies are the dominant form of Business Organisation in British Commercial life. We looked at the different categories of Company under the Companies Acts and began by looking at Separate legal personality or Corporate Personality. Corporate personality refers to the fact that, as far as the law is concerned, a company really exists. This means that a company can sue and be sued in its own name, hold its own property and – crucially – be liable for its own debts. It is this concept that allows limited liability for shareholders as the debts belong to the legal entity of the company and not to the shareholders in that company.

We looked at the early case law in this area. Corporate legal personality arose from the activities of organisations, such as religious orders and local authorities, which were granted rights by the government to hold property, sue and be sued in their own right and not to have to rely on the rights of the members behind the organisation. Over time the concept began to be applied to commercial ventures with a public interest element, such as rail building ventures and colonial trading businesses. However, modern company law only began in the mid-nineteenth century when a series of Companies Acts were passed which allowed ordinary individuals to form registered companies with limited liability. The Law as we know it was formed in a number of key cases.

Corporate legal personality and the benefits of limited liability that go with were originally intended to have a much narrower scope, it was fairly clear that the mid-nineteenth century Companies Acts intended the virtues of corporate personality and limited liability to be conferred on medium to large commercial ventures. To ensure this was the case there was a requirement that there be at least seven members of the company. This was thought to exclude sole traders and small partnerships from utilising corporate personality. In the case of *Salomon v Salomon & Co* [1897] AC 22, this assumption proved to be mistaken.

The House of Lords found that:

- the fact that some of the shareholders were only holding shares as a technicality was irrelevant; the registration procedure could be used by an individual to carry on what was in effect a one-man business;
- a company formed in compliance with the regulations of the Companies Acts is a separate person and not the agent or trustee of its controller. As a result, the debts of the company were its own and not those of the members. The members' liability was limited to the amount prescribed in the Companies Act (i.e. the amount they invested).

Lifting the Veil - Exceptions to the rule of separate legal personality

[Chapter 2 – Sealy and Worthington]

The application of the Salomon principle has mostly beneficial effects for shareholders. The price of this benefit is often paid by the company's creditors. In most situations this is as is intended by the Companies Acts. Sometimes, however, the legislature and the courts have intervened where the Salomon principle had the potential to be abused or has unjust consequences.

This is known as 'lifting the veil of incorporation'. That is, the courts or the legislature have decided that in certain circumstances the company will not be treated as a separate legal entity.

By far the most extensive inroads into the separate legal entity rule have been made by means of legislation. Where a statutory provision purports to disturb the corporate veil, the effect will normally be to pierce the veil only for the purpose of imposing liability on a human constituent of the company: the veil will not be completely removed. The overwhelming majority of the statutory provisions are aimed at curbing and penalising delinquent company directors of insolvent companies and allowing creditors to recover some money by imposing personal liability on the directors.

Additionally, the courts have ignored the principle of legal corporate personality in a number of circumstances, for example where the protection of public interest is of paramount importance or where the company is formed to evade legal obligations, and in some cases the courts have implied that a company is an agent or trustee for its members.

Statutory exceptions

Companies Acts.

This is a reflection of modern business practices. As corporate affairs became more complex and group structures emerged (that is, where a parent company organises its business through a number of subsidiary companies in which it is usually the sole shareholder) the Companies Acts began to recognise that treating each company in a group as separate was misleading. Over time a number of provisions were introduced to recognise this fact, we find these provisions in the most recent companies Act.

Group accounts – s.399 of the Companies Act 2006 provides that parent companies have a duty to produce group accounts.

Group accounts have to be filed for a group of companies, in addition to the separate sets of accounts which have to be filed for each individual company. In order to determine if the company is part of a group, the veil of incorporation is lifted and the court examines the ownership of shares, membership, board of directors or control of the board or the general meeting.

s.409 Companies Act 2006 also requires the parent to provide details of the shares it holds in the subsidiaries and the subsidiaries' names and country of activity.

However, it was the possibility of using the corporate form to commit fraud that prompted the introduction of a number of civil and criminal provisions. These provisions operate to negate the effect of corporate personality and limited liability in:

- s.993 Companies Act 2006 which provides a not much used criminal offence of fraudulent trading. The criminal offence of fraudulent trading looks beyond the company and to the individuals involved. The Act of 2006 increased the maximum sentence for the offence to 10 years imprisonment. Both criminal and civil liability can come into question if in the course of the winding up of a company it appeared that any business of the company was carried on with intent to defraud creditors or for any fraudulent purpose in which event a person who is knowingly a party to carrying on the business could be liable. Fraudulent trading involves a test involving dishonesty.

- ss.213–216 Insolvency Act 1986 contain the most important statutory veil lifting provisions. These sections give a court the power, on the application of a liquidator, to order persons who have committed fraudulent trading, to make contributions to the company's assets.

Liability for use of prohibited names – s.216 of the Insolvency Act 1986

The Insolvency Act 1986 makes it an offence for a person who has been a director of a company within the 12 months before it goes into solvent liquidation to become a director of a company with the same name or be concerned in the management, promotion or formation of another company with the same or a similar name without the leave of the court, within five years of the original company going into liquidation.

216.

Restriction on re-use of company names.

— (1) This section applies to a person where a company ("the liquidating company") has gone into insolvent liquidation on or after the appointed day and he was a director or shadow director of the company at any time in the period of 12 months ending with the day before it went into liquidation.

(2) For the purposes of this section, a name is a prohibited name in relation to such a person if—

(a)

it is a name by which the liquidating company was known at any time in that period of 12 months, or

(b)

it is a name which is so similar to a name falling within paragraph (a) as to suggest an association with that company.

(3) Except with leave of the court or in such circumstances as may be prescribed, a person to whom this section applies shall not at any time in the period of 5 years beginning with the day on which the liquidating company went into liquidation—

(a)

be a director of any other company that is known by a prohibited name, or

(b)

in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of any such company, or

(c)

in any way, whether directly or indirectly, be concerned or take part in the carrying on of a business carried on (otherwise than by a company) under a prohibited name.

(4) If a person acts in contravention of this section, he is liable to imprisonment or a fine, or both.

(5) In subsection (3) "the court" means any court having jurisdiction to wind up companies; and on an application for leave under that subsection, the Secretary of State or the official receiver may appear and call the attention of the court to any matters which seem to him to be relevant.

(6) References in this section, in relation to any time, to a name by which a company is known are to the name of the company at that time or to any name under which the company carries on business at that time.

(7) For the purposes of this section a company goes into insolvent liquidation if it goes into liquidation at at time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.

(8) In this section "company" includes a company which may be wound up under Part V of this Act.

http://www.statutelaw.gov.uk/

Such a person is personally liable for the debts of the successor company, if incurred during the period while he is a director of it or involved in the management.

Fraudulent trading – s.213 Insolvency Act 1986

Section 213 of the Insolvency Act 1986 was designed to deal with situations where the corporate form was used as a vehicle for fraud. It is known as the 'fraudulent trading' provision. If, in the course of the winding up of a company, it appears to the court that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, anyone involved in the carrying out of the business can be called upon to contribute to the debts of the company. This is most likely to be shareholders or directors but can also be employees and creditors.

In *Re Todd Ltd* [1990] BCLC 454, for example, a director was found liable to contribute over £70,000 to the debts of the company because of his activities. There is also the possibility that criminal liability could follow, with a term of imprisonment as the ultimate penalty (s.993 Companies Act 2006). While the criminal penalty was intended to act as a strong deterrent to fraudulent behaviour, it proved to have the unfortunate effect of neutralising the effectiveness of s.213 as the courts set a very high standard of proof for 'intent to defraud' because of the possibility of a criminal charge also arising.

In *Re Patrick & Lyon Ltd* [1933] Ch 786, this involved proving *'actual dishonesty, involving, according to current notions of fair trading among commercial men, real moral blame'*. This high standard proved very difficult to obtain in practice and a new provision was introduced in s.214 of the Insolvency Act 1986 which covered the lesser offence of 'wrongful trading'.

The court cannot make an order under s.213 unless the company is insolvent and therefore the liquidator will normally bring the action. Under the section personal liability can only be imposed if those responsible for managing the company's business are found guilty of dishonesty, although a single act of dishonesty will suffice.

The applicant has the burden of proof and the dishonest intention may be apparent from the circumstances in which the company's business was carried on. Therefore, in *Re William C. Leitch Bros Ltd* [1932] 2 Ch 71 the court, holding the directors personally liable for the price of certain goods delivered to the company, said:

[I]f a company continues to carry on business and to incur debts at a time when there is to the knowledge of the directors no reasonable prospect of the creditors ever receiving payment of those debts, it is, in general, a proper inference that the company is carrying on business with intent to defraud.

In *Re Grantham* [1984] QB 675 and *Re A Company (No. 001418 of 1988)* [1991] BCLC 91 the courts interpreted what amounts to a breach of s.213 and held that if a person incurs a debt on the company's behalf in the course of managing its business and he has no reason to believe that the company will be able to pay its creditors in full by the date on which the debts become due then personal liability may be imposed. A person is only personally liable if he actively participates in the company's management with intent to defraud the creditors – he is not liable if he merely fails to warn its directors that it is insolvent and no further debts should be incurred.

A shareholder cannot be made personally liable for a company's debts unless it can be shown that he took part in making management decisions which were intended to defraud creditors or cause loss, but a third party who knowingly participates in an act of fraudulent trading committed by the company's directors (i.e. a creditor of the company who accepts payment of his debt out of money he knows the directors obtained by fraud) may be compelled to restore the money.

Effect of an order making a person liable

A person made personally liable is not accountable to a creditor of the company who has been defrauded, but instead he will pay any sum ordered by the court to the company's liquidator, who will apply such funds, together with the other funds, in paying all its creditors rateably. Creditors who are defrauded have no preferential claim: *Re William C. Leitch Bros. Ltd (No. 2)* [1933] Ch. 261.

However, if a creditor of the company obtains payment of his debt from directors out of their own resources, for example by threatening to take proceedings against them for an order making them personally liable, the payment is not impressed with a trust in favour of the company's creditors and the liquidator cannot require the recipient to account to him for it: *Re Cyona Distributors* [1967] Ch. 889.

Wrongful trading – s.214 Insolvency Act 1986

Wrongful trading does not require proving intent to defraud. Rather it simply requires that a director, at some time before the commencement of the winding up of the company, knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, but continued to trade. The section operates on the basis that at some time before the company entered insolvent liquidation there will have been a point where the directors knew it was hopeless and the company could not trade out of the situation. The reasonable director would not at this point continue to trade. If he does continue to trade he risks having to contribute to the debts of the company under s.214.

In *Re Produce Marketing Consortium Ltd (No 2)* (1989) 5 BCC 569 over a period of seven years the company slowly drifted into insolvency. The two directors involved did nothing wrong except that they did not put the company into liquidation after the point of no return became apparent. They were therefore liable under s.214 to contribute £75,000 to the debts of the company.

Section 214 of the Insolvency Act 1986 provides that if in the winding-up of a company which has gone into insolvent liquidation it appears that a person who is a director or shadow director of the company at some time before the commencement of the winding-up knew or ought to have known that there was no reasonable prospect that the company would avoid insolvent liquidation, the court may, on the application of the liquidator, order that person to contribute such amount to the assets of the company as the court thinks fit.

The court may not make such an order imposing personal liability if the director (or shadow director) can show that after he first realised (or should have realised) that the company would be wound up he took every step to minimise potential loss to the company's creditors.

In determining whether the directors or shadow directors took every step to minimise potential loss to creditors, the courts will consider the following:

• facts which they should have known or ascertained

• conclusions which they should have reached

• the steps which should have been taken, as compared with those which would be known, ascertained, reached or taken by a reasonably diligent person who has the general knowledge, skill or experience which may reasonably be expected of a person carrying out those functions in relation to the company, together with any additional knowledge and experience the respondent actually had.

The standard of awareness and diligence required of a director or shadow director if he is to resist an application for an order to contribute is that of a person who is competent to fulfil the functions he was appointed to fulfil and who shows appropriate skill and care. But if he has specialist skills or knowledge a higher level of ability will be expected.

The court will make an order for wrongful trading even though there is no suspicion of dishonesty on the part of the directors, and the standard of attention to the company's financial condition required is a high one.

Sections 213 and 214 differ in the way they affect the Salomon principle. Section 213 applies to anyone involved in the carrying on of the business and therefore directly qualifies the limitation of liability of members. Section 214 does not directly affect the liability of members as it is aimed specifically at directors. In small companies, directors are usually also the members of the company and so their limitation of liability is indirectly affected.

Parent companies may also have their limited liability affected if they have acted as a shadow director. (A shadow director being anyone other than a professional advisor from whom the directors of the company are accustomed to take instructions or directions).

In summary, the legislature has always been concerned to minimise the extent to which the Salomon principle could be used as an instrument of fraud. As a result it introduced the offence of fraudulent trading now contained in s.213 of the Insolvency Act 1986.

The requirement to prove 'intent to defraud' became too difficult in practice because of the possibility of a criminal offence arising and so the lesser offence of 'wrongful trading' was introduced in order to provide a remedy where directors had behaved negligently rather than fraudulently. Therefore if a director continued to trade in circumstances where a reasonable director would have stopped, the director concerned will be liable to contribute to the company's debts under s.214.

Common law exceptions

There are a number of common law circumstances where the courts appear to be willing to lift the corporate veil. Veil lifting situations often present the judiciary with difficult choices as to where the loss should lie. As we observed with the *Salomon, Lee* and *Macaura* cases, the consequences of treating the company as a separate legal entity or not can be extreme. Over time the judiciary have swung from strictly applying the Salomon principle in these difficult situations to taking a more interventionist approach to try to achieve justice in a particular situation. It is difficult to draw a consistent or systematic thread through the cases from which to draw firm principles regarding when the courts will lift the veil, but to the extent that any common law exceptions to the separate entity rule are recognised, they include the following.

Paramount public interest

The court will disregard the separate legal personality of a company and will investigate the qualities of its shareholders or persons in control if there is an overriding public interest to be served. Therefore, the courts have been willing to lift the corporate veil in times of war or other national emergency.

In *Daimler Co Ltd v Continental Tyre and Rubber Co (GB) Ltd* [1916–1917] All ER 191 an action was brought by a company incorporated in England, all of whose shares (except one) were held by German nationals and all of whose directors were German nationals resident in Germany. The defendant argued that the company was an alien enemy and therefore unable to sue in the English Courts unless licensed by the Crown. The House of Lords upheld this contention and confirmed the basic proposition that the identity of the company's shareholders is generally immaterial since the company is a separate legal entity. However, there may be occasions when a court may peek behind that veil and take into account the identity or nationality of shareholders. The court thereby disregarded the fact that the company had British nationality by being incorporated in England and concentrated instead on where the company's business and assets lay in determining its status. The character of those who were empowered to appoint company's officers was important in such a case.

Similarly, in *Re FG (Films) Ltd* [1953] 1 WRL 483 a company was incorporated in England to enable films produced in its name to qualify as British under the Cinematograph Films Act 1938 and thereby avoid censorship laws then in place. The company was promoted by an American company with three English and one American directors (the latter held 90 per cent of the company's shares). The finance for films produced by the English company was to be provided by the American company and other business arrangements were made by the American company. The court held that the films did not qualify as British since the English company was merely a nominee of the American company and thereby bound by the censorship laws of the UK.

Evasion of legal obligations or to commit fraud

An important category where the courts will disregard the corporate veil between a company and its members is where the company is used to perpetrate fraud. The court requires evidence that the company was formed to commit fraud or, if already formed, is being used as a vehicle for fraud, for example to evade existing liability. The key point to note is that there is nothing wrong with forming a company with the motive that the company might absorb future personal liability.

In *Gilford Motor Company Ltd v Horne* [1933] Ch 935 the defendant was employed by the plaintiff company and had entered into a valid agreement not to solicit the plaintiff's customers or to enter into a competing business for a specified time after leaving the plaintiff's employment. On the termination of his employment, however, the defendant formed a company the shares of which were held by his wife and which employed him, as a director, to carry on a competing business. The court held that since the defendant in reality controlled the company, its formation was a mere sham to enable him to break his agreement with the plaintiff company, and an injunction to restrain the defendant was granted.

In *Jones v Lipman* [1962] All ER 422 the defendant entered into a contract for the sale of land with the plaintiff. He later tried to evade an order being made against him by conveying the land to a company which he had formed for this purpose and which he owned and controlled. The court held that an order for specific performance would be made against both the defendant personally and the company. The court said that the setting up of the company was just a façade and a device created to avoid personal liability.

Similarly, in *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626 Aveling Barford and Perion were companies both owned and controlled by Lee. Aveling Barford sold certain property it owned at less than market value to Perion and the former company then went into liquidation. Aveling Barford's liquidator sued to have Perion declared a constructive trustee of the proceeds of sale when Perion sold the same property at a profit. The court held that Lee, as the controlling shareholder of Aveling Barford, owed fiduciary duties to that company for the proceeds of the sale. Setting aside the corporate veil, the court said that a controlling shareholder owes duties to ensure he obtains the best price for his company.

Groups of companies

In a group of companies, one company (the parent or holding company) forms a subsidiary or a number of subsidiaries and transfers parts of its business to the subsidiary or subsidiaries. The subsidiaries are usually wholly or mainly controlled by the parent or holding company, with the directors sometimes being appointed by the parent or holding company and varying degrees of control being exercised over the subsidiary. There is some controversy over whether separate personality of the companies in a group of the companies may be ignored. In *The Albazero* [1977] AC 774 Roskill LJ said:

[It is] long established and now unchallengeable by judicial decision…that each company in a group of companies…is a separate legal entity possessed of separate legal rights and liabilities so that the rights of one company cannot be exercised by another company in that group even though the ultimate benefit of the exercise of those rights would ensure beneficially to the same person or corporate body.

The group company scenario has come under attack, usually from disgruntled creditors of the subsidiary when they are left with the debts of the subsidiary when the venture fails and the subsidiary has insufficient assets to meet its liabilities and the Salomon principle prevents the creditors of the subsidiary pursuing a claim against the parent or holding company.

The courts have therefore had to consider how to develop jurisdiction over the group of companies and lift the corporate veil.

In *DHN Food Distributors Ltd v Tower Hamlets London Borough Council* [1976] 3 All ER 462, DHN ran a business from premises owned by its wholly-owned subsidiary (Bronze). The subsidiary had no other business except the leasing of premises to the parent company and its only assets were the premises leased to the parent. The parent and subsidiary companies had the same directors. The defendant was a local authority which, under a compulsory purchase order, acquired the premises which Bronze owned and from which the parent company carried on business. The relevant legislation obliged the council to pay compensation to the owner of the land for the value of the land and the disturbance of the business. In this instance the local authority was willing to compensate the subsidiary company for the former but not the latter. The parent company (DHN) sued, arguing that they should in fact be treated as owning the premises and thereby entitled to compensation for both the loss of land and disturbance of business. The parent company was therefore asking for the corporate veil to be lifted and for the group of companies to be treated as a single entity for the purposes of obtaining compensation.

The court held that compensation could be claimed by DHN if it had an interest greater than that of the subsidiary, and all three judges in the Court of Appeal thought that DHN could claim compensation because it had a licence to occupy the premises owned by the subsidiary and such a licence qualified it for compensation under the legislation. Goff LJ and Shaw LJ also took the view that DHN could claim compensation because the subsidiary held the property on trust for it and such a beneficial interest similarly qualified it for compensation. Shaw LJ and Lord Denning also thought that the corporate veil principle between the parent and subsidiary companies was a mere technicality and that groups of companies should be treated as a single economic entity.

Shaw LJ and Lord Denning expressed the view that the test for disregarding the corporate veil was to see whether the holding and subsidiary companies were so inter-related that the former had so-called dominant control of the corporate policy of the subsidiary. If so, Lord Denning considered that the court should recognise that there was a single economic entity rather than separate companies.

In DHN different companies formed a complete entity and that completeness of identity manifested itself in various ways; for example, the directors of parent/subsidiary were the same, the shareholders of the parent and subsidiary were the same and they had a common interest. The subsidiary company was merely a shell and it simply owned property for DHN and was 'bound hand and foot' by DHN in every respect. The parent and subsidiary companies were to be seen as part of the same entity.

Following DHN the corporate veil principle reasserted itself in a series of group company cases. The focus of the court's enquiry had shifted from the inter-relationship between the holding company and its subsidiary to the purpose for which the subsidiary was set up or used.

The improper purpose for setting up a subsidiary or using an existing one that the courts have applied is borrowed from one of the standard principles applied to prevent an individual sheltering behind the corporate veil, that is, where the company is set up or used for the purposes of perpetuating a fraud (*Jones v Lipman*) or avoiding a pre-existing obligation (*Gilford Motor Company v Horne*).

Therefore, Two years later the House of Lords in *Woolfson v Strathclyde RC* [1978] SLT 159 specifically disapproved of Denning's views on group structures in finding that the veil of incorporation would be upheld unless it was a façade. The plaintiff, an individual, controlled a group of companies and, as in DHN, the question related to the entitlement of compensation for disturbance of business and loss of land under a compulsory purchase order. Company A carried on business on premises owned by company Z. A owned the majority of shares in Z but had no control over its business. The fact that both A and Z carried on separate business and had separate boards of directors was sufficient to distinguish the *Woolfson* and *DHN* cases.

Therefore the parent company was not entitled to compensation in *Woolfson*.

In *Woolfson* the court held that the corporate veil should only be lifted where special circumstances existed indicating that the company was used as a mere façade for concealing the truth, and that the Salomon principle must normally be applied in full.

Exactly when DHN is to be applied is unclear, but the importance of the case has been reduced since the Court of Appeal decision in *Adams v Cape Industries,*where it was stated that *DHN* must be regarded as a decision on the relevant statutory provisions.

The Court of Appeal in *Bank of Tokyo v Karoon* [1987] AC 45 followed Woolfson and held that the parent and subsidiary companies are separate legal entities and that this principle is fundamental to company law. In the *Karoon* case the Bank of Tokyo disclosed confidential information about a customer to its parent company in New York. The customer had accounts in both London and New York with the same bank and sued for damages for wrongful disclosure, and the bank tried to restrain proceedings on grounds that, in economic terms, parent and subsidiary were the same.

In *Adams v Cape Industries Plc* [1991] 1 All ER 929 the Court of Appeal reviewed the previous cases and disapproved Lord Denning's 'single economic unit' concept. In rejecting the Denning approach the court said:

There is no general principle that all companies in a group of companies are to be regarded as one. On the contrary, the fundamental principal is that each company in a group of companies is a separate legal entity possessed of separate legal rights and liabilities.

Furthermore, following *Adams v Cape*, in addition to the subsidiary being used or set up as a mere façade concealing the true facts, the motives of the perpetrator may be highly relevant.

Adams is an interesting case. Adams is a complex case but these, broadly, are the facts. Until 1979, Cape, an English company, mined and marketed asbestos. Its worldwide marketing subsidiary was another English company, named Capasco. Cape also had a US marketing subsidiary incorporated in Illinois, named NAAC. In 1974 in Texas, some 462 people sued Cape, Capasco, NAAC and others for personal injuries arising from the installation of asbestos in a factory. Cape protested at the time that the Texas court had no jurisdiction over it but in the end it settled the action. In 1978, NAAC was closed down by Cape and other subsidiaries were formed with the express purpose of reorganising the business in the US to minimise Cape's presence there, in respect of taxation and other liabilities. Between 1978 and 1979, a further 206 similar actions were commenced and default judgments were entered against Cape and Capasco (who again denied they were subject to the jurisdiction of the court but this time did not settle). In 1979 Cape sold its asbestos mining and marketing business and therefore had no assets in the US. Adams sought the enforcement of the US default judgment in England. The key issue was whether Cape was present within the US jurisdiction through its subsidiaries or had somehow submitted to the US jurisdiction. According to the Court of Appeal that could only be the case if it lifted the veil of incorporation, either treating the Cape group as one single entity, or finding the subsidiaries were a mere façade or were agents for Cape.

The court found that in cases where the courts had in the past treated a group as a 'single economic unit', therefore disregarding the legal separateness of each company in the group, the court was involved in interpreting a statute or document. This exception to maintaining corporate personality is qualified by the fact that there has to first be some lack of clarity about a statute or document which would allow the court to treat a group as a single entity. The court concluded that: save in cases which turn on the wording of particular statutes or contracts, the court is not free to disregard the principle of *Salomon v Salomon* & Co Ltd [1897] AC 22 merely because it considers that justice so requires. Our law, for better or worse, recognises the creation of subsidiary companies, which though in one sense the creatures of their parent companies, will nevertheless under the general law fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities.

The Court of Appeal recognised the 'mere façade concealing the true facts' as being a well-established exception to the Salomon principle. The case of *Jones v Lipman* (1962) is the classic example. There, we saw, Mr Lipman's sole motive in creating the company was to avoid a transaction. In determining whether the company is a mere façade the motives of those behind the alleged façade may be relevant. The Court of Appeal looked at the motives of Cape in structuring its US business through its various subsidiaries. It found that although Cape's motive was to try to minimise its presence in the US for tax and other liabilities (and that that might make the company morally culpable) there was nothing legally wrong with this.

The court then finally considered the 'agency' argument. This was a straightforward application of agency principle. If the subsidiary was Cape's agent and acting within its actual or apparent authority, then the actions of the subsidiary would bind the parent. The court found that the subsidiaries were independent businesses free from the day-to-day control of Cape and with no general power to bind the parent. Therefore Cape could not be present in the US through its subsidiary agent.

Adams therefore narrows the situations where the veil of incorporation is in effect lifted to three situations.

1. Where the court is interpreting a statute or document (therefore once fairness is rejected as the basis of intervention only a lack of clarity in the statute or document will allowintervention).
2. Where the company is a mere façade.
3. Where the subsidiary is an agent of the company.

The need to establish an improper motive was confirmed in *Ord v Belhaven Pubs Ltd* [1998] 2 BCLC 447, in which the court refused to disregard the corporate veil because no such motive could be found and held that the reason for restructuring and transfer of assets to a limited liability company did not amount to a fraud, but to a business decision unrelated to the litigation.

Agency law within groups of companies' cases

An alternative line of attack on the corporate veil with a group of companies has sometimes been to treat the subsidiary as an agent of the holding company. The corporate veil remains intact but transactions entered into by the subsidiary are regarded as those of the holding company and it is the latter which is liable if the veil is disregarded.

Whether an agency relationship exists is a question of fact, but in the earlier cases the agency relationship could either be expressly created or inferred from conduct. The Salomon case itself established that the fact that a person is a member of a company does not itself make the company an agent of that person – the company is not an agent of its shareholders. The agency relationship cannot be inferred merely from the fact that members of the company exercise control over the company.

The characteristic feature of the agency relationship is that the agent has authority or capacity to create legal relations on behalf of the principal, and it is not normal to hold that the company acts as an agent for its members.

However, in *Smith Stone & Knight Ltd v Birmingham Corporation* [1939] 4 All ER 116 the court attempted to catalogue the circumstances it will take into account in determining whether a subsidiary is carrying on business as an agent of its holding company (thereby acting as an agent for its shareholders). In *Smith, Stone & Knight Ltd* a company (company Z) acquired all the shares in another company (company B) and continued the business of the subsidiary. The profits of the subsidiary company were treated as profits of the parent company and control of the subsidiary rested with the parent company. The defendant corporation acquired the premises of the subsidiary company under a compulsory acquisition order, and the parent company claimed compensation. The corporation argued that the subsidiary company was the proper claimant because of its separate legal entity. The court held that the possession of separate legal status was not conclusive as to who was entitled to claim compensation.

The subsidiary company was operating not on its own behalf but for the parent company and therefore the parent company was entitled to proceed with its claim for compensation. Atkinson J, giving judgment, said the court would take a number of factors into account in determining whether a subsidiary company is carrying on its business as an agent of the holding company:

• Were the profits treated as those of the parent company?

• Were the persons conducting business appointed by the parent company?

• Was the parent company the brain of the trading venture?

• Did the parent company govern the trading venture, for example by deciding what should be done and how?

• Did the parent company make the profits by its skill and direction?

• Was the parent company in effectual and constant control?

The court held that the holding company was in occupation of the premises and entitled to compensation although the business was carried on in the name of the subsidiary company. All the shares in the subsidiary company were held by the holding company and all the directors of the subsidiary company were also the directors of the holding company. The subsidiary company had been formed simply in order to separate formally the business carried on in its name from another business carried on by the holding company.

Critically, the court in *Smith, Stone & Knight* seemed to be willing to infer an agency relationship from the factors listed rather than limiting a finding of agency to cases where there was an express agency agreement.

There also appears to be a greater willingness to find the existence of an agency relationship in a parent and subsidiary company relationship in cases involving revenue matters. In *Firestone Tyre & Rubber Company Ltd v Llewellin* [1957] an American company formed a wholly-owned subsidiary in England to manufacture and sell tyres in Europe. The agreement was that orders placed with the American company would be satisfied by the subsidiary company. In fact orders were sent to the English subsidiary and satisfied with the subsidiary company receiving payment and forwarding to the parent company its share of profits. The court held that the American company would be treated as carrying on business in UK through a subsidiary agent and that it was therefore liable to UK corporation tax. The agency relationship did not arise from any express agreement to that effect but was inferred from the trading arrangements set up by the parent company.

In *JH Rayner (Mincing Lane) Ltd v Department of Trade and Industry* [1989] Ch 72 the court concluded that an agency relationship cannot be inferred from the mere fact that the company is controlled by its shareholders. Kerr LJ said (at p.189):

The reason the House of Lords overruled the Court of Appeal in the Salomon case was because the House of Lords rejected the agency doctrine and its application between the corporation and its promoters in relation to the company's contracts and control over these contracts and in relation to who is entitled to benefit from such contracts. This rejection of the agency rule is the cornerstone of modern company law.

The view that an agency relationship must therefore be shown to exist and not merely inferred from control or ownership of its shares was reinforced in *Adams v Cape Industries Plc*. However, *Smith, Stone & Knight* has not been overruled, although it has been severely criticised on the basis that the court was willing to imply or infer an agency relationship although no direct agency could be found.

In the pre-*Adams* era there was clearly an appetite for setting aside the separate entity principle and looking beyond *Salomon* on the basis of general equitable principles. In *Littlewoods Mail Order Stores Ltd v Commissioners of Inland Revenue* [1969] WLR 1241 and *DHN Food Distributors* Lord Denning expressed the view the courts should be able to lift the corporate veil if it is necessary to achieve justice. This view has been firmly rejected by the court in *Adams v Cape Industries Plc*.

Although the courts have made several inroads into the separate entity principle, it has clearly been re-asserted in *Adams v Cape Industries Plc*. The question that must now be asked is whether the reassertion and application of the separate entity rule under *Adams* is too strict.

The Supreme court considered Lord Keith's dictum in *Woolfson v Strathclyde Regional Council* that the corporate veil can only be "pierced" at common law "where special circumstances exist indicating that [a company] is a mere façade concealing the true facts", recently in *VTB Capital plc v Nutritek International Corporation* [2013] UKSC 5. The case involved an action for fraudulent misrepresentation. The Claimant bank contended that it was entitled to pierce the corporate veil and hold the defendants jointly and severally liable with a Company by reason of the control they exercised over that company together with the connected impropriety in using the corporate structure of the company to conceal their wrongdoing.

Lord Neuberger, with whom the other Lords agreed on this point, held that piercing the corporate veil was not justified in this case. It was not appropriate to pierce the corporate veil to allow the claimant bank to pursue a contractual claim against the person alleged to be controlling the defendant companies. Equitable remedies might be granted against a company in respect of legal or equitable wrongdoing committed by an individual who controlled the company, it did not follow that an individual could be held liable for breach of a contract entered into by the company. The corporate veil could not be pierced to enable a common law claim for damages as distinct from an equitable remedy whenever a company was used as a device or facade to conceal the true facts. Where a claim of wrongdoing was made against the person controlling the company it was inappropriate to permit the corporate veil to be lifted to enable a claimant to pursue a contractual claim against that person. The court held that such an extension of the principle that piercing the corporate veil in exceptional circumstances would be inconsistent with the reasoning and decision in *Salomon v Salomon* and privity of contract generally. The decision shows that the English courts are reluctant to extend the doctrine of piercing the corporate veil beyond its current limits.

Family Law

Recently there have been a number of important Family Law cases were the cours have had to consider the extent to which the corporate veil can be pierced where there has been impropriety linked to the misuse of a company as a device or façade to conceal wrongdoing. The courts have had to consider circumstances where substantial assets that are the subject of family law proceedings are held by Companies. Despite the recent decisions discussed below this area of law remains largely ambiguous.

In *Prest v Petrodel Resources Ltd*. [2013] UKSC 34 the Supreme Court of the UK considered an appeal following a claim for ancillary relief by a wife who joined seven companies, ultimately owned and controlled by her ex-husband, as co-respondents to her application, alleging that they held certain London properties (including the matrimonial home) on behalf of the Husband. A majority of the Court of Appeal found no basis at common law or under the Matrimonial Causes Act 1973 for the property transfer order at first instance which looked beyond the corporate veil and held that the Husband 'effectively owned' the properties. The Court found there was no need to pierce the corporate veil; it was held that there these corporate structures were holding the assets on resulting and constructive trusts for the husband and so could be transferred directly to the wife without the need to pierce the 'corporate veil'. The Court accepted the existence of a general common law veil-piercing jurisdiction albeit one limited to rare and exceptional circumstances.

Company Law

This has been followed recently in *M v M* [2013] EWHC 2534 (Fam) where the Court again stepped around the corporate veil in finding that corporate structures were holding assets on resulting and constructive trusts for the husband and handed down a record breaking judgment for financial provision following the breakdown of a marriage. (The husband's wealth was estimated at approximately £107m, of which approximately £91.6m was made up of 11 commercial properties in Russia and the remainder comprising of 8 English properties, which were held by companies)

See – Christopher Hare, Family Division, 0; Chancery Division, 1: piercing the corporate veil in the Supreme Court (again), Cambridge Law Journal 2013, 72(3), 511-515

Formation of a Company

The Separate legal personality is the theoretical underpinning of the company; we will now turn to the nuts and bolts.

We have looked at the ways in Common Law and in Legislation to *go beyond the Corporate Veil* and look at the *de facto* ownership or control of Companies.

A company is registered by filing certain documents with the Registrar - a public official appointed by the Secretary of State. Duties include registering new companies, maintaining company files and supervising compliance with the administrative and disclosure requirements of the Companies Act. The Companies Act now allows most documentation to be submitted in electronic form.

The United Kingdom has had a system of company registration since 1844. (See above)

All limited companies in the UK are registered at Companies House, an Executive Agency of the Department of Trade and Industry. According to the Companies House Annual Report; in 2010 there were 2,304, 000 active companies in the England, Wales and Scotland. 362,000 new companies were incorporated.

(See – companieshouse.gov.uk)

Company Law

Incorporation is a practical process that lawyers should be able to advise clients about. We will look at;

- the process for registration/the incorporation procedure
- the nature of documents required to be filed with Registrar of Companies, their significance and their relationship to each other
- the contents of each document and its legal effect
- the significance of the certificate of incorporation.

Incorporation is a formal process by which documents are registered with the Registrar of Companies and, if satisfied, the Registrar issues a certificate of incorporation which formally incorporates the company.

Part 1 of the Companies Act 2006 provides that the application for registration must be accompanied by filing the following documents, together with a registration fee, with the Registrar of Companies:

- application for registration form (s.9)
- memorandum of association
- articles of association
- statement of guarantee, if relevant
- statement of capital and initial shareholdings (s.10)
- address of registered office
- statement of proposed officers (s.12)
- statement of compliance (s.13).

Under s.9 of the Companies Act 2006 the process of registering a company must be initiated with the application for registration form – this is a new document introduced by the Act of 2006 and it contains much of the information previously found in the memorandum of association.

In all cases, the application for registration form must state (s.9(2)):

• the company's proposed name

• whether the company's registered office is to be situated in England and Wales (or Wales), in Scotland or in Northern Ireland

• whether the liability of the company's members is to be limited and, if so, whether it is to be limited by shares or by guarantee

• whether the company is to be a private or a public company. In the case of a company that is to have a share capital, the application must also contain a statement of capital and initial shareholdings (s.10) and a company limited by guarantee must also contain a statement of guarantee (s.11).

We will look at the clauses found in the registration document in detail.

Choice of name

The choice of a name for a company is of considerable importance and subject to a number of restrictions:

• If a company is to have limited liability, the name (with the exception of companies with a charitable or social nature) must end with the word 'Limited' (permitted abbreviation 'Ltd') for a private company, and 'Public limited company' (permitted abbreviation 'Plc') for a public company.

• A company may not be registered with a name which, in the opinion of the Secretary of State for Business, Enterprise and Regulatory Reform, would constitute a criminal offence or be offensive (s.53).

• A company can only be registered with a name which suggests a connection with Her Majesty's government, a local authority or other public authority, if the use of such a name is approved by the Secretary of State (s.54).

• Certain other names which are considered 'sensitive' can only be used with prior approval of the Secretary of State (e.g. the words 'University', 'Charity', 'Chamber of Commerce', or words and expressions protected by current regulations such as the Company and Business Names Regulations 1981) (s.55).

• Section 56 of the Companies Act 2006 also enables the Secretary of State to specify that the approval of certain associations or professional bodies must be sought when seeking to use certain words or names (e.g. the approval of the General Dental Council is required for the use of either 'Dental' or 'Dentistry').

• The name must not be the same as any other kept in the Index of Company Names held by the Registrar (s.66).

Subject to the above restrictions, promoters have a free choice in selecting a company's name. However, the owners of existing business undertakings may bring an action under the tort of 'passing off' in certain circumstances.

Therefore, it is an offence for one person to represent his business to be that of another or to mislead the public into believing that there is a business association or connection between the two. The person responsible is guilty of deception and profits from the goodwill which attaches to the other's business. The commonest way this deception is practised is by the adoption of a name which is calculated to confuse the public and give the impression that the spurious business and the genuine business are the same or in some way connected. The directors of the already-established business may obtain an injunction to restrain the newly registered company from continuing business under that name. Therefore in *Reckitt & Colman Ltd v Borden Inc* [1990] 1 All ER 873 Lord Oliver reaffirmed the test for passing off and that the plaintiff has to:

…establish a goodwill or reputation attached to the goods or services which he supplies in the mind of the purchasing public by association. Secondly, he must demonstrate a misrepresentation by the defendant to the public (whether or not intentional) leading or likely to lead the public to believe that goods or services offered by him are the goods or services of the plaintiff. Thirdly, he must demonstrate that he suffers or that he is likely to suffer damage by reason of the erroneous belief engendered by the defendant's misrepresentation that the source of the defendant's goods or services is the same as the source of those offered by the plaintiff.

The three basic elements of passing off are:

- reputation
- misrepresentation
- damage to goodwill.

In *Exxon Corporation v Exxon Insurance Consultants International Ltd* [1981] 2 All ER 495 the plaintiff, a multinational oil company, devised and settled on a new corporate name for itself and its associated companies and after considerable research decided on the word 'Exxon' as part of the corporate name. The name 'Exxon' was also registered as the corporation's trade mark. The defendant company, which had no connection with the plaintiff company, subsequently used the word 'Exxon' as part of its corporate name without the plaintiff company's consent. The plaintiff company brought action for an injunction to restrain the defendant company from passing off its goods or services as the plaintiff company's goods or services by the use of the name 'Exxon'. The court held an injunction would be granted to restrain the defendant company from using the name 'Exxon' as part of its name. The court concluded that an action in passing off will lie when the defendant company carries on a business which is the same or similar to that already established/undertaken by the plaintiff, or where business transactions are likely to come to the spurious company because the public will believe that it is in some way connected with the plaintiff.

However, an action will not succeed if the common words are merely of a descriptive nature. Therefore, in *Society of Motor Manufacturers and Traders v Motor Manufacturers and Traders Mutual Insurance Company* [1925] Ch 675 a company in business of carrying out car insurance adopted as part of its name the words 'Motor Manufacturers and Traders', which had already been adopted by a society as part of its name. The court held that there was no risk of injury to the society's reputation since both names could be distinguished from each other. The words objected to were merely descriptive and would therefore be ignored in determining the action for passing off.

There are no facilities for reserving a name for a company while its articles and other documents are being prepared for incorporation. So a name which may be unobjectionable when the index of company names is searched or when the promoters obtain the consent of the Secretary of State may be objected to when the documents are filed with the Registrar of Companies.

A company's name may be an indication that the company is unsuitable for incorporation. The Registrar is entitled to refuse to register a company where it has been formed for an unlawful purpose:

The court may also be petitioned to cancel a registration if it appears that the company has been registered for purposes which are unlawful or contrary to public policy:

R v Registrar of Companies, ex p Attorney-General [1991] BCLC 476

In 1979 Lindi St Clair, a prostitute, attempted on the advice of her accountants, to register a private limited company which had its stated object: "to carry on the business of prostitution". This followed a policy decision by the Inland Revenue that tax should be paid on the proceeds of prostitution.

The Registrar refused to accept a registration using the names Prostitutes Ltd or Hookers Ltd. The Registrar accepted the registration under the name "Lindi St Clair (Personal Services) Ltd".

The Registrars decision to incorporate a Company is subject to judicial Review by the Crown.

In 1980, the Attorney-General applied to the court to quash the registration on the basis that the company had been formed for an unlawful purpose. Prostitution was a grey area in British

Law at the time. Lindi St. Clair may not have been breaking the law. It was argued the Registrar of Companies was acting Ultra Vires.

The court held that the registration should be quashed.

Though the company's objects did not necessarily involve the commission of a criminal offence, contracts for the services of a prostitute would be illegal and unenforceable as contrary to public policy.

The company had not therefore been formed for a lawful purpose.

Company's registered office

A company must at all times have a registered office to which all communication can be addressed (s.86 Companies Act 2006). A company may change the address of its registered office by giving notice to the Registrar of Companies (s.87), but it cannot change the place of registration; the latter governs the nationality of the company.

The registered office is important as all legal documents/statements and company registers can be served there and must be available for inspection there.

The concept of a Company's registered office is very different to the concept in German and other Continental systems. Sealy and Worthington write about this at 2.11. In English law a Company may be incorporated under the law of one jurisdiction but have its residence, its "head and seat and directing power" as defined by Lord Loreburn in the House of Lords in *De Beers Consolidated Mines Ltd. v. Howe* [1906] AC 455, in another jurisdiction. The same Company law rules are in force in Ireland, the USA and the Netherlands. In Germany and other Continental jurisdictions there is a strict rule that a company may be incorporated only in the jurisdiction where it is to have its principal place of business, its *siège réel* or *Sitz*. When such a company moves its Sitz out of that jurisdiction it must be wound up.

These different approaches cause difficulties in the EU harmonisation of Company Law. There is the possibility that were the English approach adopted many companies would incorporate in jurisdictions with the least strict legal regimes. This has happened in the United States of America with the popularity of incorporating in the small state of Delaware.

- There is a good discussion of this topic in Sealy and Worthington.
- We have already discussed the development of the European company.

Liability of members

This clause will set out the liability of the members of the company and whether it is to be limited by shares or by guarantee. If the company is to have a share capital there should be submitted a statement of capital and initial shareholdings (s.10). If the company is to be limited by guarantee there should be submitted a statement of guarantee (s.11).

Whether the company is a public or private company

The application form must set out the status of the company as either a public or private limited company. The application form must be accompanied by a statement of the company's proposed officers and also a compliance statement to the effect that the requirements of the Act have been complied with.

The articles of association

The company's constitution is now mainly made up of the articles alone. The articles cover matters of internal regulation (a little like a 'rule book' dealing with the rights of shareholders, directors, etc.).

The articles form a statutory contract between the company and its members, and between each of the members in their capacity as members.

Section 18 states that all registered companies are required to have articles.

The company can draft its own articles or adopt model articles – s.19 gives the Secretary of State the power to prescribe (default) model articles for different descriptions of companies. The model articles operate as a safety net which enables members of the company and directors to take decisions in circumstances where a company has failed to provide the appropriate authority in its registered articles.

Section 21 provides that a company can alter its articles if the shareholders pass a special resolution (at least 75 per cent of the shareholders voting in favour of the alteration).

This section gives a company new power to restrict alteration of the articles (known as entrenching the article in question). The promoters of a company may entrench an article when it is formed, or entrenchment may be possible after registration (s.22(2)(b)), which requires all shareholders to consent to such an alteration.

However, a company cannot alter its articles and entrench provisions which contravene or are in conflict with the provisions of the companies' legislation or with an order of the court.

Memorandum of association

Prior to the Companies Act 2006, the memorandum of association was the foremost, fundamental document in relation to a company's registration and dealings with third parties. It contained a number of clauses now found in the application for registration form. Significantly, the memorandum set out the objects clause, which was used to determine the scope of the company's objects and thereby its activities. An act done outside the objects clause could be struck down by the courts as *ultra vires* and therefore invalid.

Now, the memorandum is a simple document evidencing an intention on the part of the subscribers to form a company. It will contain an undertaking on the part of the subscribers to become members and to take at least one share (s.8). All the company's key internal rules, such as the allocation of powers between the members of a company and its directors, will be set out in the articles.

In addition to the above document, promoters of the company must provide a statement of the address of the registered office (s.9(5)(a)) and a statement of the company's proposed officers (s.12) – this is essentially a statement of those who will be the first directors of the company (a minimum of one person). A private company is no longer obliged to appoint a company secretary.

The effect of registration is set out in s.16.

From the date of incorporation mentioned in the certificate the subscribers of the memorandum, together with such persons as become members of the company, are a body corporate by the name contained in the memorandum.

The body corporate is capable of exercising all the functions of an incorporated company. The status and registered office of the company are as stated in the application for registration. Where a company has a share capital, the subscribers to the memorandum become holders of shares specified in the statement. The persons named in the statement as director or as secretary are deemed to have been appointed to that office.

Certificate of incorporation

The Registrar of Companies will examine the documents filed, and after satisfying himself that they are in order, the company's name is unobjectionable and its objects are lawful, will issue a certificate that the company is properly incorporated. The Registrar cannot refuse to register the company if the documents are in order and proper procedure has been followed; he must issue a certificate, and the court can compel him by order of mandamus.

After issuing certificate of incorporation the Registrar will give notice of incorporation of the company in the London Gazette.

In *R v Registrar of companies ex p. Bowen* [1914] 3 KB 1161 the court held that the Registrar could only refuse to register a proposed company under the Dentists Act 1878 if the use of the proposed name was an offence under the Act, and since it was not the court would make an order compelling the registration of the proposed company under the proposed name.

However, the Registrar may refuse to register a company where its objects are unlawful according to the law of the country.

The refusal to register a company and grant a certificate of incorporation is subject to judicial review. In *R v Registrar of Joint Stock Companies (ex p. Moore)* [1931] 2KB 197 the Court of Appeal held that selling lottery tickets through the intended company would have been an offence under the law in force at the time in question and therefore the decision of the Registrar of Companies to refuse registration of the company was correct. The company was not being formed for a lawful purpose and the refusal to register it was valid.

The certificate of incorporation is conclusive evidence:

• That the requirements of the Companies Act in respect of registration have been complied with and that that the proper procedure was followed. In *Oakes v Turquand* (1867) LR 2 HL 325 the court held that any procedural irregularity in the incorporation of the company was immaterial once the certificate of incorporation had been issued. So despite the fact that the memorandum and articles of association were altered after they were signed by the subscribers, but before registration, the court held the company was validly incorporated with its articles and memorandum valid in their altered form.

• That the company is authorised to be registered. In *Princess of Reuss v Bos* (1871) 40 LJ Ch 655 the court held that the company was validly incorporated even though some of its objects were unlawful.

• As to the date of incorporation. In *Jubilee Cotton Mills Ltd v Lewis* [1924] AC 958 the certificate of incorporation erroneously stated a date a few days earlier than the date on which the certificate of incorporation was actually signed by the registrar. The court held the company was validly incorporated on the date specified on the certificate, although erroneous, and therefore a contract made in the company's name on the following day was binding on the parties although at that time the certificate had not actually been issued.

• That the company has been regularly incorporated and satisfied the requirements relating to public companies under the Companies Act 2006.

The Registrar's decision to incorporate a company is subject to judicial review at the suit of the Crown as we saw in *R v Registrar of Companies ex p. AG* [1991] BCLC 47.

Company Law

From the date of incorporation mentioned in the certificate of incorporation, the subscribers to the memorandum and any other persons who from time to time become members of the company form a body corporate, that is, a legal person separate district from its members.

Certificate of entitlement to do business

A private company may enter into legally binding contracts/obligations once the certificate of incorporation has been issued, but a public limited company must obtain a certificate of entitlement to do business (sometimes called a trading certificate) before it can commence trading. This is conclusive evidence that company is entitled to commence business and that it has an issued share capital of not less than £50,000, of which 25 per cent has been paid up.

The directors or secretary of the company must make a statutory declaration that the nominal value of the issued share capital is not less than the authorised minimum, the amount paid up by the shareholders and any payment made to or benefit conferred on the promoters.

Failure to obtain a certificate does not render any transaction by the company void, but the directors are personally liable for any loss to the other party unless the certificate is obtained within 21 days of demand.

Directors' duties

Once again we look at the actions of people involved in Commerce. Directors manage and control companies under the Companies Act. This subject is covered in Chapter 6 of Sealy and Worthington. This is another area that has recently been reformed in the UK.

Courts have generally stated that someone who acts for or on behalf of another in circumstances giving rise to a relationship of trust and confidence owe fiduciary duties. The notion of fiduciary duties has been developed over time by common law rules and equitable principles. In this course we have discussed the fiduciary duties owed where one party is in a position of trust and the circumstances allow it; the duties owed by an Agent to its principal and by Partners to their fellow Partners in a partnership.

A fiduciary duty is a strict code of loyalty owed by one party (a "fiduciary") to another (a "beneficiary" or "principal") in various situations and relationships developed by the common law and equitable concepts that have developed over time.

Company Law

The Companies Act 2006 has codified some of the common law fiduciary duties owed by directors to their company.

The Companies Act 2006 attempts to simplify and clarify the position for directors by codifying the existing law and developing it where required. The duties form a code of conduct which sets out how directors are expected to behave; it does not tell them what to do.

The common law and fiduciary duties formerly to be found in case law are codified into a series of 'general duties'. More particularly, the duties address:

- the possibility that a director may put his own interest(s) ahead of the company
- the possibility that he may be negligent.

The general statutory duties (ss.171–78) are all broadly based on the existing case law and will require directors:

- to act within their powers – s.171
- to promote the success of the company – s.172
- to exercise independent judgment – s.173
- to exercise reasonable care, skill and diligence – s.174
- to avoid conflicts of interest – s.175
- not to accept benefits from third parties – s.176
- to declare an interest in a proposed transaction with the company – s.177.

Statutory duties require shareholder approval of substantial property transactions between a company and its directors and loans and credit facilities provided by the company to its directors.

Overlap

Many of the general duties frequently overlap – more than one of the general duties may apply in any given case. For example, taking a bribe from a third party would clearly fall within the duty not to accept benefits from third parties (s.176) but could also, depending on the facts, be characterised as a failure to promote the success of the company for the benefit of its members (s.172) or as an aspect of failing to exercise independent judgment (s.173).

Cumulative

The duties may be cumulative obligations; directors must therefore comply with each obligation that applies to a particular case (s.179). So, for example, the duty to promote the success of the company will not authorise the director to breach his duty to act within his powers, even if he considers that that would be most likely to promote the success of the company.

Case law replaced but relevant to interpretation

The new statutory duties are based on certain common law rules and equitable principles, and will have effect in place of them (s.171(3)). This removes the need for directors and their advisers to 'distil' the duties from principles established in case law, much of which dates back to the nineteenth century. We will look at this Case law.

The government's intention was to make the law widely known and understood by both directors and shareholders. However, the benefits of codification have been reduced by a requirement for courts to have regard to the existing common law rules and equitable principles in interpreting the new duties. Further, within the rules of precedent the courts can develop and adjust equitable principles and common law duties in a way not normally allowed by statute.

Fiduciary duties of directors and resulting liabilities

We have discussed this above.

A working definition of a fiduciary was given by Millet LJ in *Bristol and West Building Society v Mothew* [1998] Ch 1 (at p.18):

A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence.

The distinguishing obligation of the fiduciary is the obligation of loyalty.

The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several elements and includes:

- A fiduciary must act in good faith.
- He must not make a profit out of his trust.
- He must not place himself in a position where his duty and his interest may conflict.
- He may not act for his own benefit or the benefit of a third person without the informed consent of his principal.

These duties are intended to prevent fiduciaries from exercising their powers in a manner detrimental to those for whom they act and to prevent them from abusing the trust and confidence imposed on them.

Within company law, directors have all the powers of management of the company and its assets and are therefore clearly in a fiduciary relationship with the company. Directors' fiduciary duties are a mandatory element of company law and are imposed by the courts on all directors of all companies: *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378.

Further, in *Re: Lands Allotment Company* [1894] 1 Ch 616 Lindley LJ said that although directors are not properly speaking trustees, 'yet they have always been considered and treated as trustees of money which comes to their hands or which is actually under their control…directors have been liable to make good monies which they have misapplied upon the same footing as if they were trustees.'

Duties are owed to the company

The general duties are owed to the company and not individual shareholders. It follows that only the company can enforce duties owed by its directors (Companies Act 2006, s.170(1)).

It has been held that in the absence of special provisions in the articles or some collateral agreement between the company and its members, neither the company nor its directors owe any direct legal duties to its members.

In *Towcester Race Course Co Ltd v The Racecourse Association Ltd* [2003] 1 BCLC 260 at [19] Patten J stated:

If the directors act unlawfully, then they will be accountable for their actions and for any losses suffered by the company as a result…the proper claimant in such proceedings is the company and not the shareholders.

Accordingly, the court will not add implied terms to the articles of association concerning the manner in which a general power of management is to be exercised by the directors.

Nor can any terms be implied which would have the effect of making the company or its directors contractually liable to its members for the way in which the company or the directors carry out their functions. In *Percival v Wright* [1902] 2 Ch 421 the plaintiff asked for the sale of their shares to the chairman of the company to be rescinded on the ground that the chairman had a duty to disclose that he was negotiating the sale of the colliery at a price which implied that the valuation price of the shares was wrong. The court held that there was no such duty and to adopt the contrary view would place the directors in a most invidious position as they could not buy or sell shares without disclosing negotiations the premature disclosure of which might well be against the best interests of the company.

However, in *Allen v Hyatt* (1914) 30 TLR 44 the directors of a company were held, on the facts of that case, to be the agents of the members and so to come under a duty to the members to make full disclosure.

The directors of a company may come under a duty to the members of a company in other circumstances as well. Therefore, where there are rival takeover bids, it has been held that the directors must not exercise their powers in such a way as to prevent the members obtaining the best price for their shares (in *Re A Company* [1986] BCLC 382, where the chairman of a company had asserted in a misleading letter that the lower of two rival takeover bids for the company should be accepted because the other could not succeed).

Further, in *Re Chez Nico (Restaurants) Ltd* [1991] BCC 736 Browne- Wilkinson V-C stated that he considered *Percival v Wright* to be very doubtful authority for the proposition that directors of a company may purchase shares in a company without disclosing pending negotiations for the sale of the company's undertaking, and that in certain special circumstances directors may owe a fiduciary duty of disclosure to the shareholders. The court refused to follow *Percival v Wright* and commented that the standard of conduct required from a director in relation to dealings with a shareholder will differ depending on the surrounding circumstances and the nature of the responsibility which in a real and practical sense the director has assumed toward the shareholder.

Woodhouse J stated that it may not be possible either to lay down any general test as to when the fiduciary duty will arise for a company director, or to prescribe the exact conduct which will be necessary to discharge such a duty when it arises.

Further, the following factors may have some influence:

- dependence by shareholders upon the directors for information and advice
- the existence of a relationship of confidence
- the significance of some particular transaction for the parties
- the extent of any positive action taken by or on behalf of the directors to promote the transaction.

Are duties owed by directors to creditors?

In *West Mercia Safetywear v Dodd* [1988] BCLC 250 the Court of Appeal held that the director of an insolvent company must have regard to the interests of the creditors, thereby adopting into English law the rule in *Nicholson v Permakraft* [1985] 1 NZLR 242.

As well as a duty to the company to consider the interests of its creditors when the company is insolvent or there is a real risk of insolvency, it appeared for a short time that directors might directly owe a duty to the creditors and in *Winksworth v Edward Baron Developments Co Ltd* [1986] I WLR 1512 Lord Templeman said:

A company owes a duty to its creditors, present and future…to keep its property inviolate and available for the repayment of its debts. The conscience of the company, as well as its management, is confided to its directors. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and…not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.

However, in *Kuwait Asia Bank EC v National Life Nominees Ltd* [1991] 1 AC 187 it was stated that:

A director does not by reason only of his position as a director owe any duty to creditors or to trustees for creditors of the company.

This seems finally to dispose of the possibility of the creditors of a company taking action against its directors.

The general duties in the Companies Act 2006 comprise:

- fiduciary duties owed to the company
- the common law duty of care to exercise reasonable skill.

Fiduciary duties owed to the company

Directors' duty to act within their powers – s.171 Companies Act 2006

A director must:

- act in accordance with the company's constitution
- only exercise powers for the purpose for which they were conferred.

This duty codifies the director's duty to comply with the company's constitution and also codifies the current principle of law under which a director should exercise his powers in accordance with the terms on which they were granted, and do so for a 'proper purpose'.

What constitutes a proper purpose must be ascertained or decided in the context of the specific situation under consideration.

What is a proper purpose?

Company Law

Directors of a company have authority to exercise their powers in the management of the company's affairs, but there may be limits on the purposes for which those powers may be exercised and therefore limits on the director's authority.

An exercise of a power for a purpose which is outside the purposes for which a power has been given (and described as an improper, extraneous or collateral purpose) is voidable.

Whether a particular purpose is proper is generally stated to be a matter of construction of the articles of association: *Re Smith & Fawcett Ltd* [1942] 1 All ER 452.

In the Privy Council decision in *Howard Smith Ltd v Ampol Petroleum* [1974] AC 821, the court examined the proper purpose doctrine by examining the conduct of the directors in the context of the constitutional powers conferred on them to act on behalf of the company (i.e. by comparing the conduct of the directors and the transaction entered into by them and asking whether the exercise of their powers was within the scope of the memorandum and articles of association when read as a whole).

In *Howard Smith* the court expressed the view that it is:

unconstitutional for directors to use their fiduciary powers to issue shares in the company purely for the purpose of destroying an existing majority, or creating a new majority which did not previously exist. To do so is to interfere with that element in the company's constitution which is separate from and set against their powers.

Questions as to whether powers have been exercised for their proper purposes often arise:

With regard to the issue or allotment of shares; if directors allot shares for the dominant purpose of preserving their own control of the management of the company (by ensuring that there is a majority of votes in their favour) then the allotment is invalid: *Piercy v S. Mills & Co Ltd* [1920]1 Ch 77 and *Hogg v Cramphorn Ltd* [1967] Ch 254.

Similarly, if directors allot shares for the dominant purpose of manipulating voting power by favouring one shareholder or group of shareholders at the expense of another shareholder or group, the allotment will be invalid: *Howard Smith*.

In relation to other powers such as the power to cause the company to enter into contracts, as in *Lee Panavision Ltd v Lee Lighting Ltd* [1992] BCLC 22 22 and also *Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald (No. 2)* [1995] BCC 1000.

The directors are still subject to the duty to exercise their powers in what they consider to be the interests of the company and not for any collateral purpose such as their own enrichment.

The general statement of the duty of directors in exercising their powers is taken from the judgment of Lord Greene MR in Re Smith & Fawcett Ltd [1942] 1 All ER 452 at p.306, where the Judge stated that directors of a company must act *'…bona fide in what they consider – not what a court may consider – is in the interest of the company, and not for any collateral purpose.'*

In *Hogg v Cramphorn Ltd* [1967] Ch 254 Buckley J held that the statement of Lord Greene in Re Smith & Fawcett Ltd meant that directors were at fault if they act either (a) not bona fide in what they consider is the interests of the company (subjective element), or (b) for an improper purpose (objective element) even if they reasonably and actively believe they are acting bona fide in the interests of the company.

In *Howard Smith* Lord Wilberforce rejected this approach and emphasised that, in a case in which the court has found that the directors have believed they were acting bona fide in the interests of the company, the court should not question the correctness of the management's decision, whether or not the purpose for which the directors acted was objectively proper – though the judge also made it clear that the range of proper purposes may be wider than was previously thought.

This statement by the Privy Council has been accepted to be the law in England and Wales by Jonathan Parker J in Regentcrest Plc v Cohen [2001] 2 BCLC 80.

Where directors are motivated by more than one reason

The court will examine the substantial purpose for which the power was exercised and reach a conclusion whether that purpose was proper or not: Howard Smith Ltd v Ampol Petroleum [1974] AC 821.

In many cases, directors' exercise of a power may lead to two or more effects; achieving one or more effect may be a proper purpose while achieving the remainder may be improper. The court is therefore required to find whether achieving the improper effect was the 'substantial' or 'dominant' or 'the moving cause'.

Ratification

The members of a company may allow an act which would otherwise be a breach of a director's fiduciary duties. Ratification of the breach means that the company has no cause of action in respect of the breach and so cannot bring a claim in respect of it.

Retrospective permission to exercise powers in a way not bona fide in the company's interests was given in *Hogg v Cramphorn Ltd* [1967] Ch 254 and *Bamford v Bamford* [1970] Ch 212.

Duty to promote the success of the company – s.172 Companies Act 2006

Section 309 of the Companies Act 1985, which required the directors of a company to have regard to the interests of the company's employees, has been replaced by s.172 of the Companies Act 2006, which provides that 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.

In complying with s.172, directors must have regard to the long-term consequences of their decisions, the interests of employees, the need to foster the company's business relationships with suppliers, customers and others, and the impact of the company's operations on the community and the environment. The desirability of the company maintaining a reputation for high standards of business conduct and the need to act fairly between members must also be taken into consideration.

The interests of members are clearly of considerable importance, although questions arise as to whether and to what extent dissenting minority shareholders are entitled to have their interests taken into consideration.

Directors must have regard to the interests of employees as part of the general duty owed by the directors to the company. This duty can therefore only be enforced by the company. Creditors have their money tied up in the company and therefore it is logical that directors should have regard to their interests. In *Lonro v Shell Petroleum* [1980] 1 WLR 627 Lord Diplock said: 'It is the duty of the board to consider…the best interests of the company. These are not exclusively those of its shareholders but include those of its creditors.'

This view was confirmed in *The Liquidator of the Property of West Mercia Safetywear Ltd v Dodd and Another* [1988] BCLC 250, although in that case the interests of the company were said to include the interests of creditors because the company was insolvent at the relevant time. Insolvency was not an issue in *Lonro* or in *Winkworth v Edward Baron* [1987] BCLC 193, where the duty was referred to as owed to creditors. Again, in *Brady v Brady* [1989] 1 AC 755 Nourse LJ expressed the view that the interests of the company were synonymous with the interests of the creditors where the company was insolvent or of 'doubtful solvency'.

Section 172(3) provides that the duty imposed under this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of the company.

At this stage, it is not clear how this new duty will operate. There are some potentially confusing elements:

• Generally, it moves away from the concept of acting in the best interests of the company and uses the new, inherently more difficult concept of 'success'.

• More particularly, it is not clear how the requirement to take into account the long-term consequences of a decision and the range of different interest groups can be satisfied in the multitude of different situations that directors find themselves in.

Duty to act bona fide in the interests of the company

Again, reference may be made to the general statement in *Re Smith & Fawcett Ltd* [1942] 1 All ER 452 at p.306, where Lord Greene stated that directors of a company must act '…bona fide in what they consider – not what a court may consider – is in the interest of the company, and not for any collateral purpose.'

The phrase used in the Act is 'in good faith…to promote the success of the company for the benefit of its members as a whole'. This means a subjective bona fide view of the directors. It is not open to the court to overrule their decision on the ground that in the court's view the decision was not one which was for the benefit of the company: *Shuttleworth v Cox Bros Bros & Co (Maidenhead) Ltd* [1927] 2 KB 9.

In Howard Smith the court expressed the view that there is no appeal on the merits of a management decision and nor will courts of law presume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at. Similarly, in *Regentcrest Plc v Cohen* [2001] 2 BCLC 80 the court said that the question is not whether, viewed objectively by the court, the particular act or omission which is challenged was in fact in the interests of the company; still less is the question whether the court, had it been in the position of the director at the relevant time, might have acted differently. Rather, the question is whether the director honestly believed that his act or omission was in the interests of the company. The issue is as to the director's state of mind. No doubt where it is clear that the act or omission under challenge resulted in a substantial detriment to the company, the director will have a harder task persuading the court that he honestly believed it to be in the company's interest, but that does not detract from the subjective nature of the test.

Therefore, an act done in the unreasonable belief that it was in the interests of the company is not in breach of fiduciary duty, provided the belief was held honestly: *Extrasure Travel Insurance Ltd v Scattergood* [2002] All ER (D) 307.

The notion of acting bona fide in the interests of the company has been enacted under s.172 Companies Act 2006 as a duty to exercise company powers in a way which a director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole and in doing so have regard to a number of listed factors.

The legislation breaks this duty down into two inter-locking stages:

• The first element (s.172) simply requires a director to act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. As under the previous law, this is a narrow and largely subjective test of whether the directors honestly believed they were acting in the best commercial interests of the company and not for some ulterior motive.

• However, the second element (in s.172(2)) allows for a more expansive scrutiny of the decision as one that promotes the success of the company, by placing the notion of the 'success of the company' in a wider context than simply satisfying narrow shareholder commercial expectations.

Therefore, in exercising their powers for the company, directors will be expected to have regard (so far as is reasonably practicable) to a non-exhaustive list of factors set out in s.172(1), namely:

• the long-term consequences of a decision

• employee interests

• relationships with the company's trading partners

• the effect of the company's operations on the community and the environment

• the desirability of maintaining the company's reputation for high standards of business conduct

• the need to act fairly as between members.

Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, s.172(2) has effect as if the reference to promoting the success of the company for the benefit of its members were a reference to achieving those purposes.

Duty to exercise independent judgment – s.173 Companies Act 2006

This duty codifies the current principle of law under which directors must exercise their powers independently, without subordinating their powers to the will of others, whether by delegation or otherwise (unless authorised by or under the constitution to do so).

The section provides that directors must not fetter (limit) the future exercise of their discretion unless they are acting:

• in accordance with an agreement which has been duly entered into by the company; or

• in a way authorised by the company's constitution.

The duty does not confer a power on the directors to delegate or prevent a director from exercising a power to delegate conferred by the company's constitution, provided that its exercise is in accordance with the company's constitution. Under the draft model articles of association for private companies limited by shares, the directors may delegate their functions in accordance with the articles.

Duty to exercise reasonable care, skill and diligence – s.174 Companies Act 2006

This section codifies the director's common law duty to exercise reasonable skill, care and diligence.

Common law duty of care and skill

In *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 Romer J expressed the view at p.428 that: 'A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.'

This was a recognition that, at the time when the law on directors' negligence was being established, many company directors were appointed simply on the basis that they were respectable persons who were willing for their names to be associated with the companies of which they were directors.

A court assessing negligence was content to ask whether the director had, with reasonable diligence, applied his or her own knowledge and experience. This was described as a subjective test – it used only the standard of the person being tested. A court would not go on to apply an objective standard by asking whether the director had done what was reasonable.

According to the general analysis of liability for negligence in *Henderson v Merrett Syndicate Ltd* [1995] 2 AC 145 the House of Lords held that the duty of care owed by a director of a company to the company arises from the circumstance that the director assumes responsibility for the property or the affairs of the company.

Unless contractually bound to perform specific duties (e.g. under a contract of employment), a company director is in general only liable for negligence for acts rather than omissions, so that Neville J stated in *Re Brazilian Rubber Plantations and Estates Ltd* that a director is not bound by any definite part in the conduct of the company's business but, so far as he does undertake it, he must use reasonable care in its dispatch.

However, a higher standard has been set in director disqualification proceedings under the Company Directors Disqualification Act 1986. In *Re Westmid Packing Services Ltd* [1998] 2 All ER 124 the Court of Appeal held that each director of a company has an individual duty to keep himself informed of the company's affairs, especially its financial position. Therefore, in that case, the court emphasised that former directors of a company could not claim to be excused from failure to keep themselves properly informed of the company's position just because the board was dominated by another person.

If directors of a company are negligent in the performance of their duties they will be liable to the company for the damage caused by their negligence. Therefore, in *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498 a money-lending company had three directors, but no board meetings were ever held and two of the three directors left the affairs of the company to the third director, who made loans to companies controlled by himself, his clients or his brother. The loans were all unenforceable. The court held all three directors liable to the company for their negligence.

In *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 245 Neville J stated that the reasonable care which a director must show must be measured by the care an ordinary man might be expected to take in the circumstances on his own behalf, but that the director would not be responsible for damages occasioned by errors of judgment.

Directors therefore have both collectively and individually a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.

It has also become increasingly accepted at common law that there can be an objective standard of director's competence.

In *Norman v Theodore Goddard* [1991] BCLC 1028 Hoffmann J accepted without hearing argument counsel's suggestion (based on s.214 (4) of the Insolvency Act 1986 that we've studied) that the degree of care which a director of a company owes when carrying out functions in relation to the company is the care that would be taken by a reasonably diligent person having both:

a. 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 (the objective test);

and

b. the general knowledge, skill and experience that that director has (the subjective test).

This standard has been described as 'dual' or 'twofold', or the 'objective/subjective' standard.

Section 214 of the Insolvency Act 1986, we saw, is concerned with 'wrongful trading' and empowers the court to declare a director or shadow director of a company liable to contribute to the assets of the company if the director knew or should have concluded that the company had no reasonable prospect of not going into insolvent liquidation and did not take every step that they ought to have taken to minimise the potential loss to the company's creditors.

Sub-sections 214(4) and (5) require the court to consider the facts which would be known or ascertained, the conclusions which would be reached and the steps which would be taken by a reasonably diligent person having both:

a. the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by the person against whom a declaration is sought in relation to the company which is in liquidation; and

b. the general knowledge, skill and experience that that person has.

The Companies Act 2006 now incorporates the test to determine the directors' duty of care and skill for the purposes of s.214 IA 1986.

Duty to avoid conflicts of interest

The no-conflict rule at common law

As a fiduciary, a director is under a duty not to place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal (i.e. the company) – see *Bristol and West Building Society v Mothew* [1998] Ch. 1.

As a company director stands in a fiduciary relationship to the beneficiaries of the trust he will not be permitted to retain unauthorised profits which he receives as a result of holding his position as trustee, as he must not permit his interests and duties to conflict.

The rationale for the rule was stated by Lord Herschell in *Bray v Ford* [1896] AC 44 at pp.51–52: "It is an inflexible rule of equity that a person in a fiduciary position...is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict… See also the rule in *Keech v Sandford* (1726) Sel Cas 61, where the no-conflict rule was held to apply to persons who clearly occupy a fiduciary position such as trustees or agents. It will therefore apply to company directors.

There is, therefore, an irrebuttable presumption that fiduciaries cannot retain the benefit of transactions which they enter into in their personal capacity where the opportunity to enter into that transaction arose by virtue of their position as trustee.

The corporate opportunity doctrine

There is a conflict of interest/duty if a director of a company pursues for his own benefit a business opportunity which it might have been in the company's interests to pursue, and the director will have to account to the company for the profits made and is also a constructive trustee for the company of any property acquired. In *Cook v Deeks* [1916] 1 AC 554 the Privy Council held that that three out of four directors of a company who were negotiating for a contract to construct a railway and took the contract for themselves so as to exclude the fourth director acted in breach of fiduciary duty and were liable to account to the company for the profits made from the transaction. The court concluded:

[M]en who assume the complete control of a company's business must remember that they are not at liberty to sacrifice the interests which they are bound to protect, and, while ostensibly acting for the company, divert in their own favour business which should properly belong to the company they represent.

In general terms, a fiduciary is allowed to use knowledge or information acquired during the course of his fiduciary relationship for his own purposes except:

• Where a fiduciary (i) obtains knowledge or information which is not available to the general public and is obtained by him as confidential information in the course of his fiduciary relationship; and (ii) that knowledge or information has a special value in so far as it enabled him to assess the commercial feasibility of a purchase by him and the appropriate terms of a purchase offer, and thereby substantially contributes to his successful purchase.

In that situation, liability will attach to the fiduciary whether or not matters such as the skill of the fiduciary contribute to the purchase and even though the purchase involved risk-taking despite the knowledge and information gained by the fiduciary.

• Where the fiduciary obtains confidential information in the course of his fiduciary relationship and then enters into a purchase for his own benefit in circumstances where his personal interest conflicts or may conflict with his fiduciary duties, for example his duty to consider a purchase on behalf of a trust.

Whether or not the information is confidential, if the opportunity that arises by reason of the acquisition of the information puts the fiduciary in a position of conflict, the fiduciary cannot take that opportunity.

In *Boardman v Phipps* [1967] 2 AC 46 Lord Upjohn described the no-profit rule as 'part of the wider rule' against conflict of interest.

Actual or potential conflict

The no-conflict rule is often formulated to comprehend both actual and potential conflicts. In *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461 the concept of conflict of interest which the rule aims to prevent was explained by Lord Cranworth LC:

[I]t is a rule of universal application that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which may possibly conflict, with the interests of those whom he is bound to protect.

Other formulations of the rule emphasise that a conflict which is so small that it will not affect observance of a fiduciary duty will be ignored. Therefore in *Queensland Mines v Hudson* (1978) 52 ALJR 399 the Privy Council referred to 'a real sensible possibility of a conflict'; in *Chan v Zacharia* (1984) Deane J referred to a 'conflict or a significant possibility of conflict'; and in *Movitex Ltd v Bulfield* (1986) 2 BCC 99, 403, Vinelot J referred to the interest of the fiduciary being 'so small that it can as a practical matter be ignored'.

However, if an interest is sufficiently large to be capable of influencing the fiduciary's mind, the strict rule in *Boardman v Phipps* applies

Therefore, as a consequence of *Boardman v Phipps*, English law imposes a very strict liability for breach of fiduciary duty so that a fiduciary is liable to account for profits he has received whenever there was a mere possibility, no matter how remote, that his duty and interest might conflict.

The strict liability applied in *Boardman v Phipps* was further applied by the

House of Lords in *Guinness Plc v Saunders* [1990] 2 AC 663, where a director who received £5.2 million under a contract he had entered into to provide his services to help with a takeover bid was held liable to account for this money because he had acted in breach of fiduciary duty and had not disclosed his interest to the company's board.

The strict approach of the majority of the House of Lords in *Boardman v Phipps* represents the present position of English law so that the only way a fiduciary can avoid liability is by ensuring that his profit-making activities are fully authorised by his principal following full disclosure.

Companies Act s.175

The duty under s.175 replaces the no-conflict rule applying to directors, including the duty not to make an undisclosed and unauthorised profit by way of a company connection. It extends to actual and potential conflict.

The statutory duty to avoid conflicts of interest replaces the equitable no-conflict and no-profit rules with a single rule (subject to s.176).

The prohibited conflict of interest is not the director's inability to resist the temptation to derive a personal benefit from his company connection. Rather, it is his failure to disclose the benefit and be authorised to retain it that places him in actual conflict and so in breach of duty.

Importantly, the Act liberalises the position by extending this disclosure and authorisation process to the director's fellow directors. Section 175 permits the board to authorise most potential conflicts of interest disclosed to them by a director. Such authorisation is effective only if the authorising directors are independent, so the conflicted directors must not have participated in the taking of the decision to authorise the conflict. Board authorisation of conflicts of interest will be the default position for private companies, but public companies will need to make provision in their articles.

The duty is not infringed if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest or the matter has been approved by the directors.

Therefore, if a director discloses the potential conflict to the company, s.180 allows its members to authorise conflicts that would otherwise be a breach of this duty.

Remedies available in cases of conflict

Rescission

If a transaction between a company and one of its directors results in a personal profit to the director or involves a conflict between the director's duty to the company and personal interest or duty to another, the transaction is voidable at the company's option and may be rescinded.

Liability to account

The liability of a fiduciary to account under equity was described in *Chan v Zacharia* (1984) 154 CLR 178 (at 199) as follows:

…to whom the obligation is owed for any benefit or gain (i) which has been obtained or received in circumstances where a conflict or significant possibility of conflict existed between his fiduciary duty and his personal interest in the pursuit or possible receipt of such a benefit or gain (ii) which was obtained or received by use or by reason of his fiduciary position or of opportunity or knowledge resulting from it.

In *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 the court concluded that the remedy to account is given without any need to prove that the director acted dishonestly or in bad faith, but is confined to recovery for the company of the director's net profits, not those made by others.

Waiver of the conflict

A director may escape personal liability by making full disclosure of the conflict. He thereby avoids the necessity to account to the company for any benefit derived, provided that the nature and extent of any material interest of the director is disclosed to the other directors (thereby excluding the no-conflict and no-profit rules).

In *Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald* [1995] BCC 1000 it was held that the power under Table A, Art. 85 do not give directors freedom to make any contract they like for their own benefit.

Duty not to accept benefits from third parties – s.176 Companies Act 2006

This section codifies the rule prohibiting the exploitation of the position of director for personal benefit. This duty prohibits the acceptance of benefits (including bribes). The acceptance of a benefit giving rise to an actual or potential conflict of interest will fall within the duty to avoid conflicts of interest (s.175) as well as this duty. This specific duty dealing with benefits from third parties is not subject to any provision for board authorisation.

The ability of the members of a company to authorise the acceptance of benefits which would otherwise be a breach of this duty is preserved by s.180 (4).

The duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. Benefits conferred by the company (and its holding company or subsidiaries) do not fall within this duty.

Important Common Law Cases – Directors' Duties

The most relevant common law duties are outlined below:

- Once insolvency becomes likely, the directors must protect the interests of the creditors, not the shareholders, *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250.

Company Law

- Directors must exercise reasonable skill and care in carrying out their functions (*Re City Equitable Fire Insurance Company* [1925] CH 407). The standard of that duty is the standard of a reasonable company director.
- Directors' powers should not be exercised to obtain a personal profit (*Regal (Hastings) Limited v Gulliver* [1967] 2 AC 134 and *Bamford v Bamford* [1970] Ch 202).
- Directors are not entitled to sell the company's assets to save their jobs and those of other employees so that the creditors are put into a worse position than would be the case on liquidation (*Re Ipcon Fashions Ltd* (1989) 5 BCC 773). However, a sale which is an honest attempt to save the business would not be considered to be in breach of the director's duty (Re *CU Fittings Ltd* [1989] BCLC 556 and *Re Welfab Engineers Ltd* [1990] BCLC 833).
- Directors should not exceed the powers conferred on them by the company's articles and should not exceed the company's objects (Selangor *United Rubber Estates Limited v Craddock (No 3*) [1968] 2 All ER 1073).
- A controlling shareholder-director may in law commit the criminal act of theft, against 'his' company even though he is the principal shareholder. (R *v Philippou* (1989) 5 BCC 665 and *R v Gomez* [1993] AC 422).

(Source - INS48305 - Legal background: Directors' duties: What are the common law duties of directors?, http://www.hmrc.gov.uk/manuals/insmanual/ins48305.htm)

Minority shareholder protection

We've already studied how individual partners are protected in Partnership law. Today we look at the protection for Minority shareholders. In accordance with the corporate entity principle, the courts have clearly applied the rule that the company is a separate legal person from its shareholders. Although many functions are delegated to the directors, eventual power and control over the company rests with the shareholders who control a majority of the votes. Directors who are also the majority shareholders are therefore in a clear position of power in respect not only of the day-to-day management decisions, but also of decisions made/voting power exercised at shareholders' meetings.

In certain circumstances the law allows shareholders to bring an action despite the fact that the company is normally the rightful claimant.

We will examine the statutory derivative action under s.260 of the Companies Act 2006 (superseding the common law exception of fraud on the minority and then discuss of s.994 of the Act of 2006 (replacing what was previously s.459 of the Companies Act 1985).

However, whether shareholders wish to resort to these remedies may depend on whether the shares are held in a public or private company. A shareholder in a public company who does not approve of the business strategy or conduct of the directors can sell his shares rather than enter into a protracted and expensive dispute with the management. A shareholder in a private company, on the other hand, may not be able to sell his shares so readily either to the public or to other existing shareholders.

All powers within the company rest ultimately with one or other of its organs – shareholders in the general meeting and/or the board of directors.

Each of these bodies makes its decisions by a majority vote unless the articles of association of the company expressly require a greater majority (e.g. the articles of association require an alteration to be by a special resolution – s.21 Companies Act 2006).

A substantial power is therefore placed in the hands of those who control more than half of the votes on the board or at a shareholders' meeting, and minority members must accept the decisions of the majority. Circumstances may arise where a director who is also the majority shareholder commits wrongs against the company, and the question that arises is who can seek relief when a wrong has been done to the company by those in control of it.

The law has to strike a balance between allowing the wishes of the majority to prevail and the proper management of the business. Statutory protection is given to minorities in a number of different ways:

- by requiring a special resolution rather than a simple majority vote in important matters such as alteration of the constitutional documents
- by requiring the court's sanction, for example where a reduction of capital or a scheme of arrangement is involved
- by giving dissenting shareholders a right to apply to the court to have a resolution cancelled, for example in an alteration of the articles or variation of class rights.

However, these examples do not extend to situations where the minority shareholder brings an action derived from the company's right to sue for wrongs done against the corporate entity.

Other statutory provisions give shareholders direct access to the courts to seek relief on behalf of their company, for example the right to seek relief for 'unfairly prejudicial' conduct (s.994 Companies Act 2006).

Some rules have been devised to curb the abuse of power by those who control the company: statutory duties are imposed on directors, majority shareholders have to act *bona fide* in the interests of the company.

However, the courts will not interfere in the management of the company.

The company as the proper claimant

The rule in *Foss v Harbottle* [1843] 2 Hare 461 states that in order to redress (make right) a wrong done to a company or to its property, or to enforce rights belonging to the company, the company itself is the proper claimant. The court will not ordinarily allow an action to be brought on behalf of the company by its shareholders.

In *Foss v Harbottle* the claimants were two shareholders in a company called 'The Victoria Park Company' which was formed to buy land for use as a pleasure park. The defendants were directors of the company and its other shareholders. The claimants alleged that the defendants had defrauded the company in a number of ways, including by selling certain lands they owned to the company at a hugely inflated price. The claimants asked the court to order the defendants to make good the losses to the company. The court held that the action could not proceed as the individual shareholders were not the proper plaintiffs. If a wrong had been committed, it had been committed against the company and the company was therefore the proper plaintiff.

The court will therefore not ordinarily intervene in a matter which it is competent for the company to settle itself or, in the case of an irregularity, to ratify or condone by its own internal procedure. Where it is alleged that a wrong has been done to a company, *prima facie* the only proper claimant is the company itself.

This policy manifested itself in three principles in *Burland v Earle* [1902] 83 AC:

- If the wrong is done to the company (as a person rather than its members), only the company can claim redress.
- The court will not interfere in the internal management of the company.
- A member cannot sue to rectify a mere irregularity if the act when done regularly would be within the powers of the company.

The proper claimant rule applies not only to companies but also to other business entities such as trade unions and partnerships.

There has been some discussion as to the true nature of the exceptions to the rule in *Foss v Harbottle*, the rule is discussed in Sealy and Worthington at pages 524 -530.

In *Edwards v Halliwell* a trade union had rules (equivalent to articles of association) under which any increase in members' contributions had to be agreed by a two-thirds majority in a ballot of members. A meeting decided by a simple majority vote of people present to increase the subscription without a ballot of the membership. The claimants, a minority of the members, applied for a declaration that the resolution was invalid. The court held that the [Law]<u>rule in *Foss v Harbottle*</u> did not prevent a minority of a company or an association of persons from suing because the matter about which they were suing was one which could only be done or validly sanctioned by a greater than simple majority.

Jenkins LJ said that cases falling within the exceptions rule fall into the following categories:

- acts which are ultra vires or illegal
- where a special majority is needed
- breach of personal rights
- fraud on the minority.

Acts which are ultra vires or illegal

No simple majority of members can confirm or ratify an illegal act. The minority shareholders can bring an action to force the directors to comply with the law, for example as regards loans, quasi-loans and credit given by a company to directors and their connected companies.

A company could not originally ratify ultra vires acts so such acts remained beyond the capacity of the company. However, it is still possible for shareholders to restrain the company from acting ultra vires and the exception may have some significance (s.40(4) Companies Act 2006). Also, s.239 Companies Act 2006 allows ratification of a director's conduct even though that conduct amounts to 'negligence, default, breach of duty or breach of trust in relation to the company.' But note that s.239(7) provides that s.239 does not impose any limitations or requirements relating to ratification of director's conduct imposed by other provisions of the legislation – in other words, it does not interfere with the statutory derivative action under s.260 Companies Act 2006 (which we will discuss).

Where a special majority is needed

The rule in *Foss v Harbottle* does not prevent an individual member from suing if the act complained of is one which could have been sanctioned only by a special majority. In *Edwards v Halliwell* a trade union sought to increase its subscriptions in breach of the union rule book which required the consent of the union members. The court allowed the action. The same rule will apply to a company.

Breach of personal rights

If a company denies a shareholder rights that are set out in the company's constitution, the shareholder can bring an action on behalf of himself and all other shareholders denied the right to enforce the rights that have been infringed: *Wood v Odessa Waterworks* (1889) LR 42 Ch D 636. Where personal rights have been infringed a shareholder may bring an action under s.33 Companies Act 2006.

Fraud on the minority

The common law allowed a derivative action (a right of action which derives from the wrong done to the company) to be brought by shareholders on behalf of their company where those responsible for the wrong were in control of the company and thereby prevented it from claiming relief.

However, there was considerable discussion on the meaning of ‘fraud on the minority’ and ‘wrongdoer control’. Examples of fraud on the minority involved misappropriation of the company’s property: *Cook v Deeks* [1916] 1 AC 554 and *Menier v Hooper’s Telegraph Works Ltd* [1874] 9 Ch App 350; where minority shareholders were defrauded; and the expulsion of a minority shareholder: *Brown v British Abrasive Wheel Co* [1919] 1 Ch 290.

Therefore, for example, in *Cook v Deeks* [1916] 1AC 554 a shareholder was able to bring an action under this heading because directors (those who had perpetrated the fraud) had diverted corporate opportunities to themselves.

In *Prudential Assurance Co Ltd v Newman Industries Ltd (No. 2)* [1982] 1 All ER 254 the issue before the court was whether those responsible for the wrong were in ‘control’ of the company. The Court of Appeal permitted the action where the board of the company was shown to be under the control of fraudsters.

Statutory derivative actions – s.260 Companies Act 2006

Because of the difficulties caused by the common law remedy, s.260 Companies Act 2006 replaces the common law derivative action based on fraud on the minority. Instead, a statutory derivative action is permitted arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of a company.

The scope of the s.260 remedy is much wider than the common law derivative action which was based on fraud. Although a wide interpretation was given to the concept of fraud:

Estmanco (Kilner House) Ltd v Greater London Council [1982] 1 WLR 2, where it was held that fraud included an abuse or misuse of power, and *Prudential Assurance v Newman Industries Ltd (No 2)* [1982] 1 All ER 254, where the Companies Act said that the fraud exception applies not merely where there is an allegation that directors who control the company have improperly appropriated to themselves money, property or advantages which belong to the company or work in breach of their duty to the company, or have diverted business to themselves which ought to have gone to the company, but also where they, though acting in the belief they have done nothing wrong, are guilty of a breach of duty to the company.

The new action can be brought on the basis of an actual or proposed act or omission by a director involving negligence, default, breach of duty or breach of trust (s.260(3)).

Although s.260 may not cover all wrongs that a director could conceivably commit against the company, it does cover breaches of duty, including the new codified directors’ duties.

In s.260 the term ‘director’ includes both former directors and shadow directors for the purposes of imposing liability. Breach of duty under the section would probably also include other duties imposed on directors by statute and any common law duties not within the scope of the statute.

The range of the statutory remedies is wider than the pre-existing common law derivative procedure. Section 260(2)(a) reflects the fundamental principle that a member ought to be permitted to pursue a derivative claim because this is for the benefit of the company, not because it is for the benefit of the member personally.

The requirement that the action must be for the benefit of the company does not mean that the court has to consider whether a hypothetical director would think the claim worth pursuing; rather, the court merely has to refuse permission if it considers, on a balance of probabilities that such a director would not seek to continue the claim.

A member of a company who brings a derivative claim must apply to the court for permission to continue with the claim (s.261).

At first sight at least, the Companies Act 2006 appears to have radically changed the law in favour of the minority shareholder. He now has a right to sue on behalf of the company. He is not required to prove fraud on the minority. He has a right to at least initiate a derivative action under s.260 and it is then for the court to decide whether or not it should proceed. To that extent, there appears to have been a shift in the control of the decision to litigate against the director from a shareholder to the court.

Section 261(4) provides that the court has discretion:

- to grant permission;
- to refuse permission and dismiss the claim; or
- to adjourn the proceedings and give such directions as it thinks fit.

Section 262 describes a variation to the main s.260 claim and allows a member, on application to the court, to take over an action brought by a company. If it appears to the court that there is a prima facie case for granting permission for the continuation of the derivative claim then the court should not dismiss the action. So the action will lie where a company has brought a claim against a wrongdoing director and a shareholder seeks to take over the action as a derivative action because:

- the manner in which the company commenced or continued the claim may amount to an abuse of the court (e.g. the company brought the claim with a view to preventing a member from bringing a derivative claim)
- the company may fail to prosecute the claim diligently
- it may be appropriate for a member to continue the claim as a derivative claim.

Matters which will be considered in determining whether permission is to be given (or not) to pursue an action under ss.260 and 262 are set out in s.263.

Permission must be refused if the court is satisfied (s.263(2)):

- that a person acting in accordance with s.172 (duty to promote the success of the company) would not seek to continue the claim (s.263(2)(a))
- where the cause of action arises from an act or omission that has yet to occur, that the act or omission has been authorised by the company (s.263(2)(b))
- where the cause of action arises from an act or omission that has already occurred, that the act or omission (s.263(2)):
- was authorised by the company before it occurred; or
- has been ratified by the company since it has occurred.

In considering whether to give permission the court must take into account, in particular, the following (s.263(3)):

- whether the member is acting in good faith in seeking to continue the claim
- the importance that a person acting in accordance with s.172 (duty to promote the success of the company) would attach to continuing
- where the cause of action results from an act or omission that has yet to occur, whether the act or omission could be, and in the circumstances was likely to be:
- authorised by the company before it occurs
- ratified by the company after it occurs
- where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be, likely to be ratified by the company
- whether the company has decided not to pursue the claim
- whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.

In considering whether to give permission, the court will have regard to evidence before it as to the views of members of the company who have no personal interest, whether direct or indirect, in the matter.

Section 264 describes another variation and the third type of derivative claim, where the court already having decided to allow a shareholder to bring a derivative claim allows another to take over that claim because:

- the manner in which the member commenced or continued the claim may amount to an abuse of the court (e.g. the member brought the claim with a view to preventing another member from pursuing the claim)
- the member may fail to prosecute the claim diligently
- it may be appropriate for another member to continue the claim (e.g. because of illness on the part of the member who initiated the claim).

The consequences of the new statutory derivative action are difficult to predict. Much will depend on the willingness of the courts to intervene in the company's decision-making process.

The new provisions strengthen legal measures to counteract the wrongdoing of directors where necessary. However, it must be noted that there has been a shift in emphasis in the control of the company's decision to litigate against the director in breach of a management duty. Before the Companies Act 2006, the majority shareholders controlled that decision, with the court only later being called on to see if that decision truly lacked independence because there was 'wrongdoer control' of the shareholders' decision. Under the Companies Act 2006, the court controls that decision in the sense that a minority shareholder has a right at least to initiate a derivative action and it will then be for the court to decide whether or not the claim should be continued.

Critically, however, s.263 makes clear that in deciding whether to allow a derivative claim to proceed, the court will defer to any decision of the majority to ratify the breach, particularly because under s.239 such a decision has to be independent. In such a case the court must refuse permission for the claim to proceed.

There has been debate about the power of the majority to ratify a breach. Vinelott J said in *Prudential Assurance Co Ltd v Newman Industries Ltd (No. 2)* [1981] Ch 257 at p.309:

[T]here is no obvious limit to the power of the majority to authorise or ratify an act or transaction whatever its character provided that the majority does not have an interest which conflicts with the company.

Section 239 now requires ratification of any conduct by a director of a company which amounts to negligence, default, breach of duty or breach of trust in relation to the company to be by the votes of disinterested members.

Unfairly prejudicial conduct

Company Law

Sections 994–99 Companies Act 2006 give the courts wide-ranging powers to remedy conduct of a company's affairs 'that is unfairly prejudicial to the interests of its members or of some part of its members'. Previously such powers were given by s.459 Companies Act 1985.

The most common complaint is that a controlling majority of members have unfairly prejudiced the minority, and the remedy sought usually is an order that the majority must purchase the shares of the minority at a price which reflects their proportion of the company's value.

The scope of s.994

The leading authority on the scope of the jurisdiction under s.994 is *O'Neill v Phillips* [1999] 2 BCLC 1, a case decided under the predecessor to s.994 (s.459 Companies Act 1985) in which the House of Lords took the opportunity to reject the reliance on 'legitimate expectations' which had become a predominant element of the case law under s.459. Petitions were being brought on the basis that a petitioner was aggrieved that what he perceived to be his legitimate expectations as to the conduct of the company's affairs had not been met.

In 1985, Phillips, who held all the shares in the company, gave a 25 per cent shareholding to O'Neill, foreman and employee, and appointed him director on the understanding that he hoped that O'Neill would eventually take over the day-to-day management of the company and that, on that basis, O'Neill would be allowed to draw 50 per cent of the profits from the business. This having occurred, Phillips eventually retired from the business. The business prospered over the next five years, during which there were discussions about increasing O'Neill's shareholding to 50 per cent. However, the construction industry went into recession and Phillips took back control of the company, reduced O'Neill's status to that of a branch manager and withdrew his share of the profits. O'Neill took steps to leave the company and also took out a s.459 petition.

Lord Hoffmann held, with the support of the Lords, that there was no basis for a court to hold that Phillips had acted unfairly. The Judge emphasised that the term 'legitimate expectation' refers to an expectation that the company's affairs will be conducted in the manner agreed by all the members, not a personal hope of the petitioner that other members will so something which they have not in fact agreed to do.

The result recognised that it was not sufficient to found a petition under s.459 simply to plead a denial of a 'legitimate expectation'. Lord Hoffmann concluded that a member will not ordinarily be entitled to complain of unfairness unless there has been:

- some breach of the terms on which he agreed that the affairs of the company should be conducted

- some use of the rules in a manner which equity would regard as contrary to good faith – in other words, equitable considerations would make it unfair for those conducting the affairs of the company to rely on their strict legal powers.

Therefore, a s.459 petition can be brought where there has been some breach of the terms on which it was agreed that the affairs of the company should be conducted, for example an abuse by directors of their powers or an infringement of the member's rights under the constitution or company's legislation.

In *Re Saul B. Harrison & Sons Plc* [1995] 1 BCLC 14, where the Court of Appeal held that there were no grounds for saying that it would be unfair for the board to act in accordance with the company's articles. The minority shareholders' expectations amounted to no more than that the board would run the company in compliance with their fiduciary obligations.

Situations where s.994 Companies Act 2006 (previously s.459 Companies Act 1985) may still give a remedy include:

- misappropriation and diversion of assets
- improper allotment
- mismanagement
- infringement of statutory rights
- use of the rules in an inequitable manner
- removal from office
- non-payment of dividends
- destruction of the basis of the relationship
- alteration of the articles.

Misappropriation and diversion of assets

Many of the disputes under s.459 arose when majority and minority shareholders fell out and the majority decided to transfer their activities to another entity wholly owned by them. The majority shareholder might then be tempted to conduct the affairs of the first company in an unfairly prejudicial manner by appropriating to their new company opportunities and contracts which properly belonged to the first company. The effect of the misappropriation would be to reduce the value of the petitioner's holding in the original company.

For example, in *Re Little Olympian Each-Ways Ltd (No. 3)* [1995] 1 BCLC 636 the company's assets had been sold at an undervaluation by those in de facto control of another company which was also controlled by them. It was held that an order could be made against the second company requiring it to buy out the petitioner's shares at a price which reflected their value before the wrongful sale.

However, in *Re Macro (Ipswich) Ltd* (1994) the court considered the mismanagement so serious that it granted a remedy to the petitioning shareholder.

Improper allotment

It is common for the directors to make an allotment of shares in order to dilute the petitioner's interest in the company. See Re A Company (No. 005134 of 1986), ex-p Harries [1987] BCLC 82.

Mismanagement

The courts are reluctant to accept that disagreements over managerial decisions can amount to unfairly prejudicial conduct, but if mismanagement causes actual financial loss to the company, the petitioner is more likely to succeed. See Re Macro (Ipswich) Ltd [1994] 2 BCLC 354 and also Re Elgindata Ltd [1991] BCLC 959. In Re Elgindata Ltd the court refused to intervene in relation to allegedly poor managerial decisions, accepting that there was a commercial risk of bad management. However, if the mismanagement extends to exclusion from office there may be grounds for petition for winding up order. The court in Re Blue Arrow Plc (1987) 3 BCC 618 expressed the view that there could be special circumstances where exclusion from management could be the basis of a petition. There must, however, be some membership nexus: Re JE Cade & Sons [1991] BCC 360, where the petition failed because the petitioning member was trying to protect his interests as a landowner rather than a shareholder.

Infringement of statutory rights

A breach of the member's statutory rights, for example repeated failure to hold annual general meetings, is conduct unfairly prejudicial to their interests.

In *Re A Company (No. 00789 of 1987) ex parte Shooter* [1990] BCLC 384 the controlling shareholder was held to be unfit to continue to manage the business and, while the majority shareholder will normally be required to buy out the minority shareholding, the court in Shooter in fact allowed the minority shareholder to buy out the majority.

Use of the rules in an inequitable manner

The House of Lords in O'Neill v Phillips identified s.459 as grounds for appeal where there has been some use of the rules in a manner which equity would regard as contrary to good faith. The approach is to start by establishing whether equitable considerations have arisen to affect the exercise of legal powers. The type of company which will give rise to equitable constraints on the exercise of legal powers is the type identified by Lord Wilberforce in Ebrahimi v Westbourne Galleries Ltd [1973] AC 360 – an association formed or continued on the basis of a personal relationship involving mutual confidence. Such companies are commonly described as quasi-partnerships and equity will hold the majority shareholders to the agreement, promise or understanding which forms the basis of the relationship.

Removal from office

Two elements which must be present before removal from office will be treated as unfairly prejudicial conduct meriting relief under s.459:

• The parties must have come together on a quasi-partnership basis, including an agreement or understanding as to who shall participate as a director.

• The petitioner, having joined the venture on that basis, must have been removed from office without a fair offer for his shares: *Re Saul D Harrison* [1995] 1 BCLC 14. If there has been a fair offer to purchase the shares the petition will be struck out: *O'Neill v Phillips* [1999] 2 BCLC 1.

Non-payment of dividends

The courts may consider it unfairly prejudicial for no dividends to be paid to the minority shareholder even though the company is profitable while the majority shareholders are benefiting financially by having significant remuneration packages as directors: *Re Sam Weller & Sons Ltd* [1990] BCLC 80.

Destruction of the basis of the relationship

Lord Hoffmann in *O'Neill v Phillips* concluded that relief would be available under s.459 where some event has occurred which puts an end to the basis on which the parties entered into association with each other, so making it unfair that one shareholder should insist on the continuation of the association. Although a remedy would be available under s.122 (1)(g) of the Insolvency Act 1986, Lord Hoffmann expressed the view that a remedy is equally available under s.459 Companies Act 1985 (now s.994 Companies Act 2006). Doubt is therefore cast on when it would be appropriate now to seek a winding-up order.

Alteration of the articles

The passing of a special resolution to alter the company's articles of association may be unfairly prejudicial conduct, for example if the alteration will affect an understanding between the parties that the petitioner would control the management of the company, and even a proposal that such a resolution be passed may amount to unfairly prejudicial conduct.

It is clear from *O'Neill v Phillips* that an important initial step under s.459 is to consider whether the company is one which is merely a commercial association or whether the relationship within it means that it has the characteristics of a quasi-partnership (see *Ebrahimi*). If the company is purely a commercial relationship, the petitioner will be confined to allegations of breaches of the articles, the statute or director's duties. If the company has the characteristics of a quasi-partnership, the petitioner may restrain conduct which is legal but which equity would regard as unfair. In considering the nature of the company it must be remembered that the relationship between the parties may change over time. A company may start out on a purely commercial footing but become one in which equitable considerations come into play (*O'Neill v Phillips*), or vice versa.

However, in the case of a public company the position will generally be determined by the memorandum and articles of association, and where the company is a limited public company there is no scope for equitable considerations to arise: *Re Astec (BSR) Plc* [1998] 2 BCLC 556.

Winding up on the just and equitable ground

Because of the difficulties of bringing a derivative action at common law, and perhaps even under ss.260–63 Companies Act 2006, shareholders may prefer to proceed on the basis of a petition to wind up the company on the grounds that to do so 'is just and equitable' under s.122(1)(g) of the Insolvency Act 1986.

Section 124 of the Insolvency Act 1986 allows an application to be made for winding-up by any contributory, that is, any person liable to contribute to the assets of a company in the event of it being wound up (e.g. a partly paid-up shareholder). Further, any member who can show he has a tangible interest in the winding-up (notwithstanding that his particular shareholding is small) can file for a s.122 (g) petition.

In *Bryanston Finance Ltd v De Vries (No 2)* [1976] 1 All ER 25 the defendant objected to S's management of the company and its subsidiary. At the company's annual general meeting he asked various relevant questions and received an unsatisfactory response. He then repeated the questions by letter, to which he received no response despite stating that he would apply for a winding-up petition under s.122(1)(g) if the company failed to respond. The company in fact applied for an injunction to restrain him from applying for a winding-up order. The court concluded that the size of the petitioner's shareholding was irrelevant if the petitioner had valid grounds for petitioning. The company was only entitled to restrain the proceedings if filing a petition to wind up the company would prima facie be an abuse of process. The court would not restrain the filing of what was otherwise a legitimate petition.

Section 125 of the Insolvency Act 1986 provides that the court can grant an order winding up the company notwithstanding that there is some alternative remedy, and the petitioner is not being unreasonable in pursuing the other remedy.

The categories of conduct that would render winding up just and equitable are not closed, but the following are clearly recognised grounds for petitioning the courts:

- quasi-partnership
- lack of probity
- lack of substratum.

Quasi-partnership

An important ground for winding up the company is where the court decides that the company is really a quasi-partnership. Therefore, for example, it may be that shares are held by a small number of shareholders, all of whom participate in the management of the company, and that the personal relationship between the parties has broken down.

In *Re Yenindje Tobacco Co Ltd* [1916] 2 Ch 426 the company's two shareholders both participated in the management of the company but on the breakdown of their relationship only communicated with each other through a third party. The court held that the company was in essence a partnership and, that relationship having deteriorated to such an extent that there was a total breakdown of communication, the court would grant a winding-up petition.

Lack of probity

In *Loch v John Blackwood Ltd* [1924] AC 788 the directors of the company failed to hold general meetings or submit accounts or recommend dividends over a number of years, despite the company having been very successful. The majority shareholder treated the business as his own and ran it with a view to forcing out the minority. The court granted an order to wind up the company. For the court to grant a petition there must be a lack of confidence in the conduct and management of the company's affairs.

However, that lack of confidence must be grounded on the conduct of the directors with regard to the company's affairs.

Lack of substratum

If the company's main objects become impossible or illegal the company could be wound up on the grounds that it is just and equitable. This category is not likely to be applied as a result of changes in the companies' legislation in relation to a company's objects.

Modern cases on just and equitable jurisdiction

A number of modern cases have looked at the application of s.122(g). *Ebrahimi v Westbourne Galleries Ltd* held that although directors act within the authority conferred on them by the articles of association, their conduct may still be subject to the just and equitable test. In *Ebrahimi* E and N managed their carpet-selling partnership. They decided to form a registered company, with each of them holding 500 shares in the new company and acting as a director. Eventually, it was decided that N's son (A) should join the business and E and N each transferred 100 shares to A, who also became a director of the company. Relations between the three directors deteriorated and N and A eventually decided to remove E from the board of directors and to exclude him from the day-to-day management of the company. The House of Lords held that although N and A had acted within their rights in removing E as a director of the company, the exercise of that right was subject to the just and equitable jurisdiction of the court. Further, that exercise of power was not limited to cases of bad faith. Moreover, a petitioning member was not required to show that the conduct complained of affected him in his capacity as a member of the company; rather, he was entitled to rely on any circumstances of justice or equity which affected him in his relationship with the company or other shareholders.

Lord Wilberforce held that for the court to make a winding-up petition on the grounds that it was just and equitable where the parties have acted in accordance with the articles of association, one or more of the following have to be present:

• The company is an association formed or continued on the basis of a personal relationship involving mutual confidence.

• There is an agreement that all or some of the shareholders will participate in management of the business.

• There are restrictions on the transfer of members' interests in the company.

The *Ebrahimi* case has been applied subsequently.

In *Re Zinatty Properties Ltd* [1984] 3 All ER 754, A and B, who had previously carried on business together, formed a company to develop a particular property. The shares of the company were held by the petitioner (a company controlled by A) and B, and C who had joined the business and to whom both A and B had allotted part of their shares. On completion of the development, the company was left with money which was to be divided between the participants, but B and C instead used the money to acquire further properties. The petitioner filed a petition to have the company wound up.

The court held that the company had been established on the basis of trust and confidence between A and B even though they conducted their affairs through companies. That trust and confidence had broken down so it was just and equitable to wind up the company.

In *Re A & BC Chewing Gum Ltd* [1975] 1 All ER 1017 the minority shareholder was entitled under the articles and by virtue of a separate shareholders' agreement to appoint one director to the board, but the majority shareholder refused to give effect to the appointment. The court, relying on Ebrahimi, held that the company should be wound up since the majority shareholders had repudiated the minority's right to participate in the management of the company – a right which formed the basis of their participation in the company.

Corporate Insolvency

We have reached the end of this course, appropriately enough we will now look at the end of the life cycle of a business and how a business is wound up. We will study corporate insolvency with regard to Companies and the other forms of Business Organisation that we studied Partnerships.

Chapter 14 of Sealy and Worthington deals with this area of law.

Only as a last resort and after attempts to obtain payment through other methods have failed will the creditor rely on his right to realise any security. The law sets out the rules relating to the termination of various types of business associations. We will outline the methods of company liquidation and the termination of Partnerships.

The main source of Corporate Insolvency law is the InsolvencyAct 1986 that we have already come across. The rules and procedures relating to the termination of various types of business organisation are complex; let's look at some key terms:

- Dissolution is the moment at which the company ceases to exist.
- Liquidation is the process of collecting the assets of a company and paying its debts.
- A voluntary arrangement is a scheme for making arrangements with creditors which will be binding on all of them (even if some disagree). Where a company can get a plan approved to repay debts, it will prevent the immediate liquidation of the company.
- In administrative receivership, an administrator is appointed to manage the company's affairs, business and property for the benefit of the creditors. The administrator is an insolvency practitioner with the status of an officer of the court.
- With the commencement of winding-up, the directors cease to control the company's affairs and the liquidator manages the company with a view to collecting its assets.
- Voluntary winding-up is when the members of a company resolve to wind it up.

Let us look at the people involved, the insolvency practitioners. Only an authorised insolvency practitioner may act as a liquidator (or as a receiver, administrator, supervisor of a voluntary arrangement, etc.). He must be an individual; companies and partnerships cannot act as insolvency practitioners. If he is an undischarged bankrupt he may not act in this capacity except by leave of the court (Insolvency Act 1986, s.390). To obtain authorisation the applicant must satisfy either a professional body to which the Department of Business, Enterprise and Regulatory Reform (BERR) has delegated its powers of authorisation in respect of its own members or a competent authority (tribunal) appointed by BERR that he is: a fit and proper person; and satisfies prescribed requirements in respect of education, practical training and experience.

First of all, a company may enter a voluntary arrangement. The Insolvency Act 1986 (ss.1–7) introduced the voluntary arrangement scheme. The scheme allows a three-quarters majority of the company's unsecured creditors voting at a meeting of the creditors to impose on all unsecured creditors a scheme of arrangement or composition of arrangement that has been proposed by the company's directors. Voluntary arrangement is an insolvency procedure and is usually invoked in relation to insolvent companies, not solvent companies. A proposal for a voluntary arrangement must be reported to the court but does not require the court's approval.

Where the company is a going concern the proposal will be made by the company's directors acting collectively (IA 1986, s.1(1)). In such circumstances the directors retain their powers of management and the company benefits from a general moratorium under which creditors are prevented from enforcing their debts.

The scheme is prepared under the supervision of a qualified insolvency practitioner known as 'the nominee'. If the person nominated to act as nominee is already the liquidator or administrator of the company, he can submit the proposals to the creditors as part of the normal liquidation or administration process. If the nominee is not the liquidator or administrator of the company, he must submit a report to the court stating whether or not, in his opinion, the scheme is viable, and whether a meeting of the creditors should be called.

The purpose of the creditors' meeting is to decide whether or not to approve the proposal. The creditors have considerable discretion in dealing with proposals before them; they are not restricted to simply approving or rejecting the scheme as presented, but may modify the arrangements provided that the fundamental characteristics of the scheme remain unaltered and that the debtor company agrees (IA 1986, s.4(1)). The outcome of each meeting must be reported to the court. Once the proposals have been approved at the creditors' meeting, they become binding on every person who had notice and who was entitled to vote at the meeting, whether or not they actually attended.

The voluntary arrangement involves the minimal degree of court involvement, and formal approval of the scheme by the court is unnecessary. If, however, the scheme is challenged within 28 days of the court receiving the chairman's report of the creditors' meeting, it will be subject to full scrutiny. A creditor of the company, or its liquidator or administrator, or any insolvency practitioner, may challenge the scheme on the grounds that it unfairly prejudices the interests of the creditors, member or contributory, of the company, or that there was some material irregularity at or in relation to the meeting (s.6).

If a proposed scheme is approved or is not subject to challenge, the nominee then becomes the supervisor of the composition or scheme and assumes full responsibility for its implementation.

The legislation now treats small companies differently. One of the difficulties for a company in preparing a proposal for a voluntary arrangement is that when the proposal is circulated to creditors before their meeting, any creditor may take individual action to defeat the proposal, for example by appointing a receiver, repossessing hire- purchase goods or presenting a winding-up petition. This can be prevented where the company goes into administration, although that process in itself may prove expensive. To solve this problem the Insolvency Act enables an 'eligible company' (a small company) to obtain a moratorium on creditor action while a proposal for a voluntary action is considered without having to go into administration. A moratorium cannot be obtained until there is a viable proposal for an arrangement and a nominee has agreed to act.

The principle condition for being eligible for a moratorium is that in the year ending with date of filing, or in the company's financial year which ended last before that date, the company has satisfied two or more of the requirements for being a small company (turnover does not exceed £11.2m; its balance sheet total (total assets) does not exceed £1.4m; or its weekly average number of employees during the financial year does not exceed 50).

Administration orders

'Administration orders' were introduced by the Insolvency Act 1986, and the Enterprise Act 2002, s.248, has introduced improvements. The administration procedure requires greater judicial involvement and affords protection to the company's assets during the period of administration. The function of the administrator is to devise and implement a satisfactory rescue plan. An administrator may be appointed:

- by the court making an administration order, on the application of the company itself, its directors, one or more creditors, the supervisor of a voluntary arrangement, or a justices' chief executive following non- payment of a fine imposed on a company
- by the holder of a floating charge over the whole or substantially the whole of the company's property (A form of security over the assets of the company which allows the company To use and trade those Assets in the course of its business, with the security transferring to newly acquired assets in that category as items change hands)
- by the company itself or its directors.

An appointment by the court or the company or its directors cannot be made unless the company is, or is likely to become, unable to pay its debts, and an appointment by the floating charge holder cannot be made unless the floating charge is enforceable (i.e. the company is unable to pay the debt secured by the charge).

Either the company or its directors may appoint an administrator (IA 1986), but no such appointment can be made if any insolvency or liquidation procedure is already in progress or steps for a winding-up order to be made are in progress.

A qualified insolvency practitioner willing to act as an administrator must be found and his name given to the holders of floating charges entitled to appoint an administrative receiver or administrator. If the notice period of five business days has lapsed and no floating charge holder has appointed an administrative holder or applied to the court for a winding-up order then the directors may appoint the person named as administrator. A notice of appointment must be filed with the court.

The administrator's initial task will be to prepare proposals to achieve the purpose of administration. A statement of proposals must be sent to the Registrar and to creditors and members of the company within eight weeks of the company entering administration, although that time limit may be extended, on an application to the court.

A creditors' meeting may be required to approve the administrator's proposals, although such a meeting is not required if the administrator advises that the company can pay all creditors in full, or that it cannot pay unsecured creditors anything other than their statutory share of assets covered by a floating charge. The administrator must then report the meeting's decision to the court and the Registrar of Companies.

If creditors approve the proposals, the administrator must manage the company's affairs and property in accordance with the proposals.

An administrator must perform his functions with the objective of (IA 1986, Schedule 1B, para. 3(1)):

1. Rescuing the company as a going concern;

2. Achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration); or

3. Realising property in order to make a distribution to one or more secured or preferential creditors.

The first objective must be given priority unless the administrator believes it is not reasonably practicable or that objective 2 would achieve a better result for the company's creditors as a whole. Objective 3 should only be pursued if the liquidator believes that the other two objectives cannot be achieved or are likely to harm the interests of the creditors.

Once an administration order is made the administrator must send to the company and publish in the prescribed manner a notice of the order. He must notify the Companies Registry within 14 days and the company's creditors within 28 days of the making of the order.

The company's business correspondence, including invoices and orders issued during the period of administration, must indicate that an administration order has been made against the company.

On appointment, the administrator must take control of the company's assets. If the administrator is to carry out his functions and devise a rescue plan there must be an exchange of information between him and the company directors, who must prepare a statement of the company's affairs. The statement of affairs must be verified by affidavit and should include details of the company's assets, debts and liabilities, details of the creditors and the nature of securities held by them, together with any other necessary information.

The administrator has considerable powers to do such acts and enter into such transactions as are necessary for the management of the company's affairs and business and the achievement of the purpose for which the administration order was made. However, an administrator has specific powers to:

- carry on the business of the company
- raise or borrow money and grant security over the company's property
- refer disputes to arbitration
- appoint a solicitor, accountant or other professionally qualified person to assist them in the performance of their functions
- present or defend a petition for the winding-up of the company
- employ and dismiss employees
- do all things incidental to the exercise of these and other specific powers conferred on them.

Additionally, the administrator has authority to remove and appoint directors, and unless the administrator consents neither the company nor its officers can exercise any power so as to interfere with the administrator's functions. In exercising their powers, the administrator is deemed to be acting as the company's agent, and a person dealing with them in good faith and for value is protected if the administrator exceeds their authority.

An administrator may be personally liable on any contracts made by them and any contracts of employment adopted by them. On vacating their office an administrator will normally be released from all liability for any acts or omissions unless they have misapplied company assets or acted in breach of duty.

Administration automatically ends after one year, unless the administrator's term is extended by consent of the creditors or by court order. There can only be one extension by consent for a period of no longer than six months. The court can give any number of extensions it thinks fit.

An administrator may terminate the administration, by application to the court if he was appointed by the court, if he thinks that its purpose has been sufficiently achieved, or by notice to the court and the Registrar.

Administrative receivers

Administrative receiverships arise because the security contract made between a company and one or more of its creditors under the company agree to confer a certain type of contractual advantage on that creditor over the others.

An administrative receiver is a receiver or manager of the whole (or substantially the whole) of a company's property appointed by or on behalf of the holders of any debentures of the company secured by a charge which was created as a floating charge, or a person who would be such a receiver or manager but for the appointment of some other person as the receiver of part of the company's property (IA 1986, s.29(2)).

A receiver is, therefore, a person appointed to take control of certain property. From the time of appointment an administrative receiver of a company has sole authority to deal with the charged property. The directors of the company no longer have any authority to deal with the charged property, although they continue in office and are still liable, for example, to submit returns and documents to the registrar: *Newhart Developments Ltd v Co- operative Commercial Bank Ltd* [1978] QB 814. The administrative receiver of a company is deemed to be an agent of the company unless and until the company goes into liquidation.

Liquidation or dissolution of companies

A company as an artificial person comes into existence when the Registrar enters its name on the register of companies and issues a certificate of incorporation. Its existence ends three months after the Registrar removes its name from the register of active companies (IA 1986, s.205). This is called dissolution. Before a company can be dissolved it must usually be wound up or liquidated. Liquidation entails collecting the company's assets and converting them into money, using the money to pay its debts and, if anything then remains, distributing the surplus to the members in accordance with their entitlement.

The first step is therefore to put the company into liquidation and appoint a liquidator or joint liquidators. When the liquidation is completed the liquidator gives notice of it to the Registrar.

There are three types of liquidation.

- Compulsory liquidation by order of the court. The High Court, or, if the company's paid up share capital does not exceed £120,000, the local County Court has jurisdiction to order that the company shall be wound up by the court.
- Voluntary liquidation which may be either:
- Members' voluntary liquidation or

- Creditors' voluntary liquidation.

Compulsory liquidation

The majority of company liquidations are voluntary, and so initiated by a resolution passed in general meeting. However, compulsory liquidation is the remedy of last resort for the creditor or member if a company refuses to satisfy its legitimate demands or is simply unresponsive, usually because the directors have abandoned it. However, in every case a petition to the court for compulsory liquidation must state, and be supported by evidence of, certain specified grounds upon which the court at its discretion may order compulsory liquidation.

Grounds for a winding-up order

The circumstances in which a company may be wound up by the court are specified in s.122(1) IA 1986:

- The company has so resolved by special resolution.
- Default is made in delivering the statutory declaration of capital, etc., in order to obtain the Registrar's certificate that a public company may commence business.
- The company does not commence its business within a year of its incorporation or suspends its business for a whole year.
- The number of members is reduced below the statutory minimum (two for private and public companies).
- The company is unable to pay its debts.
- The court is of the opinion that it is just and equitable that the company be wound up.

Company's inability to pay debts

A company is deemed to be unable to pay its debts if it defaults for three weeks or more in meeting a demand for a debt exceeding £750 (or such other limit as the Secretary of State may fix under the IA 1986), or if it fails to satisfy a judgment debt, or the court is satisfied that it is unable to pay its debts (in which case it can take account of the company's contingent and prospective liabilities). The demands of two or more creditors may be aggregated.

Who may petition?

Most petitions are presented either by one or more creditors on the ground that the company is unable to pay its debts in excess of £750, or by one or more contributories on the basis that deadlock or oppressive conduct in the management or other grounds make it just and equitable to wind up the company. However, the full list of those who may present a petition is longer. Therefore, the petition may be presented by:

- The company.
- Any creditor or creditors who establish a prima facie case.
- Generally the court ought not to deprive a petitioning creditor of his prima facie right to a winding-up order unless his petition is opposed by creditors holding a majority by value of the debt.
- The court can and will restrain a petition which is an abuse of process. In *Re A Company (No. 001573 of 1983)* (1983) The Times 12 May, it was held an abuse to petition for winding-up on the same day that an order for costs was made against the company and the petitioner doubted its ability to pay. If a debt is genuinely disputed, the court may restrain a winding-up petition.
- A contributory or contributories, when the number of members has fallen below the statutory minimum or if the contributory is an original allottee or has held shares for six months in the 18 months preceding the winding-up or received them through devolution from a former member.
- The DTI (Department of Trade and Industry) after an investigation (IA 1986, ss.440 and s.124(4)) and on certain other grounds. The court may use a report of the inspectors as prima facie grounds for ordering a winding-up: *Re Armvent Ltd* [1975] 3 All ER 441.
- The Official Receiver, where a voluntary winding-up cannot be continued with due regard to the interests of creditors or contributories. The power of the Secretary of State is not so limited:

Re Lubin, Rosen and Associates Ltd [1975] 1 All ER 577.

Procedure

The petitioner will present a petition supported by affidavit verifying the facts stated therein. Unless the petition is presented by the company, a copy is supplied for service on the company, which is entitled to appear and oppose the petition at the hearing. The petition is advertised in the London Gazette at least seven business days in advance of the date fixed for the hearing. This is to enable creditors of the company and other interested parties to have notice in time to be represented at the hearing if they wish.

The petition is heard in open court. On hearing the petition the court may:

- dismiss it
- adjourn the hearing

- make an interim order
- make any other order it thinks fit, or
- make an order for compulsory winding-up.

At any time after the presentation of the petition the court may appoint a provisional liquidator, usually to safeguard the assets of the company pending the outcome of the hearing of the petition. It is not normally necessary to take this precaution but may be desirable since the petition, if granted, is retrospective from the date of presentation of the petition.

The order when made leads to an investigation by the Official Receiver as provisional liquidator into the causes of the company's failure and the general record of its management. The Official Receiver, like an administrative receiver, may call for a statement of affairs from company officers. He will report to the court and he may also apply to the court for the public examination of officers in open court. Such an examination of a director of a company in compulsory liquidation may be ordered irrespective of the nationality of the director and notwithstanding that he is resident abroad.

The conduct of the liquidation

The Official Receiver is automatically appointed provisional liquidator on the making of the order. The liquidator has 12 weeks in which to decide whether to convene meetings of creditors and contributories with a view to appointing someone else. If meetings are held, each meeting may nominate a liquidator but the nominee of the creditors automatically takes office, subject to a right of objection to the court. The same meetings, or subsequent meetings, may resolve to establish a liquidation committee, including representatives of creditors and of contributories, to work with the liquidator. As the liquidation progresses, the liquidator calls meetings as necessary, and in the end he will call a final meeting of creditors and contributors.

The effect of the winding-up order

The winding-up is deemed to have begun at the time of presenting the petition (or the commencement of voluntary liquidation if that preceded compulsory liquidation), and the Official Receiver becomes provisional liquidator unless already appointed as such at an earlier stage. In addition, a standstill is imposed on the company's transactions with retrospective effect to the commencement of the winding-up as follows:

- Any disposition of property of the company is void unless sanctioned by the court.
- Any transfer of shares or alteration of status of members is similarly void.
- Any attachment or similar of assets of the company is void.
- No legal proceedings against the company may be commenced or continued except by leave of the court.

- The employees of the company are dismissed but the liquidator may by mutual agreement retain them in the service of the company.

- The management of the company and the control of its business and property are in the hands of the liquidator, who has wide statutory powers. He may also apply to the court for an order vesting assets in him.

- Charges on company property and dispositions of that property may become void.

Voluntary winding-up

A company may be voluntarily wound up when the members resolve by special resolution to wind it up. The type of resolution required varies according to the circumstances:

- If the articles fix the period of duration of the company or provide that upon the happening of an event it shall be dissolved, and the period has expired or the event has occurred, it suffices to pass an ordinary resolution referring to the articles and resolving that the company be wound up accordingly. In practice articles rarely include any such automatic winding-up provisions.

- The company may resolve to wind up by special resolution (which states no reasons). This is the normal method of winding up a solvent company.

- The company may, by extraordinary resolution, resolve that by reason of its liabilities it is unable to continue its business and that it is advisable to wind up.

Any such resolution must be advertised in the London Gazette within 14 days of the meeting. A copy of it must also be delivered to the Registrar within 14 days.

Members' voluntary winding-up

Any voluntary winding-up is a creditors' voluntary winding-up unless the directors have made and delivered to the Registrar a declaration of solvency. The company must be assumed to be insolvent unless the directors accept personal responsibility for stating that they believe the company is solvent. The directors must state that after making full inquiry they are of the opinion that the company will be able to pay its debts in full within a specified period, which may not exceed 12 months.

The creditors have no part in the liquidation because it is expected that they will be paid in full and they have no right to interfere with the company's conduct of its affairs.

If in the course of the liquidation the liquidator concludes that the company will after all be unable to pay its debts in full within the specified period, he must call a meeting of the creditors, which is advertised in the London Gazette and in two local newspapers. The creditors may, before the meeting, demand information about the company's affairs. At the meeting, the liquidator will lay before the creditors a statement of affairs. Thereafter the liquidation proceeds as a creditors' voluntary winding-up, as if the declaration of solvency had not been made.

At the end of each year of the liquidation, and within three months of the anniversary date, the liquidator is required to hold a general meeting of the company and lay before it a statement of his acts and dealings. When the liquidation has been completed the liquidator will call a final meeting, by advertisement in the London Gazette. He is required to lay before the meeting accounts of his dealings with the company's property. Within a week of the meeting the liquidator must send to the Registrar a copy of his accounts and a return that the meeting has been held (or, if there was no meeting due to lack of a quorum, a return that it was duly summoned). This leads on to the dissolution of the company.

Creditors' voluntary winding-up

A creditors' voluntary winding-up may take place when the members of a company adopt a resolution to wind up the company. There is no declaration of solvency and consequently the company is required to call a meeting of its creditors no later than the fourteenth day after it holds its own meeting to wind up. At least seven days' notice to hold the meeting must be given and this is advertised in the London Gazette. The notice must either give the name and address of an insolvency practitioner from whom creditors may obtain information in advance or it must specify a place where, in the final two business days before the meeting, any creditor may obtain a list of all the creditors. No charge is to be made for these services.

At the creditors' meeting one of the directors will preside and lay before the meeting a statement of the company's financial affairs. The members and the creditors at their respective meetings may nominate an insolvency practitioner to be appointed liquidator. If different persons are nominated, the creditors' nominee takes office, subject to a right of appeal to the court given to directors, members and creditors, to be exercised within seven days.

As there may be an interval between the meeting of members and the meeting of creditors, any liquidator appointed by the members will take office until, if ever, the creditors appoint a different person. However, a liquidator appointed by the members has no power to dispose of the company's assets, except those which are perishable, etc., and such as the court may sanction, until the meeting of creditors is held. Then if the creditors do not appoint a different liquidator, the members' nominee has the usual powers conferred on a liquidator.

The creditors may resolve at their meeting to establish a liquidation committee with up to five representatives of each of the creditors and members. The function of such a committee, if established, is to work with the liquidator, who may seek its sanction for the exercise of his statutory powers.

The effect of going into voluntary liquidation

The decision to go into liquidation is effective from the day on which the resolution is passed in general meeting. The directors remain in office but their powers cease except in so far as they may be authorised by the competent authority to continue. The company's property must be applied in payment of its debts and any surplus may then be distributed to its members. The company, through the liquidator, may carry on its business, but only for purposes of the beneficial winding-up of the company, that is, its ultimate sale or closure. No transfer of shares or alteration of members' status may be made unless the liquidator sanctions it. There is no automatic restraint on legal action against the company or its property, but the liquidator may apply to the court for an order to halt any action of that kind by a creditor.

There are penalties under the Insolvency legislation. We have looked at Fraudulent Trading (S.213 IA 1986) and Wrongful Trading (S. 214 IA 1986).

Companies House provides practical guidance on liquidation and Insolvency. Their guide provides a basic overview of insolvency and liquidation proceedings and more detailed information about the documents that must be delivered to the Registrar of Companies. It summarises some of the rules that apply to corporate voluntary arrangements, moratoria, administrations, receivers, voluntary liquidations, compulsory liquidations and EU regulations. It is worth consulting.

http://www.companieshouse.gov.uk/about/pdf/gpo8.pdf

The end of Limited Liability Partnership

Earlier in this course we saw that the regulation of Limited Liability Partnerships is similar to the system for Companies. The Insolvency Act 1986 applies to limited liability partnerships in the same way as to registered companies. Sections 213 and 214 also apply to LLPs.

Members can also be made liable under s.76 of the IA, which does not apply to companies, which envisages that members of an LLP may agree to assume limited liability for debts in the same way as members of a company limited by guarantee might be assumed to have limited liability. Such liability only arises if the LLP goes into liquidation, and the member is only liable to the extent he has agreed. The liability only arises to the extent necessary to pay the LLP's debts and costs of winding-up and adjust the rights of other members who have agreed to contribute. A former member can only be liable if the obligation arising from his agreement survives his ceasing to be a member of the LLP.

Company Law

Partnerships

The Insolvency system treats traditional Partnerships differently.

Terminating a partnership

You will remember that a partnership is an organisation created by the agreement of those who want to engage in business together with a view to a profit. Partnerships are regulated by contract, trust, agency and rules codified in the Partnership Act 1890. The Act sets out various ways in which a partnership may be terminated or dissolved but it must be remembered that a partnership is essentially a contract between the members and the Partnership Act basically applies the principles of common law.

The grounds stated for dissolution of a partnership are as follows:

- where the partnership was entered into for a stated term, on the expiry of that term (s.32(a))
- where the partnership was entered into for a stated transaction or series of transaction, on the completion of that transaction or series of transactions (s.32(b))
- where any of the partners gives notice to the other partner(s) of his intention to dissolve the partnership (s.32))
- where any partner dies or becomes bankrupt (s.33(1))
- where, if the other partners so wish, one of the partners allows his or her share of the partnership to be charged in security of his or her separate debt (s.33(3))
- where any event occurs which makes the continuation of the partnership illegal, for example, where a partnership established to carry on trade with a country which later becomes an enemy in war
- where a partner becomes disabled from performing his or her part of the partnership contract (s.35(b))
- where a partner has been guilty of such conduct as is calculated to prejudice the carrying on of the business (s.35(c))
- where a partner wilfully or persistently commits a breach of the partnership agreement, or otherwise conducts him or herself in such a way that it is not practicable for the other partners to continue to work with him or her (s.35(d))
- where the business can only be carried on at a loss (s.35(e))

- where in the circumstances which have arisen it is just and equitable for the partnership to be dissolved (s.35(f)).

The s.35 grounds for dissolution contemplate an application being made to the court on behalf of the partners. The application of s.35(f) is the application of the general equitable jurisdiction of the court to dissolve the firm.